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Panel on Financial Affairs

Meeting on 6 January 2012

Background brief on the proposal for a short position reporting regime

Purpose

This paper provides background information on the proposal of the Securities and Futures Commission (SFC) for a short position reporting regime and summarizes the relevant views and concerns expressed by Members.

Background

2. Under the Securities and Futures Ordinance (SFO) (Cap. 571), naked short selling is generally prohibited. Only covered short sales are allowed, in that, shares should be borrowed before placing a short selling order on the Stock Exchange of Hong Kong (SEHK) for execution. In addition, short selling orders must be "marked" so that the short selling transaction is traceable by the regulator (i.e. transactional reporting requirement).¹ Apart from the statutory requirements, SEHK has established selection criteria such that only liquid securities are allowed for short selling (known as Designated Securities).

3. With the experience gained during the global financial crisis in September 2008 and in line with the global efforts to enhance the effectiveness of regulation of short selling, SFC launched a public consultation

¹ Sections 170 - 172 of SFO

on increasing short position transparency in July 2009. The consultation conclusions were published in March 2010. In general, the proposal of introducing a new short position reporting regime was supported by the market. To implement the short position reporting regime, SFC planned to promulgate a set of new rules, namely the Securities and Futures (Short Position Reporting) Rules, to be made under sections 397(1) and 397(2) of SFO. SFC launched a public consultation on the draft rules in May 2011.

4. The Administration and SFC briefed the Panel on Financial Affairs (FA Panel) on SFC's proposal for a short position reporting regime on 4 July 2011. The key features of the proposed regime were as follows:

- (a) the threshold of reporting is 0.02% of the issued share capital of that particular listed company or \$30 million, whichever is lower, at the end of the last trading day of each week;
- (b) the scope is limited to shares of the constituent companies of the Hang Seng Index, Hang Seng China Enterprises Index and other financial companies specified by SFC;
- (c) the reporting requirement applies to short positions resulted from trading on the SEHK and other trading venues specified by SFC only;
- (d) the person who beneficially owns the reportable short position has the obligation to report, except for short positions held on trust, in which case the trustee is the reporting party;
- (e) SFC will set up an electronic reporting facility and prescribe a template to be used for reporting;
- (f) SFC will publish aggregated short position for each stock, on an anonymous basis, one week after the receipt of the reports; and
- (g) SFC will be empowered to tighten the reporting requirements in contingency situation.

5. The Administration considered that implementing the proposed short position reporting regime would enhance market transparency and was conducive to maintaining financial stability.

Discussion at the Panel on Financial Affairs

6. During the discussion of the FA Panel on 4 July 2011 on SFC's proposal for a short position reporting regime, members were mainly concerned whether the proposed short position reporting regime, in particular the proposed threshold for short position reporting, was in line with the relevant international standards and practices.

7. SFC advised that after the global financial crisis in September 2008, the International Organization of Securities Commissions published a report entitled "Regulation of Short Selling" which recommended, among other things, that short selling should be subject to a reporting regime providing timely information to the market or to market authorities. Australia had introduced a short position reporting regime in 2010. While the stock market in the United Kingdom (UK) had introduced a short position reporting regime during the global financial crisis, the European Union was in the process of formulating a standard short position reporting mechanism for compliance by all member countries.

8. As regards the threshold for short position reporting, SFC advised that in Australia, the threshold for short position reporting was set at 0.01% of the issued share capital of the relevant listed company or A\$100,000, whichever was lower. In the UK stock market, the threshold for short position reporting was 0.25% of the issued share capital of the relevant listed company, covering derivatives and shares of the company. SFC pointed out that there was not an international standard for setting the threshold for short position reporting, as each stock market had to take into account the characteristics of its own market in devising its short position reporting regime.

Council questions

9. At the Council Meeting on 12 November 2008, Hon Emily LAU raised a written question on short selling activities. Ms LAU enquired, inter alia, whether the Administration would follow the practices of certain overseas financial markets to ban short selling activities so as to maintain the stability of Hong Kong's financial system and strengthen investors' confidence. The Administration responded that some of the measures, such as prohibition of naked short selling, introduced by overseas jurisdictions against short selling had already been included in Hong Kong's short selling regime. The existing short selling regime in Hong Kong was robust, and SFC had not found any abusive short selling activities. SFC would continue to closely monitor short

selling activities in the stock market and would introduce market-wide control measures where necessary.

10. At the Council Meeting on 7 December 2011, Hon Frederick FUNG raised a written question on regulation of credit rating agencies in Hong Kong. Noting that the European Parliament had endorsed a ban on naked short selling in shares and sovereign debts, as well as in relevant credit default swaps, Mr FUNG enquired how the relevant trading activities were regulated in Hong Kong. The Administration replied that Hong Kong had banned naked short selling since the 1970s. In 2000, the maximum penalty for naked short selling had been increased from a fine of \$10,000 and imprisonment for six months to a fine of \$100,000 and imprisonment for two years. At the same time, new criminal offences were introduced for unreported short selling. Moreover, Hong Kong imposed the uptick rule, i.e. short selling below the best current ask price was prohibited in Hong Kong. SFC understood that currently only the European Union countries had imposed a ban on the purchase of credit default swaps without owning the related bonds, and there was no similar measure in other major overseas markets. The Government and regulators would continue to closely monitor the development in this regard.

Recent developments

11. On 18 October 2011, SFC announced the conclusions of the consultation on the draft Securities and Futures (Short Position Reporting) Rules. According to SFC, there was broad market support for the draft rules except that the industry had expressed difficulties in reporting short positions on a gross basis. In view of the concerns raised, SFC proposed to revise the draft rules to require reporting of net short positions and invited comments from the public on the modified draft rules.

12. The Administration and SFC will update the FA Panel on 6 January 2012 on the progress of the work for establishing a short position reporting regime.

Relevant papers

13. The relevant papers are available at the following links:

Written question raised by Hon Emily LAU at the Council meeting on 12 November 2008	Hansard (pages 93-95)
Meeting of the FA Panel on 4 July 2011	Administration's paper Minutes (paragraphs 35-41)
Written question raised by Hon Frederick FUNG at the Council meeting on 7 December 2011	Hansard (Floor version) (page 159-161)
Consultation on increasing short position transparency conducted by SFC in July 2009	Consultation paper (31 July 2009) Consultation conclusions (2 March 2010)
Consultation on the Securities and Futures (Short Position Reporting) Rules conducted by SFC in May 2011	Consultation paper (May 2011) Consultation conclusions and further consultation (18 October 2011)

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