

For discussion  
on 15 July 2002

Paper No. 20/02

**Subcommittee on Draft Subsidiary Legislation to be made under  
the Securities and Futures Ordinance**

**Securities and Futures  
(Short Selling Exemption and Stock Lending) Rules**

This paper sets out the proposals of the Securities and Futures Commission (SFC) to prescribe (a) exemptions from the ‘naked’ short selling<sup>1</sup> prohibition in section 170 of the Securities and Futures Ordinance (SFO) (5 of 2002); (b) circumstances in which the reporting requirements to confirm short selling orders in section 171 of the SFO do not apply; and (c) reporting requirements for stock lending.

**Proposal**

2. The SFC proposes to make the Securities and Futures (Short Selling Exemption and Stock Lending) Rules, now in draft at **Annex 1**, under section 397 of the SFO.

**Power to make the Rules**

3. Section 397 of the SFO empowers the SFC to make rules to provide for a wide range of matters, including to prescribe, specify or provide for any matter which the SFO provides is, or may be, prescribed, specified or provided for by rules made thereunder. Moreover, section 398(7)(c) empowers the SFC to disapply any provision of the SFO to any specified class of transactions entered into by any specified class of persons through rules made under any provision of the SFO.

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<sup>1</sup> “Naked” short selling refers to the selling of securities at or through the Exchange where the seller does not believe or does not have reasonable grounds to believe that he has a presently exercisable and unconditional right to vest the securities in the purchaser of them.

4. Clause 3 of the draft Rules prescribes for the purposes of section 170(3)(e) classes of transactions to which the naked short selling prohibition under section 170(1) of the SFO does not apply. Clause 4 of the draft Rules prescribes the circumstances under which sellers placing, or their agents receiving, short selling orders covered by a securities borrowing and lending agreement (see definition of ‘short selling order’ in Part 1 of Schedule 1 to the SFO) need not comply with the reporting requirements prescribed in section 171 of the SFO provided they comply with the specified alternative reporting requirements.

5. Section 397 of the SFO also specifically empowers the SFC to make rules to require a lender under a securities borrowing and lending agreement to keep specified records or documents in a specified manner and give copies to the SFC at its request in the specified form and manner and within the specified time. Clause 5 of the draft Rules sets out such requirements.

6. The SFC is of the view that the draft Rules would be *intra vires* if made as drafted.

## **The draft Rules**

### ***Clause 3***

#### *Main features*

7. Section 170(1) of the SFO prohibits naked short selling and is adapted from section 80(1) of the current Securities Ordinance (Cap. 333). Under section 17 of the existing Securities (Miscellaneous) Rules (Cap. 333, Sub. Leg. A), the naked short selling prohibition in section 80(1) of the Securities Ordinance does not apply to a sale of securities falling within the following categories of transactions –

- (a) a sale of specific instruments by Hong Kong Monetary Authority (HKMA) appointed market makers;
- (b) a sale of shares of exchange traded funds by their market makers in the performance of their market making obligations;
- (c) a sale of underlying securities of stock options and stock futures contracts by their respective market makers for hedging purposes.

8. Clause 3(1) reproduces the exemption currently available to HKMA – appointed market makers (paragraph 7(a)).

9. Clause 3(2) seeks to eliminate the inconsistencies under the current law by extending the exemption to ‘on-exchange’ market making and hedging transactions of **all** classes of market makers registered with the Stock Exchange of Hong Kong Limited (SEHK) or the Hong Kong Futures Exchange Limited (HKFE). In addition to the exemption outlined in paragraph 7(a), it introduces the concept of “jobbing business”<sup>2</sup> for which the short selling prohibition under section 170(1) will not apply. The following types of transactions constitute “jobbing business” for the purpose of the draft Rules –

- (a) a sale of a security by a market maker registered with the SEHK to make markets in respect of that security in the course of performing his market making or liquidity providing activities (the market maker is required to acquire the right, within the next trading day, to vest the securities he has sold in the purchaser of them);
- (b) a sale of a security (“A”) for the purpose of hedging a market making position in another security (“B”) by a market maker registered with the SEHK as long as A and B are related (this would include where A is a component of B, or vice versa, or where A and B both have a common component);
- (c) a sale of security for the purpose of hedging a market making position in a futures contract by a market maker registered with the HKFE as long as the security sold and the futures contract position being hedged are related (this would include where the futures contract is in respect of the security or an index of securities which includes the security, or, where the futures contract is in respect of another security and that other security has a common component with the security that is sold).

10. The exemptions for market makers registered with the SEHK will also be applicable to issuers of structured products like derivative warrants and equity linked notes/instruments. Under the SEHK Rules, these issuers are required to appoint liquidity providers.

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<sup>2</sup> “Jobbing business” is a term industry participants are familiar with. This term is currently used in the Stamp Duty Ordinance (Cap. 117) to provide stamp duty relief for stock options market making transactions – both market making and hedging of market making positions are included.

## *Rationale*

11. Most market makers do not create inventory of the securities in anticipation that an “ask” order will be transacted. Market makers will be disadvantaged if they carry excess inventory as the economic risk is high and the exposure to the underlying market will be significant. Therefore it is not practical for market makers to acquire the relevant securities prior to the execution of a sale. Unless the market maker borrows securities prior to a sale, he may breach section 170(1) of the SFO.

12. The commitment of market makers is important to the success of the relevant securities. To ensure efficiency in market making, market makers must be provided with the flexibility to quote prices and respond to market demands. Therefore it is necessary for them to be permitted to short sell the relevant securities for which they are making a market as long as the short positions are covered within the next trading day.

13. In addition, as market makers, in the course of fulfilling their market making obligations, take on additional risks, there is a genuine need for them to hedge against the exposure which they build up as a result of fulfilling their market making obligations.

14. By allowing market makers to sell short the securities which are components of or share the same components as other SEHK listed securities or futures contracts traded on the HKFE, market makers will be given an additional means to hedge against their risks.

## ***Clause 4***

### *Main Features*

15. Section 171 of the SFO sets out reporting requirements for sellers as principals and agents of ‘short selling orders’.

16. The term ‘short selling order’ is defined in Part 1 of Schedule 1 to the SFO. In general, a short selling order is an order to sell securities where the seller has a presently exercisable and unconditional right to vest the securities in the purchaser of them by virtue of the following –

- (a) the seller is a party to a securities borrowing and lending agreement under which he has borrowed the securities or obtained a confirmation from the lender who has the securities to lend to him; or
- (b) the seller holds options, a subscription right or warrants, convertibles or exchangeable securities, which confer the right on the seller to acquire the securities to which the order relates.

17. In general, section 171 requires sellers (whether as principal or agent), at the time a short selling order is placed or received (as the case may be), to confirm that it is a short selling order and that the sale is covered. A broker who receives a short selling order is required to obtain a documentary confirmation from the seller prior to transmitting the order. Documents required to be collected under section 171 are to be kept for 12 months and provided to the SFC upon request.

18. Section 171 reproduces section 80B of the existing Securities Ordinance enacted in 2000. There are currently no exemptions to section 80B of the Securities Ordinance.

19. Clause 4 simplifies and streamlines the reporting requirements of section 171 for sellers of short selling orders covered by stock borrowing and lending agreements, i.e., the first limb of the definition of ‘short selling order’. Sellers of these types of short selling orders will not be required to comply with the requirements in section 171 of the SFO if they comply with the alternative requirements set out Clause 4. These requirements include –

- (a) sellers who provide or receive (as the case may be) an oral assurance (instead of a documentary assurance) when they place or accept (as the case may be) a short selling order need not comply with the section 171 reporting requirements if certain particulars are recorded on a record which is time-stamped. These particulars are specified in the draft Rules and include the securities or group of securities, their quantity etc. The record should be completed and time-stamped prior to the execution of the order. Sellers will be permitted to rely on the records kept by their agents, principals or counterparties provided prior arrangements are in place;
- (b) sellers who obtain tape-recordings of an assurance, made orally at the time the short selling order is placed, need not comply with the reporting requirements in section 171. Sellers, as principals, may

either make a tape recording of the assurance themselves or rely on the tape recordings of their agents provided prior arrangements are in place; and

- (c) sellers who obtain or convey (as the case may be) an assurance orally, at the time of the short selling order and, who by the end of the trading day, provide or receive (as the case may be) a documentary confirmation of the assurance need not comply with the reporting requirements in section 171.

