

LEGISLATIVE COUNCIL BRIEF

Securities Ordinance (Cap.333)

SECURITIES (MISCELLANEOUS) (AMENDMENT) RULES 2002

INTRODUCTION

Pursuant to section 146 of the Securities Ordinance (“SO”), the Securities and Futures Commission (“SFC”) has made the Securities (Miscellaneous) (Amendment) Rules 2002 (“the Amendment Rules”) at the **Annex**.

BACKGROUND

The current law

2. Section 80(1) of the SO prohibits selling of securities through the Unified Exchange unless the seller (where selling as an agent, the principal) has, or reasonably and honestly believes that he (where selling as an agent, the principal) has, a presently exercisable and unconditional right to vest the securities in the purchaser of them. Rule 17 of the Securities (Miscellaneous) Rules excludes certain classes of transactions from the application of section 80(1). They include –

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

3. Sections 80A to C of the SO prescribe disclosure and reporting requirements for sellers as principals and agents of “short selling orders”. “Short selling order” is defined in section 80A. In general, a short selling order is an order to sell securities where the seller (where selling as an agent, the principal) has a presently exercisable and unconditional right to vest the securities in the purchaser of them, either by way of a securities borrowing and lending agreement or where the seller holds an option or other instrument

conferring the right to acquire the securities to which the order relates. Section 80B 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. Documentary records obtained under the provision is required to be retained for 12 months and provided to the SFC upon request. There is no exemption regarding the application of section 80B.

Reasons for making the Amendment Rules

4. Earlier this year, the SFC has engaged market participants in its efforts to identify possible areas of relaxation that will help facilitate market development, enhance liquidity and reduce compliance burden. They have put forward a number of proposals. The SFC, in consultation with the Hong Kong Monetary Authority, has included in the Securities and Futures (Short Selling and Securities Borrowing and Lending (Miscellaneous)) Rules (“Short Selling Rules”) to be made under the Securities and Futures Ordinance (Cap. 571) (“SFO”), those proposals that will help achieve the aforesaid objectives while without posing additional risks to the stability of the market or compromising the regulators’ ability to monitor market volatility. The SFO is scheduled for commencement in early 2003. With a view to bringing the benefits of the relaxation proposals to the market as soon as possible, the SFC makes the Amendment Rules under the SO to effect the same relaxation proposals for commencement on 15 November 2002.

THE AMENDMENT RULES

5. Clause 2 of the Amendment Rules eliminates the inconsistencies under the current law and extends the exemption from the prohibition against naked short selling, 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. Moreover, the exemptions for market makers registered with the SEHK will also be available to issuers of structured products like derivative warrants and equity linked notes/instruments who have liquidity providing obligations.

6. Clause 3 of the Amendment Rules exempts sellers of short selling orders covered by stock borrowing and lending agreements from compliance with the applicable requirements under section 80B, if they comply with the alternative requirements set out in the provision. Salient circumstances under which exemptions are available to sellers who as principals or agents (as the

case may be) provide or receive (as the case may be) at the time of or prior to placing or accepting (as the case may be) a short selling order, an oral assurance to ensure existence of the right to vest the relevant securities in the purchasers of them, include -

- (a) if time-stamped record of the assurance with prescribed particulars is available;
- (b) if tape-recording of the assurance is available; or
- (c) if by the end of the day on which the assurance is given, documentary confirmation of the assurance is available.

7. In addition, clause 3 of the Amendment Rules requires retention of the records referred to in paragraph 6 above for 12 months and their production to the SFC upon request.

PUBLIC CONSULTATION

8. As mentioned in paragraph 4 above, the Amendment Rules effect the same new relaxation proposals set out in the draft Short Selling Rules. The SFC released a consultation document and an exposure draft of the Short Selling 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 Short Selling Rules as appropriate. The draft Short Selling Rules have been further revised in the light of the comments of the Legislative Council Subcommittee on Draft Subsidiary Legislation to be made under the Securities and Futures Ordinance (“the Subcommittee”) as expressed at its meeting on 15 July 2002. The Amendment Rules essentially replicate the relevant provisions of the revised draft Short Selling Rules.

9. The HKEx has also been consulted and supports the relaxation proposals.

FINANCIAL AND STAFFING IMPLICATIONS

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

COMMENCEMENT DATE

11. The commencement date for the Amendment Rules will be 15 November 2002 (i.e. 28 days after tabling before the Legislative Council). As the Amendment Rules essentially replicate the draft Short Selling Rules which have already been considered by the Subcommittee and early commencement of the Amendment Rules will be beneficial to the market, we seek Members' understanding and support for this fast track arrangement.

