

# **LEGISLATIVE COUNCIL BRIEF**

## **SECURITIES ORDINANCE (Cap. 333)**

### **SECURITIES (MISCELLANEOUS) (AMENDMENT) (NO.2) RULES 2001**

#### **INTRODUCTION**

On 18 June 2001, the Securities and Futures Commission (“the Commission”) made the Securities (Miscellaneous) (Amendment) (No. 2) Rules 2001 (“the Amendment Rules”) at the Annex.

#### **BACKGROUND**

##### Present Situation

2. Section 80(1) of the Securities Ordinance (“SO”) prohibits naked short selling. It provides that a person shall not sell securities through the Stock Exchange of Hong Kong (“SEHK”) unless at the time he sells them, he has or he reasonably and honestly believes that he has a presently exercisable and unconditional right to vest the securities in the purchaser.

3. Sections 80(4)(d) and 146(1) of the SO empower the Commission to prescribe regulations to exempt classes of transactions from the short selling prohibition embodied in section 80(1). Currently, market making sales of Exchange Fund Bills, Exchange Fund Notes and notes of the MTR Corporation Limited, the Airport Authority, the Hong Kong Mortgage Corporation Limited and Kowloon-Canton Railway Corporation issued under the Hong Kong Monetary Authority note issuance programmes are exempted from section 80(1). Moreover, short sales of shares in Exchange Traded Funds which are carried out by market makers registered with the SEHK and acting in their capacity as market makers are also exempted subject to certain conditions.

### Proposal

4. Stock options and stock futures contracts are traded with a market making system. As set out in the rules of the SEHK and Hong Kong Futures Exchange (“HKFE”), market makers are required to quote two way prices at specified times to enhance liquidity of the markets. In the course of fulfilling their market making obligations, market makers take on additional risks and have to hedge against the exposure that they build up when making a market. To facilitate hedging activities of the market makers, the Commission made the Amendment Rules to exempt stock options and stock futures market makers<sup>1</sup> from section 80(1) of the SO in respect of their short sales for hedging purposes. This will provide greater flexibility for their hedging strategies involving short sale of underlying securities of stock options and stock futures, and help increase the overall liquidity of the market.

### Safeguards

5. Since all underlying securities of stock options and stock futures are liquid stocks, allowing market makers to sell short these liquid stocks to hedge against their exposure before borrowing the stocks from stock lenders would not create additional risks to the market.

6. In addition, the SEHK and HKFE will put in place a reporting and monitoring system to monitor the short sales by market makers in stock options and stock futures to prevent abuse of the exemption. In general, a market maker in stock options or stock futures who wishes to enjoy the exemption will be required to designate a particular participant of the SEHK through which all its exempt short selling transactions of the underlying stocks are to be made. These short sales of stocks have to be executed through the SEHK’s automatic order matching and execution system (AMS) and the designated SEHK participant will be required to make daily reports to the respective exchanges. The SEHK and HKFE will check daily the stock options

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<sup>1</sup> Stock futures market maker is registered as “Registered Trader” under the rules of the HKFE. For ease of reference, it is referred to as a “market maker” in this brief.

and stock futures trading records and the positions of the market makers, the short selling transactions which will be reported daily and the records from the AMS. The records from the AMS and the daily reports will enable the exchanges to ascertain whether the short sales are genuinely for the hedging of the market making positions.

7. If a market maker were identified as abusing the exemption, he will be in contravention of section 80(1) of the SO and be liable on conviction to a fine of \$100,000 and to imprisonment for two years (section 80(2) of the SO).

8. The monitoring system is similar to the one currently in place for monitoring the exemption from the Tick Rule in the rules of the SEHK, which has been in place for three years and proven to be effective.

#### **THE AMENDMENT RULES**

9. The Amendment Rules amend Rule 17 of the Securities (Miscellaneous) Rules to exempt stock options and stock futures market makers registered with the SEHK and HKFE respectively, from section 80(1) of the SO when they short sell securities on or through the SEHK to hedge the stock options or stock futures positions built up in the performance of their market making obligations in the respective markets.

10. The exemption will only be available for hedging positions acquired on the respective exchanges and not positions acquired “over the counter”. The securities sold short must be the relevant underlying securities for the stock options or stock futures position being hedged.

#### **PUBLIC CONSULTATION**

11. The Commission has consulted market participants concerned and the Hong Kong Exchange and Clearing Limited. They welcome the amendment.

## **FINANCIAL AND STAFFING IMPLICATIONS**

12. There are no financial or staffing implications for the Government.

## **COMMENCEMENT DATE**

13. The Amendment Rules will come into operation on 26 October 2001.

## **PUBLICITY**

14. The Amendment Rules will be published in the Government Gazette on 6 July 2001.

## **ENQUIRIES**

15. For any enquiries on this brief, please contact Noelle Tai, Counsel of the Legal Services Division of the Commission, at 2840-9252 or Alexandra Yeong, Senior Manager of the Supervision of Markets Division of the Commission, at 2840-9247.

The Securities and Futures Commission

4 July 2001

**SECURITIES (MISCELLANEOUS) (AMENDMENT) (NO. 2) RULES 2001**

(Made by the Securities and Futures Commission under  
section 146(1) of the Securities Ordinance  
(Cap. 333) as read with section 80(4)(d)  
of that Ordinance)

**1. Commencement**

These Rules shall come into operation on 26 October 2001.

**2. Prescribed class of transaction for the purpose  
of section 80(4)(d) of the Ordinance**

Rule 17 of the Securities (Miscellaneous) Rules (Cap. 333 sub. leg.) is amended by  
adding -

- "(3) (a) A sale of securities carried out by a Stock Options Market Maker for the purpose of hedging the risks of a position previously acquired on the Unified Exchange in options of such securities shall be a class of transaction prescribed for the purposes of section 80(4)(d) of the Ordinance.
- (b) In this subrule -
- "Stock Options Market Maker" (股票期權市場莊家) means any person who is registered as a Stock Options Market Maker by the Exchange Company in accordance with its rules.
- (4) (a) A sale of securities carried out by a Registered

Trader of stock futures contracts for the purpose of hedging the risks of a position previously acquired on the Commodity Exchange in stock futures contracts of such securities shall be a class of transaction prescribed for the purposes of section 80(4)(d) of the Ordinance.

(b) In this subrule -

"Commodity Exchange" (商品交易所) means the commodity exchange established and operated by the Futures Exchange Company under the Commodities Trading Ordinance (Cap. 250);

"Futures Exchange Company" (期貨交易所) means the Exchange Company within the meaning of section 2(1) of the Commodities Trading Ordinance (Cap. 250);

"Registered Trader" (註冊買賣商) means any person who is registered as a Registered Trader by the Futures Exchange Company in accordance with its rules;

"stock futures contract" (股票期貨合約) means a stock futures contract of which the contract specifications are set out in the rules of the Futures Exchange Company."

Andrew Len Tao SHENG  
Chairman,  
Securities and Futures Commission

**3 July 2001**

**Explanatory Note**

Under section 146(1) of the Securities Ordinance (Cap. 333) as read with section 80(4)(d) of the Ordinance, the Securities and Futures Commission may make rules to prescribe a class of transaction of securities to which section 80(1) of the Ordinance does not apply.

2. The Securities (Miscellaneous) Rules (Cap. 333 sub. leg.) are now amended to prescribe, as a class of transaction to which section 80(1) of the Ordinance does not apply, sales of securities carried out by Stock Options Market Makers and Registered Traders of stock futures contracts for the purposes of hedging the risks of positions they have previously acquired on the Unified Exchange and the Commodity Exchange respectively.