20. The oral assurance that must be provided by the sellers is to the effect that the counterparty to the securities borrowing and lending agreement has the securities to which the short selling order relates available to lend or deliver to the seller.

21. Records (including documents and tape recordings) made or kept under Clause 4 are required to be retained for 12 months and produced to the SFC upon request.

### *Rationale*

22. In earlier discussions with the SFC, industry participants expressed that the requirement of section 171 (currently, section 80B of the Securities Ordinance) to obtain a documentary assurance at the time of placing or receiving an order (as the case may be) usually results in delays (of sometimes up to 15 minutes) of execution. Therefore, transactions that arbitrage small price differentials e.g., index arbitrage, are inhibited. The delay is usually a result of waiting for the documentary assurance from lenders or counterparts that the securities are available for lending.

23. The proposals in Clause 4 seek to facilitate timely execution of transactions and alleviate the compliance burden on intermediaries.

24. Having consulted both the SFC and the Monetary Authority, we believe that the exemptions and relaxations proposed in Clauses 3 and 4 will facilitate market development and help enhance liquidity, without posing additional risks to the stability of the markets or compromising the regulators' existing ability to monitor market volatility.

## ***Clause 5***

### *Main features*

25. Under Clause 5, lenders of securities under a securities borrowing and lending agreement are required to record specified particulars relating to the lending transaction (including the giving of a blanket assurance, hold or a borrow) in a document. The document is required to be kept for one year and provided to the SFC upon request.

### *Rationale*

26. Clause 5 reproduces the current Securities (Stock Lending) Rules (Cap. 333, Sub. Leg. M). No new policy changes are introduced. The purpose is to create an audit trail and ensure that there is no ‘double-lending’ of securities by lenders.

## **Public Consultation**

27. The SFC released a consultation document and an exposure draft of the Rules on 24 May 2002 for comments by the public. A total of five submissions were received. The SFC has considered all the comments received and revised the draft Rules as appropriate. We attach the following documents for Members’ reference –

- (a) Consultation document on the draft Rules, at **Annex 2**, which sets out the underlying policy, together with the exposure draft of the Rules. The draft Rules as revised are at Annex 1 for Members’ consideration; and
- (b) Consultation Conclusions and Summary of Comments and SFC’s Responses, at **Annex 3**, which set out the conclusions from the consultation and the SFC’s responses, in the form of a table, to the comments received. A list of respondents is attached to the Summary of Comments and SFC’s Responses.

## **Way Forward**

28. Subject to Members' views, the SFC will proceed to make the Rules under the authority vested in it and publish the Rules so made in the Gazette for tabling before the Legislative Council in the normal manner. The intention is that the Rules will come into operation on the commencement of the SFO.

Securities and Futures Commission  
Financial Services and the Treasury Bureau  
8 July 2002



[cf: sections 170, 171, 397 and 398 of the Securities and Futures Ordinance]

**SECURITIES AND FUTURES (SHORT SELLING AND  
SECURITIES BORROWING AND LENDING  
(MISCELLANEOUS)) RULES**

(Made by the Securities and Futures Commission under section 397  
of the Securities and Futures Ordinance (5 of 2002))

**1. Commencement**

These Rules shall come into operation on the day on which Part VII of the Securities and Futures Ordinance (5 of 2002) comes into operation.

**2. Interpretation**

In these Rules, unless the context otherwise requires –

“blanket assurance” (概括性保證) means a confirmation from a lender to a borrower that the lender has a sufficient overall supply of a defined group of securities such that for a specific period of time as agreed on by the parties the securities concerned are available to lend to the borrower;

“borrow” (借用安排), in relation to a securities borrowing and lending agreement, means a borrowing of securities under the securities borrowing and lending agreement, irrespective of whether the borrowed securities have been delivered by the lender to the borrower;

“Exchange Fund” (外匯基金) means the fund established under section 3 of the Exchange Fund Ordinance (Cap. 66);

“Exchange Fund Bill” (外匯基金票據) means any instrument described as such which is issued by the Government for the account of the Exchange Fund under the Exchange Fund Ordinance (Cap. 66);

“Exchange Fund Note” (外匯基金債券) means any instrument described as such which is issued by the Government for the account of the Exchange Fund under the Exchange Fund Ordinance (Cap. 66);

“Futures Market Maker” (期貨莊家) means a person who is registered with the Futures Exchange Company for the purpose of performing, in accordance with rules made by the Futures Exchange Company under section 23 of the Ordinance, market making or liquidity providing activities in respect of futures contracts admitted to trading on the recognized futures market it operates;

“hold” (持有確認) means a confirmation from a lender to a borrower that for a specific period of time as agreed on by the parties, specific securities in a specific quantity are available to lend to the borrower;

“lender” (借出人), in relation to a securities borrowing and lending agreement, means a person who lends securities under the securities borrowing and lending agreement and if the person is lending as an agent for clients, that person instead of his clients shall be regarded as the lender for the purposes of these Rules;

“Listing Rules” ( ) means rules made by the Stock Exchange Company under section 23 of the Ordinance and known as the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited;

“Monetary Authority-appointed Market Maker” (金融管理專員委任的莊家) means a person appointed as a market maker by the Monetary Authority under a letter of appointment currently in force for the purpose of conducting market making activities in respect of Exchange Fund Bills, Exchange Fund Notes or specified instruments;

“Securities Market Maker” (證券莊家) means a person who is registered with the Stock Exchange Company for the purpose of performing, in accordance with rules made by the Stock Exchange Company under section 23 of the Ordinance, market making or liquidity providing activities in respect of

securities listed or admitted to trading on the recognized stock market it operates or an issuer of any structured product listed on the recognized stock market operated by the Stock Exchange Company under Chapter 15A of the Listing Rules;

“specified instrument” (指明文書) means any note issued by the MTR Corporation Limited, the Airport Authority, the Hong Kong Mortgage Corporation Limited and the Kowloon-Canton Railway Corporation under their respective note issuance programmes;

**3. Classes of transactions to which section 170(3)(e) of the Ordinance not to apply**

(1) The following classes of transactions are prescribed for the purposes of section 170(3)(e) of the Ordinance –

- (a) a sale by a Monetary Authority-appointed Market Maker of any of the following securities –
  - (i) Exchange Fund Bills;
  - (ii) Exchange Fund Notes; or
  - (iii) specified instruments;
- (b) a sale by an agent of a Monetary Authority-appointed Market Maker of any of the following securities –
  - (i) Exchange Fund Bills;
  - (ii) Exchange Fund Notes; or
  - (iii) specified instruments;where the agent is acting in such capacity and believes and has reasonable grounds to believe that his principal is a Monetary Authority-appointed Market Maker of the security sold.
- (c) a sale of securities effected in the course of conducting jobbing business.

(2) The following sales of securities shall be regarded as a sale of securities in the course of conducting jobbing business –

- (a) the sale of a listed security (“A”) by a Securities Market Maker where the sale is for the purpose of hedging the risks of a position previously acquired in another listed security (“B”) and –
  - (i) A is a component of B or vice versa; or
  - (ii) where both A and B have a security as a common component;
- (b) the sale of a listed security by a Futures Market Maker where the sale is for the purpose of hedging the risks of a position previously acquired in –
  - (i) a futures contract in respect of the security or an index of securities which includes the same security; or
  - (ii) a futures contract in respect of another security which has a common component with the security that is sold; or
- (c) the sale of a listed security by a Securities Market Maker in performing market making or liquidity providing activities in respect of such security, where the Securities Market Maker acquires the right to vest such security in the purchaser of them before the end of the trading day following the day of the sale.

(3) In this section, “listed” means listed or admitted to trading on a recognised stock market operated by the Stock Exchange Company.

