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

**Background brief**

**Purpose**

This paper provides background information on the Securities and Futures (Short Position Reporting) (Amendment) Rules 2016 ("the Amendment Rules"), and summarizes the major views and concerns expressed by member on relevant issues including the short position reporting regime in Hong Kong during discussion at meetings of the Financial Affairs Panel ("FA Panel") in recent years.

**Background**

Regulatory framework for short selling

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).<sup>1</sup> As of 30 October 2015, there were 889 securities that could be short sold under the rules of SEHK, known as Designated Securities.<sup>2</sup> 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.

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<sup>1</sup> Sections 170 - 172 of the Securities and Futures Ordinance

<sup>2</sup> In general, only securities with sufficient liquidity will be accepted as Designated Securities. A list of Designated Securities which can be short sold is published on the website of Hong Kong Exchanges and Clearing Limited.

### The short position reporting regime

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") proposed the establishment of a new short position reporting regime in Hong Kong, and launched relevant consultations in July 2009, and May and October 2011. According to SFC, there was broad market support for the proposal.

4. To implement the short position reporting regime, the Securities and Futures (Short Position Reporting) Rules ("SPR Rules") and the Securities and Futures (Offences and Penalties) (Amendment) Regulation 2012 were tabled at the Council meeting of 28 March 2012, and the Securities and Futures (Short Position Reporting) Rules (Commencement) Notice was tabled at the Council meeting of 6 June 2012.<sup>3</sup> The short position reporting regime came into effect on 6 June 2012, and the requirement for SFC to publish the reportable short positions notified to it commenced on 7 September 2012. Key features of the reporting regime are as follows:

- (a) net short positions are to be reported;
- (b) the threshold of reporting is 0.02% of the issued share capital of a particular listed company or \$30 million, whichever is lower, at the end of the last trading day of each week;
- (c) the scope is limited to shares of the constituent companies of the Hang Seng Index ("HSI"), Hang Seng China Enterprises Index ("HSCEI") and other financial companies specified by SFC ("specified shares");
- (d) the reporting requirement applies to short positions in any specified shares established via trades executed on SEHK or other trading venues specified by SFC;
- (e) SFC will set up an electronic reporting facility and specify a form for reporting;
- (f) SFC will publish the aggregated short position for each stock, on an anonymous basis, within three business days after the receipt of the reports;

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<sup>3</sup> No subcommittees have been formed to scrutinize the three pieces of subsidiary legislation.

- (g) in normal circumstances, the report is to be made once a week, and SFC will be empowered to tighten the reporting requirements in a contingency situation by publishing a notice in the Gazette, in which case, the report is to be made for each trading day; and
- (h) breaches of the reporting requirements in (g) above will be an offence with penalty.

### Consultation on expanding the scope of the short position reporting regime

5. According to SFC, as at 30 October 2015, only 127 of the 889 Designated Securities were subject to the short position reporting regime. SFC has observed that short selling activities of the remaining 762 Designated Securities not subject to short position reporting have grown to become significant. SFC conducted a public consultation on the proposal to expand the scope of short position reporting and on the draft Amendment Rules from 27 November to 31 December 2015. Having regard to the feedback<sup>4</sup> to the consultation, SFC concluded that expanding the scope of short position reporting to all Designated Securities would be appropriate for the Hong Kong market.

### **The Securities and Futures (Short Position Reporting) (Amendment) Rules 2016**

6. The Amendment Rules were made by SFC under section 397(1) and (2) of SFO after consultation with the Financial Secretary to amend the SPR Rules. The key features are as follow:

- (a) to expand the scope of the existing short position reporting regime to cover all Designated Securities;
- (b) to provide for separate thresholds for reporting short positions in relation to CISs<sup>5</sup>;
- (c) to 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;

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<sup>4</sup> A majority of the financial institutions and professional associations that responded to the consultation supported the proposal while there were individual commentators who raised objection and proposed to do away with the SPR Rules altogether or to raise the reporting threshold.

<sup>5</sup> The current reporting threshold of 0.02% of the issued share capital of a particular listed company or \$30 million, whichever is lower, will remain unchanged. The reporting threshold trigger for CISs will be set at \$30 million.

- (d) to provide that SFC may designate one or more electronic systems for reporting; and
- (e) to add a requirement that the daily reporting requirement notice must identify the specified shares to which the notice relates.

7. Details of the Amendment Rules are set out in paragraph 13 of the Legislative Council Brief (issued by SFC on 24 February 2016), and paragraph 7 of the Legal Service Division Report (LC Paper No. LS41/15-16).

8. The Amendment Rules were published in the Gazette on 26 February 2016 and tabled before the Legislative Council at the meeting of 2 March 2016. The Amendment Rules will come into operation on 15 March 2017.

