For discussion
on 1 February 2016

Legislative Council Panel on Financial Affairs

Proposed expansion of the scope of the short position reporting regime in Hong Kong

PURPOSE

This paper briefs the Panel on the proposal of the Securities and Futures Commission ("SFC") to expand the scope of the short position reporting regime in Hong Kong to cover all securities that can be short sold.

BACKGROUND

2. 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[1] as part of the global regulatory reforms to restore investor confidence and to reduce systemic risk. In view of the global regulatory developments, the SFC introduced a short position reporting regime in Hong Kong. On 18 June 2012, after public consultation, the Securities and Futures (Short Position Reporting) Rules (Cap. 571AJ) ("SPR Rules") which implemented the short position reporting requirement came into effect.

3. In brief, the current short position reporting regime covers the constituent stocks of the Hang Seng Index ("HSI"), Hang Seng China Enterprises Index ("HSCEI") and other financial stocks specified by the

[1] The International Organization of Securities Commissions ("IOSCO") published in June 2009 the final report on "Regulation of Short Selling" which sets out four high-level principles for effective regulation of short selling. One of the four principles relates to the merits of enhancing transparency on short selling. The IOSCO recommended "*short selling should be subject to a reporting regime that provides timely information to the market or to market authorities*." Reporting requirements were introduced in major markets including the US, the EU, Australia and Japan.

SFC ("specified shares")[2]. If a short seller has a net short position in any specified shares at the end of the last trading day of each week which equals to or exceeds 0.02% of the market capitalization of the listed issuer concerned or $30 million ("Reporting Threshold"), whichever is lower, it must notify the SFC of the short position within two business days. The short seller has to continue to report until its net short position value falls below the Reporting Threshold.

4. The SFC publishes aggregated short position for each stock, on an anonymous basis, one week after the reporting day. The SFC has been publishing the information on its website on a weekly basis since September 2012.

5. The SFC is empowered to require daily reporting on short positions in circumstances (whether in Hong Kong or otherwise) that would pose a threat to the financial stability of Hong Kong. The change from weekly reporting to daily reporting will enable the SFC to receive timely information during a contingency situation.

6. Since the introduction of the regime, the SFC has gained a better insight into short selling activities of the specified shares based on the short position reports. The following are some key observations -

(a) the aggregated market value of short positions has been in the range of 1.0% to 1.5% of the total market capitalization of the specified shares;

(b) the market value of the aggregated short positions was $198 billion as of 31 December 2015, compared to $191 billion as at the end of 2014;

(c) as of 31 December 2015, the top 10 stocks with the largest short positions by market value accounted for about 49% of aggregated short positions; and

(d) top short position holders were mainly investment banks. Other short position holders included funds, market makers and individuals.

[2] As of 30 October 2015, a total of 127 stocks were subject to the short position reporting. The constituent stocks of the HSI and the HSCEI and the financial stocks specified by the SFC may change from time to time and as a consequence, this number will change accordingly.

THE SFC'S PROPOSAL TO EXPAND THE SCOPE OF SHORT POSITION REPORTING REGIME

7. On 27 November 2015, the SFC issued a consultation paper to consult the public on the proposal to expand the scope of short position reporting and a few other enhancements, and on the corresponding amendments to the SPR Rules. Respondents were requested to revert with comments by 31 December 2015.

Expanding the scope of reporting

8. As of 30 October 2015, there were 889 securities that could be short sold under the rules of The Stock Exchange of Hong Kong Limited ("SEHK"), known as Designated Securities[3]. The list of Designated Securities is published on the website of the Hong Kong Exchanges and Clearing Limited ("HKEx").[4] In general, the list comprises stocks and collective investment schemes ("CISs") which include exchange traded funds ("ETFs"), Real Estate Investment Trusts and other Unit Trusts/Mutual Funds.

9. The 127 specified shares that were subject to short position reporting as of 30 October 2015 was a subset of the 889 Designated Securities. Under the existing short position reporting regime, the SFC does not require short position reporting on the remaining 762 Designated Securities.

10. The short selling activities of these 762 Designated Securities have grown to become significant. During the period from January to October 2015, they accounted for about 44% of the short selling turnover in the Hong Kong market. The SFC estimated that the aggregated short positions in these securities could be over $100 billion. In addition, during the same period, the short selling turnover of some of these Designated Securities represented about 13% of the turnover of these stocks which was higher than the average 9% for the market as a whole. In

[3] In general, only securities with sufficient liquidity will be accepted as Designated Securities. The current list of Designated Securities include constituent stocks of equity indices, ETFs, underlying stocks of options and futures contracts as well as other stocks with a relatively large market capitalisation and turnover volume. For details on the categories of securities that may be designated as Designated Securities, please refer to the Eleventh Schedule to the Short Selling Regulations of the Rules of the SEHK: http://www.hkex.com.hk/eng/rulesreg/traderules/sehk/Documents/sch-11_eng.pdf

[4] See http://www.hkex.com.hk/eng/market/sec_tradinfo/stkcdorder.htm

a few cases, the short selling turnover reached a level as high as 69% of the overall turnover.