**4. Classes of persons and circumstances in which certain requirements of section 171 not to have effect**

(1) Section 171(1) of the Ordinance does not have effect in relation to a short selling order described in subsection (4), which is made by a person, where selling as a principal, and who at the time of conveying the short selling order, provides his agent with an oral assurance that the counterparty to the securities borrowing and lending agreement in question has the securities to which the order relates available to lend to him provided such person –

- (a) (i) records such oral assurance in the form of a tape recording;
  - (ii) enters into an arrangement with his agent whereby the agent has agreed to –
    - (A) record such oral assurance in the form of a tape recording; or
    - (B) at the time of his receiving a short selling order, record the particulars as described in subsection (5) to which the order relates on a time-stamped record; or
  - (iii) confirms the giving of the oral assurance in the form of a document to the agent by the end of the day on which it was given; and
- (b) complies with the applicable requirements of subsection (6).

(2) Section 171(3) of the Ordinance does not have effect in relation to a short selling order described in subsection (4), which is made by an exchange participant, where selling as a principal provided that –

- (a) prior to conveying the short selling order, such exchange participant -
  - (i) has received from the counterparty to the securities borrowing and lending agreement in question an oral assurance that the counterparty has the securities to which the order relates available to lend to him; and
  - (ii) has –

(A) recorded the oral assurance in the form of a tape-recording;

(B) recorded the particulars as described in subsection (5) to which the order relates on a time-stamped record; or

(C) entered into an arrangement with the counterparty whereby the counterparty has agreed to –

(1) record the particulars as described in subsection (5) to which the order relates in the form of a document; and

(2) provide such document to the exchange participant by the end of the day on which the assurance was given; and

(b) complies with the applicable requirements of subsection (6).

(3) Section 171(5) of the Ordinance does not have effect in relation to a person, where selling as an agent provided such person–

(a) prior to conveying a short selling order -

(i) has received from his principal, or the other person for whose benefit or on whose behalf such order is made an oral assurance that the counterparty to the securities borrowing and lending agreement in question has the securities to which the order relates available to lend to him; and

(ii) has –

(A) recorded the oral assurance in the form of a tape recording;

(B) recorded the particulars as described in subsection (5) to which the order relates on a time-stamped record; or

(C) entered into an arrangement with his principal, or that other person (as the case may be), whereby his principal, or such other person (as the case may be) has agreed to provide a confirmation of the oral assurance in the form of a document to him by the end of the day on which the assurance was given; and

(b) complies with the applicable requirements of subsection (6).

(4) Subsections (1), (2) and (3) apply to a short selling order which is such order by virtue of paragraph (a)(i) of the definition of “short selling order” in section 1 of Part 1 of Schedule 1 to the Ordinance.

(5) For the purposes of subsections (1)(a)(ii)(B), (2)(a)(ii)(B) and (ii)(C)(1) and (3)(a)(ii)(B), particulars are –

(a) the securities or group of securities borrowed under the securities borrowing and lending agreement, available for borrowing and the quantity; and

(b) whether a blanket assurance or a hold has been given or a borrow has been entered into, and the time it was given or entered into (as the case may be).

(6) Any person who records an oral assurance, particulars as described in subsection (5) or a confirmation of an oral assurance in the form of a document (including a tape recording or time-stamped record) under subsections (1), (2) or (3) shall –

(a) retain such document for not less than one year from the date of recording, collecting or receiving such assurance or particulars (as the case may be); and

(b) upon request made by the Commission at any time within that period give the Commission access to and produce the document within the time and at the place specified by the Commission.

**5. Record keeping by lenders under securities borrowing and lending agreements**

(1) When a lender under a securities borrowing and lending agreement gives a blanket assurance or a hold to a borrower, or enters into a borrow, the lender shall keep records in the form of a document, containing the following particulars –

- (a) the name of the borrower;
- (b) the securities or group of securities borrowed, or available for borrowing and the quantity thereof; and
- (c) whether a blanket assurance or a hold has been given or a borrow has been entered into, and the time it was given or entered into, as the case may be.

(2) The lender shall –

- (a) subject to paragraph (b), retain the records referred to in subsection (1) for not less than one year from the date the relevant record was made; and
- (b) upon request made at any time within that year by the Commission, provide copies of any such record to the Commission.

(3) In this section, “securities” means securities which are listed on a recognized stock market operated by the Stock Exchange Company.

Chairman,  
Securities and Futures Commission



# **D R A F T**

## **Explanatory Note**

These Rules are made by the Securities and Futures Commission under section 397 of the Securities and Futures Ordinance (5 of 2002). They prescribe for the purposes of section 170(3)(e) of the Ordinance the classes of transactions that are exempt from section 170(1) of the Ordinance. They specify the circumstances in which certain requirements of section 171 do not have effect. They also specify the record keeping requirements for lenders under securities borrowing and lending agreements.



**SECURITIES AND  
FUTURES COMMISSION**  
證券及期貨事務監察委員會

**A Consultation Paper on the Securities  
and Futures (Short Selling Exemption and Stock  
Lending) Rules**

《 - 》諮詢文件

Hong Kong  
May 2002

香港  
2002年5月

## A Introduction

1. This consultation document invites public comments on the draft **Securities and Futures (Short Selling Exemption and Stock Lending) Rules** (“the draft Rules”), which are to be made under section 397 and 398 of the Securities and Futures Ordinance (No. 5 of 2002).
2. The draft Rules will be based on the Securities (Miscellaneous) Rules (“the existing Rules”), which have been made under the Securities Ordinance (Cap.333). In addition, the SFC proposes to extend the existing exemptions in rule 17 of the existing Rules (which was made under section 80(4)(d) of the Securities Ordinance) and create exemptions from the requirements in section 171 of the Securities and Futures Ordinance (i.e., sections 80B and C of the Securities Ordinance).
3. The public may obtain copies of the consultation document free of charge at the SFC’s office and on the SFC’s Internet website at <http://www.hksfc.org.hk>.
4. There are controls built into the legislative system, whereby any rules made by the SFC must be subject to negative vetting by the Legislative Council. In addition, a mandatory consultation requirement is stipulated in section 398 of the Securities and Futures Ordinance.
5. The SFC invites interested parties to submit written comments on the proposed exemptions or to comment on related matters that might have a significant impact upon the draft Rules no later than 21 June 2002. Any persons wishing to comment should provide details of any organization whose views they represent. In addition, persons suggesting alternative approaches are encouraged to submit proposed text to be incorporated into the draft Rules.

## B. The existing law and exemptions

### *Section 80 of the Securities Ordinance (SO)*

6. Section 80(1) of the SO prohibits naked short selling, that is, selling of securities at or through the Exchange where the seller does not have a reasonable and honest belief that he has a presently exercisable and unconditional right to vest the securities in the purchaser of them. Section 80 is repeated in section 170 of the Securities and Futures Ordinance.
7. Currently, there are some situations in which section 80(1) does not apply. These are set out in Rules 17 of the Securities (Miscellaneous) Rules and include –
  - (a) sales of specific instruments by Hong Kong Monetary Authority appointed market makers;

- (b) sales of exchange traded funds shares by their market makers in performance of market making obligations;
  - (c) sales of underlying securities of stock futures and stock options contracts by their market makers for hedging purposes.
8. Exemptions for section 170 are to be provided for in the draft Rules.

*Sections 80A to C*

9. Sections 80A to C of the SO apply to sell orders for securities where the seller has a presently exercisable and unconditional right to vest the securities in the purchaser by virtue of the following ways –
- (a) the seller is a party to a securities borrowing and lending agreement under which he has borrowed the securities or obtained a confirmation from the lender that he has the securities available to lend to him;
  - (b) the seller holds options, a subscription right or warrant or convertible or exchangeable security which, in any case, confers the right to acquire the securities to which the order relates.
10. In general, these sections oblige sellers (whether principals or agents) to, at the time the order is placed or received, confirm that it is a short selling order and that the sale is covered. A broker who receives such an order is required to obtain a confirmation from the seller prior to transmitting the order. Documentary records obtained under these provisions are required to be retained for 12 months and provided to the Commission upon request.
11. Section 80A of the SO is repeated in the Part 1 of Schedule 1 of the Securities and Futures Ordinance and sections 80B and C are repeated in Sections 171 and 172 of the Securities and Futures Ordinance respectively. There are currently no exemptions for sections 80A to C of the SO although the Commission has power to create exemptions in rules.

