

# **LEGISLATIVE COUNCIL BRIEF**

## **Securities and Futures Ordinance (Cap. 571)**

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

#### **INTRODUCTION**

Pursuant to section 397 of the Securities and Futures Ordinance (Cap. 571) (the SFO), the Securities and Futures Commission (the SFC), after consultation with the Financial Secretary, has made the Securities and Futures (Short Selling and Securities Borrowing and Lending (Miscellaneous)) Rules (the Rules) at the **Annex**.

#### **BACKGROUND**

##### **The SFO**

2. The SFO was enacted in March 2002. It consolidates and modernizes ten existing ordinances governing the securities and futures markets into a composite piece of legislation to keep the regulatory regime on a par with international standards and practices. For effective regulation, the SFO has already provided flexibility in addressing changing market practices and global conditions by empowering the Chief Executive in Council, the Financial Secretary, the Chief Justice and the SFC to prescribe detailed and technical requirements as necessary by way of subsidiary legislation, to supplement the regulatory framework laid down under the primary legislation.

3. On 22 February 2002, the House Committee of the Legislative Council established the Subcommittee on Draft Subsidiary Legislation to be made under the Securities and Futures Ordinance (the Subcommittee) to study the subsidiary legislation necessary for commencing the SFO. From March 2002 to October 2002, the Subcommittee held 12 meetings and considered a total of 37 sets of draft subsidiary legislation, including the *vires* to make them.

## **THE PROPOSALS**

### **Major policy considerations**

4. Earlier this year, the SFC engaged market participants in its efforts to identify possible areas of relaxation with a view to facilitating market development, enhancing liquidity and reducing compliance burden. In particular, some market participants have asked for extended and new exemptions in respect of the prohibition against naked short selling under section 170(1) of the SFO and the requirements to confirm short selling orders under section 171 of the SFO. The SFC, taking into account comments from market participants and in consultation with the Hong Kong Monetary Authority (HKMA), has put forward a number of proposals that will help achieve the aforesaid objectives without posing additional risks to the stability of the market or compromising the regulators' ability to monitor market volatility. Proposals covered in the Rules are set out in paragraphs 6 and 7 below.

### **The Securities (Miscellaneous) (Amendment) Rules 2002**

5. The proposals outlined in paragraphs 6 and 7 below have also been effected through the recently made Securities (Miscellaneous)(Amendment) Rules 2002 which came into effect on 15 November 2002. The making of the Securities (Miscellaneous) (Amendment) Rules 2002 ahead of the Rules was to enable market participants to benefit from the relaxation measures as soon as possible.

### **Extended exemption from section 170**

6. Section 170 of the SFO prohibits the selling of securities through a recognized stock market unless the seller (where selling as an agent, the principal) has, or believes and has reasonable grounds to believe that he (where selling as agent, his principal) has a presently exercisable and unconditional right to vest the securities in the purchaser of them. There were certain exemptions already granted under existing law. The SFC proposes to eliminate the inconsistencies which until recently existed under current law (prior to the making of the Securities (Miscellaneous) (Amendment) Rules 2002) and extends the exemption so that "on-exchange" market making and hedging transactions of all classes of market makers registered with the Stock Exchange of Hong Kong Limited (the SEHK) or the Futures Exchange Limited will be exempted.

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.

### **New exemption from compliance with section 171**

7. Section 171 of the SFO prescribes the reporting obligations for sellers (principals, exchange participants selling as principal, and agents) of a “short selling order”<sup>1</sup>. Sellers (as principal, exchange participant selling as principal, or agent) are required to, at the time placing or receiving (as the case may be) a “short selling order”, confirm that it is a “short selling order” and that the sale is “covered”. An agent receiving a “short selling order” is required to obtain a documentary confirmation that the order is a “short selling order” and that it is “covered” from the seller prior to transmitting the order. The Rules provide that sellers, instead of complying with the requirements prescribed in section 171, can comply any of the three methods of reporting prescribed in section 4 of the Rules.

### **THE RULES**

8. Section 2 contains interpretation provisions that apply throughout the Rules.

9. Section 3 prescribes classes of transactions to which the prohibition against naked short selling under section 170(1) of the SFO (paragraph 6 above) does not apply, namely –

- (i) sales of specified securities (exchange fund bills and notes and specified instruments) by HKMA appointed market makers and agents of these market makers; and

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<sup>1</sup> A “short selling order” is an order to sell securities where the seller’s (if selling as an agent, the principal) presently exercisable and unconditional right to vest the securities in the purchaser of them is either by way of a borrowing under a securities borrowing and lending agreement or where the seller holds an option or other instrument which confers a right on him to acquire the securities to which the order relates.

