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Paper for the House Committee meeting on 22 April 2016

**Report of the Subcommittee on Securities and Futures
(Short Position Reporting) (Amendment) Rules 2016**

Purpose

1.1. This paper reports on the deliberations of the Subcommittee on Securities and Futures (Short Position Reporting) (Amendment) Rules 2016 ("the Amendment Rules").

Background

2. Under the Securities and Futures Ordinance (Cap. 571) ("SFO"), naked short selling is generally prohibited. Only covered short sales are allowed, in that, shares should be borrowed before the person can place a short selling order on the Stock Exchange of Hong Kong ("SEHK") for execution. In addition, short selling orders must be "marked" so that a short selling transaction is traceable by the regulator (i.e. transactional reporting requirement).¹ As at 1 April 2016, there were 873 securities² that could be short sold under the rules of SEHK, known as Designated Securities.³ In general, the list of Designated Securities comprises stocks and collective investment schemes ("CISs") which include exchange traded funds, real estate investment trusts and other unit trusts/mutual funds.

¹ Sections 170 to 172 of SFO.

² The list of Designated Securities eligible for short selling effective from 7 March 2016 as published on the website of the Hong Kong Exchanges and Clearing Limited at http://www.hkex.com.hk/eng/market/sec_tradinfo/stkcdorder.htm.

³ In general, only securities with sufficient liquidity will be accepted as Designated Securities. The list of Designated Securities is published on the website of the Hong Kong Exchanges and Clearing Limited.

3. Following the collapse of Lehman Brothers in September 2008, regulators in a number of overseas markets took steps to enhance the effectiveness of regulation of short selling as part of the global regulatory reforms to restore investor confidence and to reduce systemic risk. In view of the global regulatory developments, the Securities and Futures Commission ("SFC") made the Securities and Futures (Short Position Reporting) Rules (Cap. 571AJ) ("SPR Rules"), which came into effect on 18 June 2012, to introduce a short position reporting regime in Hong Kong. The current regime covers the constituent stocks of the Hang Seng Index, Hang Seng China Enterprises Index and other financial stocks specified by SFC (collectively referred to as "specified shares"). According to SFC, as at 1 April 2016, there were 133 specified shares (i.e. a total of 133 stocks out of the Designated Securities) subject to short position reporting.

4. The SPR Rules impose a duty on a person who has a net short position in any of the specified shares that amounts to or exceeds the reporting threshold to report the short position to SFC on or before the reporting deadline. The reporting threshold is 0.02% of the market capitalization of the listed company concerned or \$30 million, whichever is lower. In normal market conditions, short positions are to be reported at the end of the last trading day each week (i.e. on a weekly basis). In contingency situations, SFC is empowered to require daily reporting of short positions in all the specified shares.

The Amendment Rules

5. The Amendment Rules are made by SFC under section 397(1) and (2) of SFO after consultation with the Financial Secretary to amend the SPR Rules to –

- (a) expand the scope of the short position reporting regime to cover all Designated Securities;
- (b) provide for separate thresholds for reporting short positions in relation to CISSs;
- (c) provide for the calculation of the net short position value in the specified shares where the closing price is expressed in a currency other than Hong Kong dollars;
- (d) provide that SFC may designate one or more electronic systems for reporting; and

- (e) add a requirement that the daily reporting requirement notice must identify the specified shares to which the notice relates.

The Amendment Rules will come into operation on 15 March 2017.

The Subcommittee

6. At the House Committee meeting on 11 March 2016, Members agreed to form a subcommittee to study the Amendment Rules. The membership list of the Subcommittee is in the **Appendix**. Under the chairmanship of Hon CHAN Kam-lam, the Subcommittee has held one meeting with the Administration and SFC.

7. To allow more time for scrutiny, the Chairman of the House Committee gave notice to move a motion at the Council meeting of 16 March 2016 to extend the scrutiny period of the Amendment Rules to 20 April 2016. However, the motion was not dealt with when the said Council meeting was adjourned on 18 March 2016. The scrutiny period for the Amendment Rules has therefore lapsed at the said Council meeting.

Deliberations of the Subcommittee

Implementation of the short position reporting regime

8. Question has been raised on the need to put in place a short position reporting regime, as well as the regulatory measures that can be taken by SFC to deal with irregularities. SFC explains that the reporting regime will enhance the transparency and monitoring of short selling activities, and is particularly important for maintaining market orderliness and stability at times of volatilities. It will enable SFC to ascertain whether there is a build-up of short positions by certain persons and where necessary, take appropriate actions to deal with suspected market manipulation. Currently, SFC is empowered under relevant legislation to make inquiry with the persons concerned regarding their holding of short positions. In extreme circumstances, SFC may also specify a limit on the short positions held by certain person(s) or require the person(s) concerned to reduce their short positions in specified shares.