**C. The proposed exemptions**

12. The application of the proposed exemptions are described in the following sections.
- Section 170 exemptions (section 80 of the Securities Ordinance)*
13. The current exemption for Hong Kong Monetary Authority appointed market makers will be reproduced in the draft Rules.
14. The current exemption which allows exchange traded funds (ETFs) market makers to short sell ETF shares under the existing rules will be extended to all SEHK registered market makers and liquidity providers.

15. The current exemptions which allow stock options market makers and stock futures market makers to short sell underlying securities for hedging purposes will be extended to all SEHK and HKFE participants who are registered with the respective exchanges to perform market making or liquidity providing functions for derivative products listed or traded on SEHK (like ETFs, derivative warrants and stock options) and futures contracts which are traded on the HKFE. In addition, hedging transactions of issuers of structured products under the proposed new chapter of the SEHK's Listing Rules<sup>1</sup> will also be exempt from section 170(1).

*Section 171 exemptions*

16. The SFC intends to create exemptions to the reporting requirements under section 171 (sections 171(1), (3) and (5)). There are currently no exemptions to these reporting requirements. We propose three exemptions.
17. The first exemption - sellers who provide or receive (as the case may be) an oral assurance (instead of a documentary assurance) when they place or accept (as the case may be) a short selling order will be exempt from the section 171 reporting requirements if certain particulars are recorded on a record which is time-stamped. These particulars are specified in the draft Rules and include the securities or group of securities, their quantity etc.. The record should be completed and time-stamped prior to the execution of the order and kept for 12 months. Sellers will be permitted to rely on the records kept by their agents, principals or counterparties provided prior arrangements are in place.
18. The second exemption - sellers who obtain tape-recordings of an assurance, made orally at the time the short selling order is placed, of the matters set out in sections 171(1), (3) and (5) will be exempt from the reporting requirements in those sections. The tape recordings will be required to be kept for 12 months. Sellers may either make a tape recording of the assurance themselves or rely on the tape recordings of their agents, principals or counterparties provided prior arrangements are in place.
19. The third exemption - sellers who obtain or convey (as the case may be) an assurance orally, at the time of the short selling order, of the matters set out in sections 171(1), (3) and (5) and, who by the end of the trading day, provide or receive (as the case may be) a documentary confirmation of the matters in these sections will be exempt from the reporting requirements in section 171. The documentary confirmation is to be kept for 12 months.
20. These proposed exemptions will apply to sellers, as principals and agents, of short selling orders which are made pursuant to a stock

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<sup>1</sup> These issuers are required to appoint an Exchange Participant to make markets or provide liquidity in the structured products.

borrowing and lending agreement as defined in the Securities and Futures Ordinance.

21. Notwithstanding these exemptions, the records made or kept under the draft Rules are required to be produced to the Commission upon request.

**D. New Policy Initiatives**

22. The proposed exemptions are based on discussions, which the SFC has had with industry participants. They have been proposed for the purpose of facilitating market making transactions and, in the case of the section 171 exemptions, reducing compliance burdens of industry participants and facilitating timely execution of transactions.

*Section 170 exemptions*

23. No new policy changes will be incorporated into the draft Rules, which will on the whole amalgamate the existing Rules and address the inconsistencies in the current exemptions to enable market makers to short sell securities in performing their market making obligations as well as to short sell underlying securities of products for which they act as market makers for hedging purposes.

*Section 171 exemptions*

24. There are currently no exemptions from the reporting requirements in the Securities Ordinance. The SFC appreciates that the reporting requirements may, in some cases, delay timely execution of transactions and increase compliance costs and burdens of industry participants. The exemptions are for the purposes of enabling timely execution of transactions and alleviating compliance burdens whilst preserving a proper audit trail for short selling transactions. Sellers who do not or fail to adopt the methods in these exemptions are required to comply with the requirements in section 171.

*The Securities (Stock Lending) Rules*

25. The current Securities (Stock Lending) Rules made under the SO have also been incorporated into the draft Rules. There have been no policy changes to these Rules.

**E. Other matters**

26. Please note that the names of the commentators and the contents of their submissions may be published on the SFC web site and in other documents to be published by the SFC. In this connection, please read the Personal Information Collection Statement attached to this consultation paper.
27. You may not wish your name to be published by the SFC. If this is the case, please state that you wish your name to be withheld from publication when you make your submission.

28. Written comments may be sent

By mail to: SFC (short selling exemptions)  
12/F, Edinburgh Tower  
The Landmark  
15 Queen's Road Central  
Hong Kong

Attn: Supervision of Markets Division

By fax to: (852) 25217917

By on-line submission at: <http://www/hksfc.org.hk>

By e-mail to: [short\\_selling\\_exemptions@hksfc.org.hk](mailto:short_selling_exemptions@hksfc.org.hk)

## **Personal Information Collection Statement**

1. This Personal Information Collection Statement (“PICS”) is made in accordance with the guidelines issued by the Privacy Commissioner for Personal Data. The PICS sets out the purposes for which your Personal Data<sup>2</sup> will be used following collection, what you are agreeing to with respect to the SFC’s use of your Personal Data and your rights under the PDPO.

### **Purpose of Collection**

2. The Personal Data provided in your submission to the SFC in response to this Consultation Paper may be used by the SFC for one or more of the following purposes:
  - to administer the relevant Ordinances, rules, regulations, codes and guidelines
  - made or promulgated pursuant to the powers vested in the SFC
  - for the purposes of performing the SFC’s statutory functions under the relevant Ordinances
  - for research and statistical purposes
  - other purposes permitted by law

### **Transfer of Personal Data**

3. Personal Data may be disclosed by the SFC to the members of the public in Hong Kong and elsewhere, as part of the public consultation on the Consultation Paper. The names of persons who submit comments on the Consultation Paper together with the whole or part of their submission may be disclosed to members of the public. This will be done by publishing this information on the SFC web site and in documents to be published by the SFC throughout and at the conclusion of the consultation period.

### **Access to Data**

4. You have the right to request access to and correction of your Personal Data in accordance with the provisions of the PDPO. Your right of access includes the right to obtain a copy of your Personal Data provided in your submission on the Consultation Paper. The SFC has the right to charge a reasonable fee for processing any data access request.

### **Enquiries**

5. Any enquiries regarding the Personal Data provided in your submission on the Consultation Paper, or requests for access to Personal Data or correction of Personal Data, should be addressed in writing to:

The Data Privacy Officer  
The Securities and Futures Commission  
12/F, Edinburgh Tower, The Landmark  
15 Queen’s Road Central, Hong Kong

A copy of the Privacy Policy Statement adopted by the SFC is available upon request.

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<sup>2</sup> Personal Data means personal data as defined in the Personal Data (Privacy) Ordinance, Cap 486 (“PDPO”)





## **SECURITIES AND FUTURES (SHORT SELLING EXEMPTION AND STOCK LENDING) RULES**

(Made by the Securities and Futures Commission under section 397(1)  
of the Securities and Futures Ordinance (5 of 2002))

### **1. Commencement**

These Rules shall come into operation on the day on which Part VII of the Securities and Futures Ordinance (5 of 2002) comes into operation.

### **2. Interpretation**

In these Rules, unless the context otherwise requires –

“blanket assurance” ( ) means a confirmation from a lender to a borrower that the lender has a sufficient overall supply of a defined group of securities such that for a specific period of time as agreed on by the parties the securities concerned are available to lend to the borrower;

“borrow” ( ) means a borrowing of securities pursuant to a securities borrowing and lending agreement, irrespective of whether the borrowed securities have been delivered by the lender to the borrower;

“Exchange Fund” ( ) means the fund established under section 3 of the Exchange Fund Ordinance (Cap. 66);

“Exchange Fund Bill” ( ) means any instrument described as such which is issued by the Government for the account of the Exchange Fund under the Exchange Fund Ordinance (Cap. 66);

“Exchange Fund Note” ( ) means any instrument described as such which is issued by the Government for the account of the Exchange Fund under the Exchange Fund Ordinance (Cap. 66);

“Futures Market Maker” ( ) means an exchange participant who is registered with the Futures Exchange Company for the purpose of performing market making or liquidity providing activities in respect of futures contracts admitted to trading on the recognized futures exchange it operates in accordance with its rules;

“hold” ( ) means a confirmation from a lender to a borrower that for a specific period of time as agreed on by the parties, specific securities in a specific quantity are available to lend to the borrower;