### **Views and concerns expressed by members of the Panel on Financial Affairs**

9. The Administration and SFC briefed FA Panel on the proposal to introduce a short position reporting regime at the meetings on 4 July 2011 and 6 January 2012. FA Panel was consulted on the proposal to expand the scope of the short position reporting regime at the meeting on 15 February 2016. The major views and concerns expressed by members at the above meetings are summarized in the ensuing paragraphs.

#### Implementation of the short position reporting regime

10. During the discussion of the proposal to establish a new short position reporting regime at the FA Panel meetings on 4 July 2011 and 6 January 2012, members enquired about the rationale for devising a short position reporting regime in Hong Kong, and whether the proposed regime was in line with the relevant international standards and practices. Some members considered that the reporting threshold was set at a relatively low level (i.e. 0.02% of the issued share capital of a particular listed company or \$30 million, whichever was lower), and expressed concern about the low threshold imposing an undue compliance burden on investors conducting short selling. There were also concerns about potential circumvention of the reporting requirements by short sellers through reducing the short position to below the reporting threshold before reporting their short positions, and short selling the same stock through multiple intermediaries.

11. SFC advised that after the global financial crisis in September 2008, the International Organization of Securities Commissions ("IOSCO") 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 and market authorities. A number of major stock markets had introduced or contemplated the establishment of short position reporting regimes. The proposed short position reporting regime in Hong Kong was in line with the practice of other major stock markets in the world. The regime would also enable SFC to monitor the build up of short positions in the Hong Kong market, and take appropriate actions to deal with the situation as and when necessary.

12. On the reporting threshold, SFC advised that a balance had to be struck between minimizing compliance burden on short sellers and enhancing market transparency for regulators. There was no international standard on the reporting threshold, and each stock market had to take into account its market characteristics in devising its own regime. It was observed that the Australian stock market had set the threshold at 0.01% of the issued share capital of the relevant listed company or A\$100,000. The proposed reporting threshold was set given the similarities of the Hong Kong and Australian stock markets and the significant variance of the issued share capitals of the constituent companies of HSI and HSCEI, and having regard to the feedback to the public consultation exercises. SFC would review the threshold sometime after implementation of the regime.

13. As regards concerns about possible circumvention of the reporting requirements, SFC advised that based on the proposal, a short seller was required to report any reportable short position at the end of the last trading day of each week, and to report on a net basis. If a person had a net short position above the reporting threshold, the person was required to report the net short position, irrespective of whether the relevant stock was traded through multiple intermediaries. Since short selling usually formed part of the overall investment strategy, it was unlikely that a short seller would deliberately change the short position at the end of the week in order to circumvent the short position reporting requirements.

14. During the briefing on SFC's proposal to expand the scope of the short position reporting regime at the FA meeting on 15 February 2016, members enquired about the review of the existing short position reporting regime since its introduction in June 2012. SFC advised that taking into account different views from stakeholders on the proposed short position reporting regime in 2012, SFC then decided that the regime should only cover some of the Designated Securities. Having regard to developments in short selling activities since 2012, such as significant growth in short selling activities of securities not covered in the reporting regime, including CISs, SFC had proposed to expand the scope of the reporting regime to cover all Designated Securities.

### Regulation of short selling activities

15. At the FA meetings 6 January 2012 and 15 February 2016, some members raised concern that the short selling system in Hong Kong would only facilitate large overseas investment institutions/investors to manipulate the stock market. They considered that given the existing restrictions on short selling, small investors were unable to participate in short selling activities and this had created an unlevel playing field in the stock market. As short selling activities had a significant impact on share prices, members also enquired about measures the Administration and SFC would take to protect small investors, and whether SFC would consider suspending short selling activities under extreme market situations.

16. SFC advised that while short selling was a highly sophisticated investment activity undertaken mostly by large investment institutions and investors, it was a legitimate means for such institutions and investors to manage risks and conduct arbitrage. On the issues of providing a level playing field in the market and investor protection, the Administration and SFC advised that when a new financial product emerged in the market, the Government and the regulatory bodies would assess the merits and/or impact of the product and liaise with the relevant sectors to devise measures to regulate the relevant product/market activities. They would also strike a balance between market development and investor protection in implementing measures to regulate the stock market. At members' request, the Administration provided supplementary information on short selling activities in Hong Kong, including short selling transactions handled by participant brokers, and benefits of short selling for stock market and investors.<sup>6</sup>

17. As regards the suspension of short selling activities, SFC advised that during the global financial crisis in 2008, a number of countries including the United States, Australia and some member countries of the European Union had temporarily suspended short selling activities. It was later considered more appropriate to implement a short position reporting regime in order to better understand short selling activities and enhance market transparency instead of banning the activities. SFC added that in formulating the regulatory measures on short selling activities, it would strike a balance between facilitating market development and maintaining orderliness and stability of the market.