PUBLICITY

12. The Amendment Rules will be published in the Gazette on 11 October 2002. A press release will be issued on the same day.

ENQUIRIES

13. For any enquiries on this brief, please contact Ms Alexandra Yeong of the Supervision of Markets Division of the SFC at 2840 9247 or Ms Mary Ahern of the Legal Services Division of the SFC at 2283 6809.

The Securities and Futures Commission
11 October 2002

SECURITIES (MISCELLANEOUS) (AMENDMENT) RULES 2002

(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 15 November 2002.

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

Rule 17(2), (3) and (4) of the Securities (Miscellaneous) Rules (Cap. 333 sub. leg.) is repealed and the following substituted –

“(2) A sale of any of the following securities by an agent of a Monetary Authority-appointed market maker shall be a class of transaction prescribed for the purpose of section 80(4)(d) of the Ordinance –

- (a) Exchange Fund Bills;
- (b) Exchange Fund Notes;
- (c) 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.

(3) A sale of securities effected in the course of conducting jobbing business as described in subrule (4) shall be a class of transaction prescribed for the purpose of section 80(4)(d) of the Ordinance.

(4) For the purpose of this rule, 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 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 (“C”) by a Futures Market Maker for the purpose of hedging the risks of a position previously acquired in –
 - (i) a futures contract in respect of C or an index of securities which includes C; or
 - (ii) a futures contract in respect of another security (“D”) which has a common component with C; 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 before the end of the trading day following the day of the sale.

(5) For the purpose of subrule (4) -

“Futures Exchange Company” (期交所) means the Exchange Company within the meaning of section 2(1) of the Commodities Trading Ordinance (Cap. 250);

“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, market making or liquidity providing activities in respect of futures contracts admitted to trading on the commodity exchange it operates;

“listed” (上市) means listed or admitted to trading on the Unified Exchange;

“Listing Rules” (《上市規則》) means the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited made by the Exchange Company;

“Securities Market Maker” (證券莊家) means a person who is registered with the Exchange Company for the purpose of performing, in accordance with rules made by the Exchange Company, market making or liquidity providing activities in respect of listed securities or an issuer of structured products which are listed on the Unified Exchange under Chapter 15A of the Listing Rules.”.

3. Rule added

The following is added –

“18. Classes of persons and circumstances in which certain requirements of section 80B of the Ordinance not to have effect

(1) Section 80B(1) of the Ordinance does not have effect in relation to a specified short selling order, which is made by a person, where he is 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 receiving the short selling order, record the particulars as described in subrule (4) 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 subrule (5).

(2) Section 80B(3) of the Ordinance does not have effect in relation to a specified short selling order, which is made by an exchange participant, where he is selling as a principal, provided such exchange participant -

- (a) prior to conveying the short selling order –
 - (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 subrule (4) 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 –
 - (I) record the particulars as described in subrule (4) to which the order relates in the form of a document; and
 - (II) 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 subrule (5).

(3) Section 80B(5) of the Ordinance does not have effect in relation to a specified short selling order, which is made by a person, where he is selling as an agent, provided such person -

- (a) prior to conveying the short selling order -
 - (i) has 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 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 subrule (4) 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 subrule (5).

(4) Particulars required under subrules (1)(a)(ii)(B), (2)(a)(ii)(B) and (C)(I) and (3)(a)(ii)(B) include -

- (a) the securities or group of securities borrowed under the securities borrowing and lending agreement in question, 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).

(5) Any person who records an oral assurance or particulars as described in subrule (4) or who receives a confirmation of an oral assurance in the form of a document (including a tape recording or time-stamped record) under this rule 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.

(6) For the purpose of this rule -

“blanket assurance” (概括性保證), in relation to a securities borrowing and lending agreement, 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 agreement, irrespective of whether the borrowed securities have been delivered by the lender to the borrower;

“hold” (持有確認), in relation to a securities borrowing and lending agreement, 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;

“securities borrowing and lending agreement” (證券借貸協議) has the meaning assigned to it by section 80A of the Ordinance;

“specified short selling order” (指明賣空指示) is an order which is a short selling order within the meaning of paragraph (a)(i) of the definition of “short selling order” in section 80A of the Ordinance.”.

Andrew Len Tao SHENG
Chairman,
Securities and Futures Commission

October 2002

Explanatory Note

These Rules are 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 the Ordinance. They prescribe for the purpose of section 80(4)(d) of the Ordinance, the classes of transactions that are exempt from section 80(1) of the Ordinance and provide the classes of persons and circumstances in which certain requirements of section 80B of the Ordinance do not have effect.