“lender” ( ) means a lender of securities under a securities borrowing and lending agreement, provided that where securities are being lent under the agreement as agent for clients, the agent and not also its clients shall be regarded as the lender for the purposes of these Rules;

“Monetary Authority-appointed market maker” ( ) means any person appointed as a market maker by the Monetary Authority under a letter of appointment currently in force for the purpose of conducting market making activities in respect of Exchange Fund Bills, Exchange Fund Notes and specified instruments;

“Securities Market Maker” ( ) means an exchange participant which is registered with the Stock Exchange Company for the purpose of performing market making or liquidity providing activities in respect of securities listed or admitted to trading on the recognized stock market it operates in accordance with its rules and an issuer of structured products which are listed on the recognized stock market operated by the Stock Exchange Company under Chapter 15A of its Listing Rules;

“specified instrument” ( ) means any note issued by the MTR Corporation Limited, the Airport Authority, the Hong Kong Mortgage Corporation Limited and the Kowloon-Canton Railway Corporation under their respective note issuance programmes arranged by the Monetary Authority;

### **3. Classes of transactions prescribed for the purposes of section 170(3)(e) of the Ordinance**

(1) The following classes of transactions are prescribed for the purposes of section 170(3)(e) of the Ordinance –

- (a) a sale by a Monetary Authority-appointed market maker of –

- (i) Exchange Fund Bills;
    - (ii) Exchange Fund Notes; or
    - (iii) specified instruments;
  - (b) a sale of a security in conducting jobbing business.
- (2) For the purpose of this section, the following transactions or dealings constitute jobbing business –
- (a) the sale of a security listed or admitted to trading by the Stock Exchange Company by a Securities Market Maker where the sale is for the purpose of hedging the risks of a position previously acquired in another security and the security that is sold is a component of that other security or vice versa;
  - (b) the sale of a security listed or admitted to trading by the Stock Exchange Company by a Futures Market Maker where the sale is for the purpose of hedging the risks of a position previously acquired in a futures contract in respect of the security or an index of securities which includes the same security;
  - (c) the sale of a security listed or admitted to trading by the Stock Exchange Company by a Securities Market Maker in the performance of market making or liquidity providing activities in the security if the Securities Market Maker acquires the right to vest the security in the purchaser of them before the end of the trading day following the day of the sale.

**4. Circumstances in which certain requirements of section 171 not to have effect**

- (1) Subject to subsections (2) to (8), section 171 of the Ordinance does not apply to a short selling order which is such order by virtue of paragraph (a)(i)

of the definition of “short selling order” in section 1 of Part 1 of Schedule 1 to the Ordinance.

(2) A person, where selling as a principal, at the time of conveying a short selling order referred to in subsection (1), shall provide his agent with an oral assurance that the counterparty to the securities borrowing and lending agreement has the securities to which the order relates available to lend or deliver to him and such person shall –

- (a) record such oral assurance in the form of a tape-recording;
- (b) have entered into an arrangement with his agent whereby the agent has agreed to –
  - (i) record such oral assurance in a tape recording; or
  - (ii) at the time of receiving a short selling order, record the particulars as described in subsection (5) to which the order relates on a time-stamped record; or
- (c) confirms the giving of the oral assurance in the form of a document to the agent by the end of the day on which it was given.

(3) An exchange participant, where selling as a principal, prior to conveying a short selling order referred to in subsection (1), shall –

- (a) have received from the counterparty to the securities borrowing and lending agreement an oral assurance that the counterparty has the securities to which the order relates available to lend or deliver to him and
- (b) have –
  - (i) recorded the oral assurance in a tape-recording;
  - (ii) recorded the particulars as described in subsection (5) to which the order relates on a time-stamped record; or

- (iii) entered into an arrangement with the counterparty whereby the counterparty has agreed to –
  - (A) record the particulars as described in subsection (5) to which the order relates in the form of a document;
  - (B) provide such document to the exchange participant to by the end of the day of which the assurance was given.

(4) A person, where selling as an agent, prior to conveying a short selling order referred to in subsection (1), shall –

- (a) have received from his principal, or the other person for whose benefit or on whose behalf such order is made (as the case may be) an oral assurance that the counterparty to the securities borrowing and lending agreement has the securities to which the order relates available to lend or deliver to him, and
- (b) have –
  - (i) recorded the oral assurance in a tape recording;
  - (ii) recorded the particulars as described in subsection (5) to which the order relates on a time-stamped record; or
  - (iii) entered into an arrangement with his principal, or the other person for whose benefit or on whose behalf the order is made (as the case may be), whereby his principal, or such other person (as the case may be) has agreed to provide a confirmation of the oral assurance in the form of a document to him by the end of the day on which the assurance was given.

(5) Particulars required under subsection (2)(b)(ii), (3)(b)(ii) and (iii)(A) and (4)(b)(ii) include –

- (a) the securities or group of securities borrowed, available for borrowing and the quantity; and
- (b) whether a blanket assurance or a hold has been given or a borrow has been entered into, and the time it was given or entered into, as the case may be.

(6) Any person who records an oral assurance, particulars as described in subsection (5) or a confirmation of an oral assurance in the form of a document (including a tape recording or time-stamped record) under this section must retain such document for not less than one year from the date of recording, collecting or receiving such assurance or particulars as the case may be.

(7) Upon request made at any time within the one year period referred to in subsection (6) by the Commission, the person must give the Commission access to and produce the document (including a tape recording or the time-stamped record (as the case may be)) containing the oral assurance or particulars (as the case may be), within the time and at the place specified by the Commission.

## **5. Record keeping by stock lender**

(1) When a lender gives a blanket assurance or a hold to a borrower, or enters into a borrow, the lender must record in the form of a document the following particulars –

- (a) the name of the borrower;
- (b) the securities or group of securities borrowed, or available for borrowing and the quantity thereof;
- (c) whether a blanket assurance or a hold has been given or a borrow has been entered into, and the time it was given or entered into, as the case may be.

(2) The lender must –

- (a) subject to paragraph (b), retain the document referred to in subsection (1) for not less than one year from the date the relevant record was made; and
  - (b) upon request made at any time within that year by the Commission, provide any such record to the Commission.
- (3) In this rule, “securities” means securities which are listed by the Stock Exchange Company.

Chairman,  
Securities and Futures Commission

2002

### **Explanatory Note**

These Rules are made by the Securities and Futures Commission under section 397(1) of the Securities and Futures Ordinance (5 of 2002). They prescribe for the purposes of section 170(3)(e) of the Ordinance the classes of transactions that are exempt from section 170(1) of the Ordinance and provide the circumstances in which certain requirements of section 171 do not have effect.





**SECURITIES AND  
FUTURES COMMISSION**  
證券及期貨事務監察委員會

## **Consultation Conclusions on the Securities and Futures (Short Selling Exemption and Stock Lending) Rules**

《證券及期貨(賣空豁免及證券借出)規則草擬本的諮詢  
總結》

Hong Kong  
July 2002

香港  
2002年7月

## **A Introduction**

1. On 24 May 2002, the Securities and Futures Commission (“the SFC”) released a consultation document inviting public comments on the draft **Securities and Futures (Short Selling Exemption and Stock Lending) Rules** (“the draft Rules”).
2. The draft Rules provide – (a) exemptions from the ‘naked’ short selling prohibition in section 170 of the Securities and Futures Ordinance (SFO) (No. 5 of 2002); (b) circumstances in which the reporting requirements in section 171 do not apply; and (c) reporting requirements for stock lending.
3. The consultation period ended on 21 June 2002.
4. A summary of the comments received on the draft Rules (“summary of comments”) is attached as Annex 1.
5. Taking into account the comments received, several amendments to the draft Rules were considered appropriate.
6. The purpose of this report is to provide an analysis of the main comments raised during the consultation process and the rationale for the Commission’s conclusions. This report should be read in conjunction with the consultation paper, the draft Rules and the summary of comments.