### Regulatory cooperation between Hong Kong and the Mainland

18. At the FA Panel meeting on 15 February 2016, noting the increasing interconnection between the Mainland and Hong Kong market through

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<sup>6</sup> The supplementary information provided by SFC was circulated to members vide LC Paper No. CB(1)969/11-12 on 11 February 2012.

implementation of measures such as the Shanghai-Hong Kong Stock Connect ("SH-HK SC"), some members enquired how regulators of both sides would combat short selling activities aiming to manipulate the market. They also sought details on the regulatory co-operation between SFC and the China Securities Regulatory Commission in providing mutual assistance in respect of enforcement actions against shorting selling activities in their markets, and addressing regulatory loopholes arising from differences between their regulatory regimes.

19. On the cooperation between SFC and regulators of other jurisdictions including the Mainland, SFC pointed out that while it had signed agreements under IOSCO with other regulators for providing mutual assistance in investigation and enforcement, regulators of other jurisdictions could not take enforcement actions by themselves in Hong Kong. As regards the short selling regimes in the Hong Kong and the Mainland, SFC clarified that Hong Kong investors could not easily short sell A-shares through SH-HK SC, and Mainland investors were not permitted to conduct short selling in the Hong Kong market. The proposed expansion in the scope of the short position reporting regime could enhance transparency of short selling activities in Hong Kong as currently some H-shares were not subject to short position reporting.

### **Latest development**

20. At the House Committee meeting on 11 March 2016, Members agreed to form a subcommittee to examine the Amendment Rules.

### **Relevant papers**

21. A list of relevant papers is in the **Appendix**.

## Appendix

### List of relevant papers

Date	Event	Paper/Minutes of meeting
July 2009 – September 2009	Consultation on increasing short position transparency conducted by the Securities and Futures Commission ("SFC")	<a href="#"><u>Consultation paper</u></a>  <a href="#"><u>Consultation conclusions</u></a>
May 2011 – November 2011	Consultations on the Securities and Futures (Short Position Reporting) Rules conducted by SFC	<a href="#"><u>Consultation paper</u></a>  <a href="#"><u>Consultation conclusions and further consultation</u></a>  <a href="#"><u>Conclusions on further consultation</u></a>
4 July 2011	The Panel on Financial Affairs ("FA Panel") was briefed on the proposal on short position reporting regime	<a href="#"><u>Administration's paper</u></a> (LC Paper No. CB(1)2601/10-11(02))  <a href="#"><u>Minutes</u></a> (LC Paper No. CB(1)324/11-12)
6 January 2012	FA Panel was further briefed on the proposal on short position reporting regime	<a href="#"><u>Administration's paper</u></a> (LC Paper No. CB(1)732/11-12(03))  <a href="#"><u>Minutes</u></a> (LC Paper No. CB(1)1145/11-12)  Follow-up papers <u>1</u> and <u>2</u> (LC Paper Nos. CB(1)969/11-12(01) and (02))
28 March 2012	The Securities and Futures (Short Position Reporting) Rules and the Securities and Futures (Offences and Penalties) (Amendment) Regulation 2012 were tabled in the Legislative Council ("LegCo")	<a href="#"><u>Legislative Council Brief</u></a> (File Ref.: SUB14/1/4(2010))  <a href="#"><u>Legal Service Division Report</u></a> (LC Paper No. LS51/11-12)



Date	Event	Paper/Minutes of meeting
6 June 2012	The Securities and Futures (Short Position Reporting) Rules (Commencement) Notice was tabled in LegCo	<a href="#">Legislative Council Brief</a> <a href="#">Legal Service Division Report</a> (LC Paper No. LS77/11-12)
November 2015 – December 2015	Consultation on expanding the scope of short position reporting conducted by SFC	<a href="#">Press release</a> <a href="#">Consultation paper</a> <a href="#">Consultation conclusions</a>
15 February 2016	FA Panel was briefed on the proposed expansion of the short position reporting regime	<a href="#">Administration's paper</a> (LC Paper No. CB(1)440/15-16(07))
2 March 2016	The Securities and Futures (Short Position Reporting) (Amendment) Rules 2016 were tabled in LegCo	<a href="#">Content of the subsidiary legislation</a> (L.N. 39 of 2016) <a href="#">Legislative Council Brief</a> <a href="#">Legal Service Division Report</a> (LC Paper No. LS41/15-16)