- (ii) sales of securities in the course of “jobbing business”<sup>2</sup>.

10. Section 4 provides that sellers (principals, exchange participants selling as principal, and agents) are not required to comply with the requirements to confirm short selling orders under section 171 of the SFO (paragraph 7 above), if, generally, they provide or receive (as the case may be) an oral assurance that the order is a “short selling order” and that it is “covered” at the time the order is placed or received (as the case may be); and -

- (a) a time-stamped document of the assurance with prescribed particulars is available;
- (b) a tape-recording of the assurance is available; or
- (c) a documentary confirmation of the assurance is available by the end of the day it was given.

Records (including documents and tape recordings) made or kept under section 4 are required to be retained for one year and produced to the SFC upon request.

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<sup>2</sup> Section 3(2)(a) to (c) sets out the types of transactions which constitute ‘jobbing business’ for the purpose of the Rules. They are -

- (a) a sale of a security by a Stock Exchange of Hong Kong Limited (SEHK) market maker in the course of performing market making activities for that security (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 SEHK market maker 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 third security as a common component); or
- (c) a sale of security (“C”) for the purpose of hedging a market making position in a futures contract by a Hong Kong Futures Exchange (HKFE) market maker as long as C and the futures contract position being hedged are related (this would include where the futures contract is in respect of C or an index of securities which includes C, or, where the futures contract is in respect of another security (“D”) and D has a common component with C).

11. Section 5 requires lenders of securities under a stock borrowing and lending agreement 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.

## **PUBLIC CONSULTATION**

12. On 24 May 2002, the SFC released a consultation document and an exposure draft of the Rules for comments by the public. A total of five submissions were received. The SFC has considered all the comments received, including subsequent comments received as part of a continuing dialogue with certain respondents, and has revised the draft Rules as appropriate.

13. A draft of the Rules was considered by the Subcommittee at its meeting held on 15 July 2002. No major concerns were expressed by members of the Subcommittee at the meeting.

## **FINANCIAL AND STAFFING IMPLICATIONS**

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

## **COMMENCEMENT DATE**

15. The Rules will come into operation on the day appointed for the commencement of the SFO, together with other subsidiary legislation necessary for the commencement. We expect this to take place shortly, after completion of the negative vetting procedure through the Legislative Council and allowing the industry a reasonable period of time for making necessary adjustments with reference to the subsidiary legislation. We aim to announce the target commencement date by the end of 2002.

## **PUBLICITY**

16. The Rules will be published in the Gazette on 13 December 2002. The SFC will issue a press release on the same day.

## **ENQUIRIES**

17. 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  
13 December 2002

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

(Made by the Securities and Futures Commission under sections 397(1) and 398(7) of the Securities and Futures Ordinance (Cap. 571), and under section 397(2) of that Ordinance after consultation with the Financial Secretary)

**1. Commencement**

These Rules shall come into operation on the day appointed for the commencement of the Securities and Futures Ordinance (Cap. 571).

**2. Interpretation**

In these Rules, unless the context otherwise requires –

“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;

“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, 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), 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;
- “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 Stock Exchange Company;
- “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, 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 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”) where D 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.

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

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

(1) Section 171(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 his receiving the short selling order, record the particulars as described in subsection (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 subsection (5).

(2) Section 171(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 that 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 subsection (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 subsection (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 subsection (5).

(3) Section 171(5) of the Ordinance does not have effect in relation to a specified short selling order 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 subsection (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 subsection (5).

(4) For the purposes of subsections (1)(a)(ii)(B), (2)(a)(ii)(B) and (C)(I) 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).

(5) Any person who records an oral assurance or particulars as described in subsection (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 subsection (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.

(6) For the purposes of this section, a “specified short selling order” 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 1 of Part 1 of Schedule 1 to the Ordinance.

**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 –

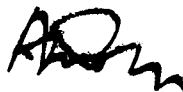
- (a) the name of the borrower;
- (b) the securities or group of securities borrowed, or available for borrowing and the quantity thereof; and
- (c) whether a blanket assurance or a hold has been given or a borrow has been entered into, and the time it was given or entered into (as the case may be).

(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) Where a lender under a securities borrowing and lending agreement is lending as an agent, such person shall be regarded as the lender for the purposes of subsections (1) and (2).

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



**Andrew Len Tao SHENG**  
Chairman,  
Securities and Futures Commission

*9<sup>th</sup> December,* 2002

### **Explanatory Note**

These Rules are made by the Securities and Futures Commission under sections 397 and 398 of the Securities and Futures Ordinance (Cap. 571) (“the Ordinance”). 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 of the Ordinance do not have effect. They also specify the record keeping requirements for lenders under securities borrowing and lending agreements.