11. CISs and in particular, ETFs have also grown over the past few years to become an important segment of the Hong Kong market. In 2012, the trading of CISs only accounted for 4% of the total market turnover. However, during the period from January to October 2015, that percentage increased to 9%. During the same period, short selling turnover of CISs accounted for about 24% of the daily trading turnover of these CISs and 22% of daily short selling turnover of the entire Hong Kong market. ETFs were the most actively short-sold CISs.

12. In view of the development of short selling activities in the Hong Kong market, there is a need to expand the coverage of the SPR Rules to obtain more comprehensive information on short selling activities to further improve the transparency and monitoring of short selling activities. Thus, the SFC proposes to expand the scope of the short position reporting regime to cover all Designated Securities. Other major markets, such as the EU and the US, require short position reporting on all listed securities. This is also the case in Australia and Japan.

Threshold trigger for reporting short positions in relation to collective investment schemes

13. The existing Reporting Threshold as mentioned in paragraph 3 above was set after taking into consideration various factors such as the size of the listed companies, market capitalization, liquidity, the type of market participants and investors and their trading activities. The SFC notes that the market value of some of the securities proposed to be subject to short position reporting is generally smaller than that of the current specified shares (mainly the index constituent stocks) and hence, it may be argued that a different reporting threshold trigger is to be considered. However, the SFC is mindful that the reporting regime may become too complex if different reporting thresholds were to apply to different classes of stocks. To avoid complications, the SFC proposes that the existing Reporting Threshold will apply to all Designated Securities except CISs.

14. For those Designated Securities that are CISs, which include open-ended CISs, it would be impractical and inappropriate to set the reporting threshold by referencing them to market capitalization given that the value of market capitalization depends on the total number of outstanding units or shares which number can change frequently and substantially as a result of the daily creation and redemption process. The

SFC proposes that the reporting threshold trigger for short positions in CISs will be set only at the HK$30 million threshold.

Designated Securities that are traded in foreign currency

15. There may be some Designated Securities which are traded in a foreign currency (i.e. US dollars or Renminbi) or are traded in multiple currencies. To determine the value of a net short position in relation to these Designated Securities, where the trade price is expressed in a foreign currency, the closing price should first be converted into Hong Kong dollars. It is proposed to adopt the rate of exchange for that foreign currency which is the buying rate for telegraphic transfers on the reporting day, as determined by the Hong Kong Monetary Authority ("HKMA"). In practice, the applicable rate of exchange can be obtained from the website of the HKEx.[5] This conversion arrangement is the current practice in relation to reportable stocks that are denominated in Renminbi.

Reporting in contingency situations

16. Under the SPR Rules, the SFC is empowered to change the reporting frequency from weekly to daily in a contingency situation. When short position reporting is extended to cover all Designated Securities, the SFC recognizes that it could be operationally burdensome for market participants if daily reporting on short positions in all Designated Securities is required. Moreover, depending on the market situation, the SFC may not need the daily reporting of short positions for all Designated Securities. Therefore, the SFC proposes that, in contingency situations, the SFC will determine the Designated Securities that will be subject to daily reporting ("Daily Reporting Securities"). A public notice identifying the Daily Reporting Securities will be provided by the SFC before daily reporting takes effect. Depending on the prevailing market situation, the SFC may decide to stop daily reporting on one or more of the Daily Reporting Securities. In this regard, the SFC will issue a public cessation notice to notify market participants accordingly.

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5 The HKEx publishes these exchange rates to be used for calculating stamp duty on a particular day (as determined by the HKMA) under section 18 of the Stamp Duty Ordinance (Cap. 117): http://www.hkex.com.hk/eng/market/sec_tradinfo/stampfx/stampfx.asp

Reporting through SFC designated electronic system

17. Currently, market participants must report short positions using an electronic system developed by the SFC specifically for this purpose. In view of the rapid pace at which technology evolves, the SFC takes this opportunity to provide for the flexibility in the SPR Rules such that the SFC may adopt more than one electronic system for reporting in the future.

COMMENTS FROM THE PUBLIC

18. A majority of the financial institutions and professional associations that responded to the consultation supported the proposal while there were individual commentators who raised concerns about the proposal. The SFC is studying the comments received and will take them into consideration before finalising the proposal.

WAY FORWARD

19. The SFC aims to issue the consultation conclusions by the end of February 2016 and table the proposed rule amendments to the Legislative Council for negative vetting in March 2016.

20. The SFC will provide the market with an indicative implementation time table when it publishes the consultation conclusions. In this regard, reasonable lead time will be given to market participants to prepare their reporting systems and procedures to comply with the amended SPR Rules.

ADVICE SOUGHT

21. The Panel is invited to note the above proposal to expand the scope of the short position reporting regime in Hong Kong.

Financial Services and the Treasury Bureau
Securities and Futures Commission
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