9. A member has sought SFC's view on the implementation of the short position reporting regime since 2012, in particular whether any useful market information has been collected. The SFC has advised that the reporting regime has enhanced its monitoring of short-selling activities in Hong Kong. According to the information reported to SFC, over 70% of the short positions in

specified shares are held by investment banks while the remaining are mainly held by hedge funds. It appears that short positions are held by the investment banks mainly for the purposes of hedging market risks arising from their over-the-counter transactions.

10. Regarding a member's concern about possible collusion between different parties to manipulate the stock prices through short-selling activities, SFC highlights that the shares of listed companies with a smaller market capitalization are usually more vulnerable to manipulation. Many of the stocks outside the 133 specified shares belong to this type (i.e. such stocks are not subject to the short position reporting requirement under the existing SPR Rules). With the implementation of the Amendment Rules, the scope of the short position reporting regime will be expanded to cover all Designated Securities. The SFC will therefore be in a better position to monitor short-selling activities and take appropriate action in a timely manner to ensure market stability.

Reporting threshold

11. There is a view that the current reporting threshold (i.e. 0.02% of the market capitalization of the listed company or \$30 million, whichever is lower) is too low and may impose an undue compliance burden on investors.

12. In this connection, SFC advises that there is no single international standard on the reporting threshold. When devising the reporting threshold in 2012, SFC has made reference to the reporting requirements in overseas jurisdictions. For instance, some European markets adopt 0.2% of the issued share capital of the listed company as the reporting threshold with no alternative reporting threshold set with reference to a fixed monetary amount. Hong Kong has taken into account its own characteristics in devising its specific regime. On whether different reporting thresholds should be set with reference to the market capitalization of listed companies, SFC considers that such an approach would be too complicated for the Hong Kong market. According to SFC, it is not aware of any adverse feedback from the short position holders that the existing reporting threshold, which has been in operation since 2012, has given rise to an undue compliance burden.

13. The Subcommittee notes that there is no upper limit on the reportable short positions that can be held by a person. On whether the holding of heavy short positions would have an impact on the stock market, SFC highlights that a person must borrow the shares before placing an order for short-selling. Moreover, SFC is also empowered to take special measures under contingency market conditions.

Transparency of information on reportable short positions

14. Members consider it important to maintain transparency of the information on reportable short positions. The SFC has informed the Subcommittee that it publishes aggregated short positions for each specified share on an anonymous basis. This data is typically published on SFC's website three business days after the receipt of the weekly short position reports. As confirmed by SFC, it has not required daily reporting on short positions of specified shares since the SRP Rules come into effect in June 2012.

15. The Subcommittee notes that as advised by SFC, in the event that daily reporting of short position is required in contingency situations, a public notice identifying the relevant specified shares⁴ will be provided by SFC before daily reporting takes effect and the notice will also be published on SFC's website.

Designated electronic system

16. The Subcommittee notes that currently, short positions are reported through the Short Position Reporting Service, an online communication system designated by SFC. Noting that under the Amendment Rules, SFC may designate more than one electronic system for reporting, some members are concerned whether the cost for providing additional system(s) would be transferred to market participants by way of an increase in levy.

17. According to SFC, although it will be empowered under the Amendment Rules to designate more than one electronic system for reporting, it does not have any immediate plan to do so. The SFC explains that this proposal has been made to enhance flexibility in the light of comments from the market that SFC should explore the possibility of providing a fully automated electronic system that does not require any manual uploading of data to the regulator's system. On cost implications, SFC informs the Subcommittee that the existing Short Position Reporting Service has been developed by SFC with its own resources without separately charging market participants.

Recommendation

18. The Subcommittee does not object to the Amendment Rules.

⁴ Under rule 8 of the Amendment Rules, rule 7(2) of the SPR Rules will be amended such that the daily reporting requirement notice published by SFC will identify the specified shares to which the notice relates.

Advice sought

19. Members are invited to note the deliberations of the Subcommittee.

Council Business Division 4
Legislative Council Secretariat
20 April 2016

Appendix

Subcommittee on Securities and Futures (Short Position Reporting) (Amendment) Rules 2016

Membership list

Chairman Hon CHAN Kam-lam, SBS, JP

Members Hon Andrew LEUNG Kwan-yuen, GBS, JP
Hon Alan LEONG Kah-kit, SC
Hon Christopher CHEUNG Wah-fung, SBS, JP
Hon SIN Chung-kai, SBS, JP

(Total : 5 members)

Clerk Miss Polly YEUNG

Legal Adviser Miss Rachel DAI

Date 1 April 2016