## **B. Public Consultation**

### **Background**

7. The draft Rules were prepared to provide exemptions to the short selling prohibition under section 170 for market makers when they perform market making activities or for hedging their market making positions. The existing exemptions under the Securities (Miscellaneous) Rules are largely reproduced in the draft Rules. The draft Rules also set out circumstances in which the reporting requirements in section 171 do not apply. Finally, it reproduces the current Securities (Stock Lending) Rules.
8. From a policy perspective, the draft Rules are intended primarily to –
  - (a) enable all categories of SEHK and HKFE registered market makers to short sell securities in performing their market making obligations as well as for hedging purposes. In this respect, the draft Rules rationalise the current exemptions available to some market makers, eliminate the inconsistencies under the current law and extend the exemption to all categories of market makers;
  - (b) enable the timely execution, as well as reducing the compliance burden, for sellers placing short selling orders which are covered by virtue of a stock borrowing and lending arrangement; and

- (c) provide record keeping requirements for stock lenders to ensure that proper audit trails are created. In this respect, the record keeping requirements reproduce the existing legislation and no new policy changes are introduced.

### **Consultation Process**

- 9. In addition to the press release regarding the consultation exercise which was issued on 24 May 2002, the consultation paper and the draft Rules were also posted on the website of the SFC and distributed to all registrants through FinNet.
- 10. Five submissions were received. The overall tone of the comments was positive. Commentators generally welcomed the draft Rules. Comments varied considerably in range and depth, with some focusing on broad principles and others on points of detail and clarification.

## **C. The Consultation Conclusions**

The following summarises the main comments received and the SFC's responses.

### **Clause 2**

- 11. One commentator expressed that certain definitions should be removed from the draft Rules and left to the interpretation of business professionals or case law.
- 12. The SFC believes that the definitions provide greater clarity and will assist industry participants in complying with the provisions. Clarity in the scope of the provisions is desirable especially since non-compliance may lead to criminal sanctions. In addition, there is little or no case law on many of these terms.

### **Clause 3**

- 13. It was suggested that the exemption should be given to all proprietary trades of exchange participants.
- 14. The SFC takes the view that market makers have a need to be able to conduct naked short sales when they are performing their market making functions. The present exemptions are for the purpose of facilitating market making which will help to increase the liquidity of the respective securities or futures contracts. Market makers recognised by the SEHK and HKFE are subject to strict eligibility criteria of the respective exchange which are approved by the SFC. The SFC will consider, at a later stage, reviewing the monitoring systems and risk management measures to see if it is appropriate to extend the exemptions to proprietary transactions of exchange participants.
- 15. One commentator expressed the view that the exemptions will not assist industry participants unless corresponding exemptions and tick rule exemptions are made to the Rules of the Stock Exchange of Hong Kong Limited (SEHK).

16. The SFC and SEHK are working on introducing these exemptions to their rules. The corresponding exemptions in the SEHK Rules will be introduced at around the same time as the exemptions proposed in the draft Rules.
17. A question was raised as to whether a dealer who effects a short sale on behalf of a Monetary Authority appointed market maker is required to comply with the requirements of section 170(1) of the SFO and the provisions of the draft Rules.
18. The provision repeats the existing exemptions which have been in place since 1999. HKMA-appointed market makers generally execute their trades on the exchange through their brokerage arm. For the purposes of greater clarity, Clause 3(1) has been amended by adding a new subsection which will exempt agents acting for HKMA-appointed market makers from section 170(1) as long as the agent has reasonable grounds to believe that his principal is effecting the short sale in its capacity as a HKMA-appointed market maker.
19. Several commentators expressed that it was unclear whether the market making exemptions are available to issuers or other persons who perform market making activities but are not exchange participants.
20. The policy intention is for the exemption to be applicable to any person whom the relevant exchange recognises as performing market making or liquidity providing services. These persons may not necessarily be exchange participants but should be 'registered' or otherwise recognised by the relevant exchange as market makers. The SFC believes that the draft Rules which were released for consultation were not clear in this respect and amendments have been made to Clause 2.
21. Commentators raised questions as to whether Clause 3(2) applies to the hedging of one security by short selling another security, where the security hedged and that sold both share the same, third, underlying security.
22. The policy intent is to allow genuine hedging activities where 2 securities are related. Where 2 securities share the same underlying security, which may be a third security, they will be considered to be related. The SFC agrees that the draft Rules which were released for consultation were not clear and an amendment has been made to Clause 3(2)(a)(ii) and (b)(ii).
23. One commentator noted that the exemption did not extend to pre-hedging activities and suggested that pre-hedged should also be included. The SFC does not believe that it would be appropriate at present to include pre-hedging as these activities are difficult to monitor and may be open to abuse.

24. Some commentators questioned how a market maker would acquire the right to vest the securities in the purchaser of them before the end of the next trading day so as to comply with Clause 3(2)(c).
25. This provision is based on the existing Securities (Miscellaneous) Rules which specify the method for acquiring such a right in respect of exchange traded funds. The SFC considered that as long as the market maker acquired the right within the next trading day, it does not matter the method by which he acquires such right. Accordingly, the draft Rules do not specify the method of acquiring the right. Market makers who borrow or buy the securities will comply with the clause. Similarly, in the case whether the security that is sold is a share in an exchange traded fund, the seller can place a creation order for the exchange traded fund shares.

#### **Clause 4**

26. One commentator expressed that the scope of Clause 4 should be extended to all short selling orders.
27. The draft Rules are aimed at facilitating the stock lending business. In addition, the SFC understands that a large majority of short selling orders are covered by stock lending arrangements. Accordingly, the SFC does not consider that it the scope of the exemption should be extended.
28. The commentator also raised an issue that sellers receiving the documentary record and time stamps it is required to include information under Clause 4(5) which goes beyond what is required under section 171.
29. Under the requirements in section 171 (and 172), an audit trail is produced so that covered short sales can be traced backwards from an input of an order. The SFC considers that in the absence of the information that sellers are required to retain under section 171 or the other routes in Clause 4, the information under Clause 4(5) is required so that the audit trail is not broken. In making this proposal, the SFC had consulted industry participants who gave the SFC a list of the information which they would normally obtain from their principal and record on a time-stamped order ticket when receiving a short selling order. The information required in Clause 4(5) is the same as that provided to the SFC by industry participants. The SFC believes that this route is likely to be used by conduit brokers who either act as stock lenders for their clients or arrange for stock lendings on behalf of their clients. Other brokers who feel that this proposed exemption does not suit their needs may elect to use the other proposed exemptions set out in the draft Rules.

#### **Clause 5**

30. One commentator suggested including capital, operational competence and risk management requirements on dealers who provide stock borrowing and lending services to clients.

31. As the purpose of the draft Rules is to create a proper audit trail for short selling and stock lending, the SFC believes it would be inappropriate to include the suggested requirements in the draft Rules. However, the SFC will consider whether it is necessary to include such requirements in the Code of Conduct for Persons Registered with the SFC.

**D. Commencement Date**

32. The Securities and Futures (Short Selling Exemptions and Stock Lending) Rules will become effective on the commencement of the SFO.

**E. Other Matters**

33. The SFC will publish a revised Guidance Note on short selling to provide industry participants with guidance on the application of these provisions before the commencement of these exemptions.
34. The SFC wishes to thank the commentators who have made valuable suggestions and comments.

