

## **LEGISLATIVE COUNCIL BRIEF**

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

#### **SECURITIES (MISCELLANEOUS) (AMENDMENT) RULES 2001**

#### **INTRODUCTION**

1. On 26 February 2001, the Securities and Futures Commission (“the Commission”) made the Securities (Miscellaneous) (Amendment) Rules 2001 (“the Amendment Rules”) at Annex.

#### **BACKGROUND AND ARGUMENT**

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 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 of them.
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 MTR Corporation Limited, the Airport Authority, the Hong Kong Mortgage Corporation Limited and Kowloon-Canton Railway Corporation issued under Hong Kong Monetary Authority note issuance programmes are exempted.

4. The Amendment Rules provide for a new exemption class. The new exemption will apply to short sales of shares in Exchange Traded Funds (“ETFs”) which are carried out by market makers registered with the Stock Exchange of Hong Kong Ltd (“SEHK”) and acting in their capacity as market makers provided that the market makers purchase, borrow or place a creation order for such shares within the same day to cover the short position.
5. In general ETFs are open-ended mutual funds (or unit trusts) that are listed and traded on recognised exchanges. Investors may buy and sell shares of an ETF in the same way as they would stocks of an individual company. Each share of an ETF usually represents a portfolio of stocks designed to closely track a specific index. Investors can create ETF shares (i.e. exchange constituent stocks for shares of ETFs) (“a creation order”) or redeem ETF shares (i.e. exchange shares of ETFs for constituent stocks).
6. ETFs will be traded under a market making system so as to increase the liquidity of the market. Under their market making obligations, market makers are required to place simultaneous bid and ask prices on the SEHK for shares of the ETFs irrespective of whether they have inventory of a particular ETF. As a result, a market maker is not able to anticipate which side of the market making quotes he will be required to execute. No market maker will create inventory in anticipation that the “ask” order will be transacted against. Market makers would be disadvantaged if they carried excess inventory as the economic cost is high and the exposure to the underlying market could be significant. Moreover, they may not be able to borrow shares as the ETF may not be sufficiently liquid in Hong

Kong in the initial period of trading and the time zone differences make it difficult to borrow shares overseas. Therefore, it is not practical for market makers to place a creation order for the shares or arrange to borrow the shares prior to the execution of the sale. .

7. The proposed amendment will allow market makers who are registered as such with the SEHK to short sell shares of ETFs provided that such sales are conducted by them in their capacity as market makers and provided also that they cover their short positions on the same day by purchasing, borrowing or placing a creation order to obtain the sold shares.
8. The fact that market makers will be allowed to cover their short positions after (rather than before) the sale transaction should not pose additional risks to the market given the requirement for them to cover such short positions within the same day and given also that the SEHK and the Commission have proper and adequate monitoring systems to detect any abuse of the exemptions.

## **THE AMENDMENT RULES**

9. The Amendment Rules amend Rule 17 of the Securities (Miscellaneous) Rules by providing for a new class of transactions to be exempted from the prohibition in section 80(1) of the SO.

## **PUBLIC CONSULTATION**

10. Both the Commission and the SEHK support the changes noted above.

Public consultation is considered unnecessary as the amendments are technical in nature and have no direct impact on public investors.

## **FINANCIAL AND STAFFING IMPLICATIONS**

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

## **COMMENCEMENT DATE**

12. The Amendment Rules will commence on 6 April 2001.

## **PUBLICITY**

13. The Amendment Rules will be published in the Government Gazette on 2 March 2001.

## **ENQUIRIES**

14. For any enquiries on this brief, please contact Thrity Mukadam, Counsel of the Legal Services Division of the Commission, at 2840-9209 or Alexandra Yeong, Senior Manager of the Supervision of Markets Division of the Commission, at 2840-9247.

The Securities and Futures Commission  
1 March 2001

**SECURITIES (MISCELLANEOUS) (AMENDMENT) RULES 2001**

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

**1. Commencement**

These Rules shall come into operation on 6 April 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 -

(a) by renumbering it as rule 17(1);

(b) by adding -

"(2) (a) A sale of shares of Exchange Traded Funds by a market maker in such capacity shall be a class of transaction prescribed for the purposes of section 80(4)(d) of the Ordinance subject to the market maker acquiring on the same day as the sale the right to vest such shares in the purchaser of them, by virtue of -

(i) purchasing such shares;

(ii) borrowing such shares; or

(iii) placing an order for the creation of such shares in accordance with the terms for the creation of shares required by the issuer of those shares.

(b) In this subrule -

"Exchange Traded Funds" (交易所買賣基金) means mutual funds or unit investment trusts that hold portfolios of securities which are designed generally to correspond to the price and yield performance of the underlying portfolio of securities with in kind creation and redemption facilities and which are listed or traded on the Exchange Company as a single security;

"market maker" (市場莊家) means any person who is registered as a market maker by the Exchange Company in accordance with its rules."

Andrew Len Tao SHENG  
Chairman,  
Securities and Futures Commission

28 February 2001

### **Explanatory Note**

Under section 146(1) as read with section 80(4)(d) of the Securities Ordinance (Cap. 333), 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 shares of Exchange Traded Funds by market makers (acting in such capacity) prior to acquiring the right to vest such shares in the purchaser of them provided that the market maker purchases the shares, borrows the shares or places an order for the creation of the shares with the issuer of the Exchange Traded Funds, within the same day as the sale.