**Draft Securities and Futures (Short Selling Exemption and Stock Lending) Rules**  
**Summary of comments received and SFC's response**

<b>Item No.</b>	<b>Section Reference</b>	<b>Details of the Rules</b>	<b>Respondent's Comments</b>	<b>SFC's Response</b>
1.	general comment	N.A.	<i>Wocom:</i> The short selling exemptions have been extended to all market makers. This should be accompanied by tighter scrutiny of market makers' role in providing liquidity. Examples were given as to market makers not fully complying with their market making obligations.	<p>The proposed exemptions extend the scope of the current exemptions to all categories of market makers. The SFC believes that these exemptions facilitate the performance of market makers' market making functions and provide them with incentive to act as market makers.</p> <p>The SFC has requested HKEx to review market making obligations and market makers' performance to ensure that they fulfil the obligations.</p> <p>The Exchange has disciplinary power to penalize market makers who do not comply with their market making obligations.</p>
2.	general comment	N.A.	<i>Respondent A:</i> It is a market practice that the related short selling transactions by the underwriters would be reported to the Exchange as cross trades. This practice, however, may have technically breached the requirements of the SEHK Rules which require short sales in Designated Securities to be automatically struck through the AMS and to be made at or above the best current ask price. (n.b. the references in the submission to sections 3 and 15 should correctly be references to Regulation 3 and 15 of the 11 <sup>th</sup> Schedule of the SEHK Rules).	<p>If the short selling transactions have technically breached the SEHK Rules, the appropriate avenue to address this is in the SEHK Rules rather than in the draft Rules. The SFC will follow up with the SEHK.</p>

**Attachment to  
Annex 3**

<b>Item No.</b>	<b>Section Reference</b>	<b>Details of the Rules</b>	<b>Respondent's Comments</b>	<b>SFC's Response</b>
3.	2	Clause 2 sets out the definitions used in the draft Rules	<b>SHK:</b> The definitions for “blanket assurance” and “hold” should be removed from the draft Rules and left to the interpretation of business professionals or case law.	The definitions are derived from the existing Securities (Stock Lending) Rules. The SFC believes that it would be inappropriate to omit them from the draft Rules. Although securities practitioners should be familiar with these terms, there are few or no case laws on the exact meaning of them. The SFC believes that it is desirable to have the definitions to provide clarity to industry participants, especially where non-compliance with the provisions is a criminal offence.
4.			<b>SHK:</b> Most of the definitions in the current Stock Lending Rules have been incorporated into the draft Rules. But the definition of “documentary record” has been removed.	The observation is correct. However, the reference to “documentary record” in the current Stock Lending Rules is replaced by “in the form of a document” in the draft Rules and the term “document” is defined in Schedule 1 to the SFO.
5.	3	Clause 3 sets out the exemptions from the naked short selling prohibition under section 170 of the Ordinance for market makers	<b>Linklaters:</b> The short selling exemptions are of limited use unless equivalent exemptions from the tick rule are also introduced. In addition, corresponding exemptions should be included in the SEHK Rules to permit exchange participants to conduct the types of naked short selling permitted by the draft Rules.	The SFC is working with HKEx to introduce corresponding exemptions under the SEHK Rules as well as relevant tick rule exemptions. The exemptions under the SEHK Rules are intended to be implemented at around the same time as those in the draft Rules.
6.			<b>Wocom:</b> By virtue of the definition of ‘short selling order’, market makers can already hedge their positions. If this is not sufficient, the short selling exemptions should be extended to all SEHK and HKFE participants irrespective of whether they are market makers.	The provisions relating to ‘short selling orders’ are in relation to ‘covered’ short sales whilst section 170 (and the current exemptions) are in respect of naked short sales.  The SFC takes the view that market makers need to be able to do naked short sales when they are



Item No.	Section Reference	Details of the Rules	Respondent's Comments	SFC's Response
				performing market making functions. The SFC will consider reviewing the corresponding monitoring system and risk management measures to see whether it is appropriate to extend the exemptions to proprietary transactions of SEHK and HKFE participants in future.
7.			<b>SHK:</b> Exemptions given under the draft Rules should be replaced by the granting of some kinds of special permits, founded on a set of criteria and based on an objective assessment of the capability of the persons who can meet statutory requirements on capitalization, operational control, risk management competence, the ability to secure or otherwise provide an assurance of the “presently exercisable and unconditional” right to vest shares to the buyer, or the borrower.	The exemptions apply only to different categories of market makers recognized by the Exchanges. The Exchanges apply strict eligibility criteria which are approved by the SFC. These criteria, in general, relate to risk management, capital, operational control, expertise etc. Therefore although not specified in any legislation, the suggestion is already catered for in practice.  In addition, these market makers are either SFC registrants or persons whom the SFC has “regulatory reach” over <sup>1</sup> . Also, Exchange Participants (SFC registrants) who execute the market making transactions on behalf of these persons (who are not directly regulated by the SFC) are held responsible for the transactions.
8.	3(1)(a)	Clause 3(1)(a) sets out the exemptions from section 170 for to HKMA appointed market makers. This provision repeats the	<b>SHK:</b> In the case when Monetary Authority-appointed market maker elects to effect a “naked sales” through a dealer, it is not clear whether the dealer must comply with the requirements of subsection 170(1) of the SFO and the	The provision repeats the existing exemptions which have been in place since 1999. HKMA-appointed market makers generally execute their trades on the exchange through their brokerage arm. For the purposes of greater clarity, Clause 3(1) has been amended by adding a new subsection

<sup>1</sup> For example, Designated Specialists are regulated by their home regulator who has in place an MOU with the SFC. If there is any misconduct or impropriety by the Designated Specialist, the SFC can request the home regulator to take appropriate action. In addition, the Designated Specialists registration with the SEHK can be withdrawn.

Item No.	Section Reference	Details of the Rules	Respondent's Comments	SFC's Response
		current exemption under Rule 17 of the Securities (Miscellaneous) Rules.	provisions of the draft Rules.	which will exempt agents acting for HKMA-appointed market makers from section 170(1) as long as the agent has reasonable grounds to believe that his principal is effecting the short sale in its capacity as a HKMA-appointed market maker.
9.			<b>SHK:</b> HKMA has relinquished its role to act as an arranger for the debts issued under the respective note issuance programmes of the MTRC, the HKAA, the HKMC and the KCRC. A deletion of the reference to "... arranged by the Hong Kong Monetary Authority" in the definition of the term "specified instruments" is suggested.	Agreed. The clause is amended to delete the reference.
10.	3(2)	Clause 3(2) sets out the types of transactions which constitute "jobbing business" for the purpose of the draft Rules.	<b>Linklaters:</b> It appears that only Securities Market Makers and Futures Market Makers are able to rely on the exemptions. However, other parties, such as offshore affiliates who hedge the position and use the relevant market maker merely to execute the trade, would also be able to rely on the exemption.	The exemptions are intended to be available to any person who is registered with the SEHK or HKFE to perform market making or liquidity providing activities. These will include persons who may not be exchange participants but whom the relevant Exchange recognizes as performing market making or liquidity providing activities, e.g., Designated Specialists <sup>2</sup> or issuers of structured products under Chapter 15A of the SEHK Listing Rules <sup>3</sup> . The

<sup>2</sup> These are overseas specialists who are clients of an Exchange Participant who is a registered market maker. Under the SEHK Rules, an Exchange Participant may allow such a person, who is its client, to register with the SEHK to perform market making functions. They are required to be regulated by their home securities regulator who must have a MOU with the SFC and SFC approval of the Designated Specialist is also required. These Designated Specialists are required to fulfil the market making obligations under the SEHK Rules.

<sup>3</sup> Issuers of products (like equity-linked instruments and derivative warrants) under Chapter 15A of the SEHK Listing Rules are required to appoint an exchange participant to act as its liquidity provider. Liquidity providing is performed, similar to market making obligations, by responding to quote requests or providing continuous quotes. The positions that are built up in the course of providing liquidity may be either the issuer's positions or the positions of an affiliate of the issuer. Hence, the exemptions have also been drafted to apply to such persons. It should be noted that the liquidity provider is required to report the liquidity providing transactions daily to the Exchange.

**Attachment to  
Annex 3**

Item No.	Section Reference	Details of the Rules	Respondent's Comments	SFC's Response
				clause has been amended to better reflect the intention that the exemptions are available to any person whom the SEHK or the HKFE recognizes as performing market making or liquidity providing activities.
11.	3(2)(a)	Where a Securities Market Makers short sells a listed security to hedge the risks of another listed security, where both securities are related is exempt from section 170. Securities Market Maker is defined in Clause 2.	<b>Respondent A:</b> Clarification was sought as to whether the exemption under Clause 3(2) would apply to an issuer of derivative warrants who will carry out the hedging and liquidity providing activities through the "Securities Market Maker". The exemptions would not be meaningful if the principal is not exempt from the requirements of section 170(1) of the SFO.	The exemptions are intended to apply to, amongst other persons, issuers of structured products. As issuers are not exchange participants, the clause has been amended to better reflect the intention that the exemptions are available to any person whom the SEHK recognizes as performing market making or liquidity providing activities.
12.	3(2)(a)		<b>Respondent A:</b> Clarification was sought as to the definition of "component" and whether hedging a stock options position or warrant position with a single stock is permitted.	The exemptions are intended to enable hedging a position in a listed security ("B") by short selling another listed security ("A") if either (1) A is an underlying stock of B or vice versa (Clause 3(2)(a)(i)) or (2) both A and B share the same underlying security (Clause 3(2)(a)(ii)). Clause 3(2)(a) has been revised to better reflect this. So, a market maker will be able to short sell the underlying securities of an option or a warrant to hedge a position he has acquired in an option or warrant over that security.
13.			<b>Linklaters:</b> The current drafting of the hedging sections under Rule 3 ("... a component of that other security") would not include an underlying of that other	The intention has always been to allow hedging by another security which has the same underlyings as the security being hedged. This was not clearly reflected in the draft Rules. Amendments have

Item No.	Section Reference	Details of the Rules	Respondent's Comments	SFC's Response
			security. It is suggested that it should include an underlying of that other security.	been made to Clause 3(2)(a) to clarify this.
14.	3(2)(a) and (b)	These provisions enable Securities Market Makers and Futures Market Makers to short sell securities to hedge against risks of market making positions which they have acquired.	<b>Linklaters:</b> Pre-hedging should be permitted.	<p>The purpose of the exemptions is to extend the current exemptions which are only available to stock options and stock futures market makers (under Rule 17 of the Securities (Miscellaneous) Rules) to all categories of market makers. Under the current rules, pre-hedging is not permitted.</p> <p>The SFC does not intend to widen the scope of the exemptions, at this time, to pre-hedging. This is because pre-hedging will be difficult to monitor and may be subject to abuse, e.g. where the market maker takes a directional view on a security and short sells the security. Subsequently, if the position is not favourable, he can acquire a position in a derivative of the security and claim that the prior short sale is for the purpose of pre-hedging the position in the derivative product.</p>
15.			<b>Linklaters:</b> Clarification was sought as to the evidence which the SFC would require to show that the short sale was for the purpose of hedging.	<p>Under corresponding exemptions in the SEHK Rules, it is intended that special indicators will be required when the market making orders are input into AMS/3. This will enable identification of the market making transactions claiming the exemption. In addition, the SEHK is in the process of developing a monitoring and/reporting system for monitoring these exemptions. This may include filing of reports for complicated transactions.</p> <p>Market making transactions and positions should</p>

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				be clearly set out/ reflected in the market making books of the market maker which should be separate from the other trading or proprietary trading books. The market making books would be the primary source of evidence.
16.	3(2)(c)	This provision enables short sales to be made by Securities Market Makers in performing market making obligations provided that they acquire the securities that are sold by the end of the next trading day.	<b>Linklaters:</b> Confirmation was sought as to whether a Securities Market Maker who has submitted a redemption application on an exchange traded fund has acquired the right to vest the securities in the purchaser of them from the time the redemption application is submitted, and therefore satisfies the test in Clause 3(2)(c).	Where a Securities Market Maker short sells shares of an exchange traded fund, he will satisfy the requirement under section 3(2)(c) if he places a creation order for the exchange traded fund shares by the end of the next trading day. If the Securities Market Makers short sells the underlying shares of an exchange traded fund, the requirement will be fulfilled if he places a redemption order for the underlying shares by the end of the next trading day.
17.			<b>Calvin Lee:</b> Request to clarify what constitutes “the Securities Market Maker acquires the right to vest the security in the purchaser of them before the end of the trading day following the day of the sale”	The Securities Market Maker should acquire the securities he sold by the end of the next trading day. For example, he can do so by buying back the securities, borrowing them, or in the case where the security that was sold is an exchange traded fund, placing a creation order for them.
18.	4	Clause 4 sets out the circumstances in which the reporting requirements for ‘short selling orders’ in section 171 of the Ordinance do not apply.	<b>Linklaters:</b> <i>It appears that Clause 4 provides an alternative means of complying with the reporting requirements under Section 171 of the SFO but as drafted it appears to be mandatory to follow one of the routes set out in the Rule.</i>	Clause 4 has been redrafted to address market comments.
19.			<b>Linklaters:</b> The scope of Clause 4 is rather	Under the Commission's rule-making power in

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			<p>narrow as it only applies to short selling orders that are by virtue of a stock borrowing and lending arrangement.</p> <p>This differentiation would result in an obligation on sellers/broker to ascertain the type of short selling order they are placing/receiving and is impractical when the intention of the draft Rules is to provide a relaxed regime.</p> <p>The application of section 4 should be extended to all categories of short selling orders.</p>	<p>sections 397 and 398 of the SFO, exemptions can only be made so as to apply to “a specified transaction of class of transactions entered into by any specified person or class of persons”. As the suggestion to extend section 4 of the draft Rules to all categories of short selling orders would, in effect, negate the application of section 171, such suggestion is likely to be ultra vires.</p> <p>As 2 other alternatives are provided in the Clause 4, a seller may choose to obtain a tape recording of the oral assurance. In such case, he will not need to ascertain this information.</p> <p>A majority of short selling orders are covered by stock lending arrangements. The SFC's intention is to facilitate the stock lending business. As such, the exemptions are only made available to short sales by virtue of stock lending transactions.</p>
20.	4(2)(b), 4(3)(b)(iii) & 4(4)(b)(iii)	Provisions relating to where an arrangement is made between the agent and principal so that one party will provide the document of the assurance at the end of the trade day	<b>Linklaters:</b> Clarification was sought as to what evidence SFC will require to substantiate “an arrangement” as mentioned in Rules 4(2)(b), 4(3)(b)(iii) and 4(4)(b)(iii).	The SFC believes that ideally the arrangement should be set out in writing or otherwise documented. Please refer to the following comment/response for the reasons.
21.	4(4)(b)(iii)		<b>Linklaters:</b> It was queried what consequences there would be if the client did not send any documentary assurance at the end of the day.	As the requirement under section 171 is placed on the agent, the agent would not be held liable if the client did not provide a documentary assurance by the end of the day PROVIDED that the agent had

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				made an arrangement with the client that the client would provide documentary assurance. Hence, (see comment/response above) it would be in the agent's interest to ensure that the arrangement he has with his client is documented.
22.			<b>Linklaters:</b> It was queried whether an e-mail message from the client is sufficient to form "a confirmation of oral assurance in the form of a document".	Yes, as long as the e-mail message contains all the information required under the assurance.
23	4(5)	Clause 4(5) sets out the information that is to be included in the document provided at the end of the trade day	<b>Linklaters:</b> If the person receiving the order makes a documentary record and timestamps it, that "document" has to include the information in Rule 4(5). This goes beyond what Section 171 requires in a documentary assurance. It should be unnecessary for the seller to provide details of the time the blanket assurance or hold has been given or a borrow has been entered into.	Under the requirements in sections 171 and 172, a chain of evidence is produced so that covered short sales can be traced backwards from input of an order (section 172) to the seller who placed the order (section 171(1)).  The SFC considers that in the absence of the information that sellers are required to retain under section 171 or the other routes in Rule 4, the information required under Rule 4(5) is required so that this chain of evidence is not broken.
24.	5	Clause 5 sets out the record keeping requirements for stock lenders. This clause repeats the current Securities (Stock Lending) Rules.	<b>SHK:</b> Dealers who are involved with the provision of securities borrowing and leading to clients should meet very high capital requirements, a satisfactory level of operational competence and maintain adequate risk management. Such requirements should be included in the draft Rules.	The purpose of the draft Rules is to create a proper audit trail for short selling and stock lending. It would be inappropriate to include the suggested requirements in the draft Rules.  However, the SFC will consider whether it is necessary to include the suggestions in its Code of Conduct for Registered Persons.

List of Respondents

<b>Dated Received</b>	<b>Respondent</b>
10 June 2002	Wocom Securities Limited (“Wocom”)
10 June 2002	Calvin Lee
21 June 2002	Sun Hung Kai Securities Limited (“SHK”)
21 June 2002	Linklaters & Alliance (“Linklaters”), submitting on behalf of Credit Suisse First Boston (Hong Kong) Limited, Deutsche Securities Asia Limited, Goldman Sachs (Asia) L.L.C., Merrill Lynch (Asia Pacific) Limited, Morgan Stanley Dean Witter Asia Limited, Salomon Smith Barney Hong Kong Limited and UBS Warburg
24 June 2002	A financial institution who wished to remain anonymous (“Respondent A”)