

**Ref.: C9/29C**

## **LEGISLATIVE COUNCIL BRIEF**

Securities Ordinance  
(Chapter 333)

### **SECURITIES (AMENDMENT) BILL 1999**

#### **INTRODUCTION**

At the meeting of the Executive Council on 7 December 1999, the Council ADVISED and the Acting Chief Executive ORDERED that the Securities (Amendment) Bill 1999, at Annex A, should be introduced into the Legislative Council.

#### **BACKGROUND AND ARGUMENT**

##### **General Background**

2. Short selling is a common practice in many major overseas stock markets and an integral part of a well-developed stock market. It is however widely accepted that there should be sufficient prudential and surveillance measures to ensure the fairness and transparency of such activities and the market efficiency they provide. In Hong Kong, pursuant to section 80 of the Securities Ordinance (SO), a person shall not sell securities at or through the Stock Exchange of Hong Kong (SEHK) unless, at the time he sells them, he or his principal (if he is selling as an agent) has or reasonably and honestly believes that he has or his principal has a presently exercisable and unconditional right to vest the securities in the purchaser of such securities<sup>1</sup>. Contravention of the provision constitutes an offence liable on conviction to a fine of \$10,000 and to imprisonment for six months.

3. There is no specific reporting or disclosure requirement for short selling under the existing law. Members of SEHK are, however, bound by the requirements under the Rules of SEHK to report a short selling order. The SEHK Rules provide that if a Member knows or is informed that an order to

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<sup>1</sup> A sale of securities whereby the seller, at the time of selling the securities, does not have a presently exercisable and unconditional right to vest the securities in the purchaser of such securities is commonly known as “naked” or “uncovered” short selling.

sell is a short selling order, he should disclose the order as such; where he is acting as an agent, he should ascertain that his principal has a presently exercisable and unconditional right in respect of the securities to which the short selling order relates. The SEHK Rules however do not have the force of law and breaches could only be subject to the disciplinary actions of the SEHK including in the extreme case suspension and removal of membership.

### **The Problem**

4. Although covered short selling is legal and subject to the Rules of the SEHK, such activities if unreported would be capable of circumventing the regulation over short selling and from a market regulation point of view is of the same effect as blatant “naked” short sales. It is therefore necessary to put unreported short sales on par with “naked” short sales in order to maintain effective regulation and uphold market discipline. It is also necessary to increase penalties against “naked” short selling to strengthen the deterrent effect.

### **The Proposal**

5. In early September 1998, the Financial Secretary announced a 30-Point Programme to further strengthen the discipline and transparency of the securities and futures markets. One of the proposed measures is to strengthen the regulation of short selling in Hong Kong to safeguard the markets from the failure of price-discovery and lack of transparency brought about by non-compliance with the disclosure rules of short selling.

6. Under the proposal, a person selling as a principal is obliged to inform his agent if the sale order is a short selling order and provide to the agent an assurance that he has a presently exercisable and unconditional right in respect of the relevant securities. If he obtains such a right by virtue of entering into a securities borrowing and lending (SBL) agreement or other similar agreements, he must also provide an assurance that all relevant parties to the agreement will provide the securities to which the short selling order relates. In addition, the person is required to provide such other information as prescribed by regulations made by the Securities and Futures Commission (SFC). Under the current proposal, this may include a unique reference code and documentary proof received from the stock lender that the relevant securities will be on hold for the borrower. Other additional information that SFC considers necessary having regard to the prevailing market circumstances may also be included. The Bill further requires that a market intermediary (including a securities dealer, an exempt dealer and a stockbroker) should only

accept or convey a short selling order if he has obtained from his principal (i.e. the beneficiary short seller) an assurance as described above or he possesses such information as prescribed by SFC. Contravention of the above requirements will be liable on conviction to a fine of \$50,000 (level 5) and to imprisonment for 1 year.

7. In addition, to strengthen the deterrent effect against “naked” short selling, it is also proposed under the 30-point Programme to increase the existing penalties to a maximum fine of \$100,000 (level 6) and an imprisonment of two years.

8. To further enhance transparency of short selling activities, it is proposed to extend the rule making power of SFC under section 146(ra) of SO to enable SFC to make rules to require short sellers to disclose to the brokers when they close out their outstanding short positions by purchases at or through the SEHK. Moreover, given that securities borrowing and lending activities are always complementary to short selling activities, we propose to provide SFC with additional rule making powers to provide for the record keeping by a lender under a securities borrowing and lending agreement. This would help strengthen the surveillance capability of SFC by allowing a proper audit trail to check if the short seller has been given a “hold” of the relevant securities by the lender before the short selling order is executed.

## **THE BILL**

9. Clause 3 of the Bill amends the SO to increase the penalties against illegal short selling.

10. Clause 4 of the Bill introduces three new sections to provide for -

- a) new definitions for the purposes of those new sections;
- b) an obligation to confirm short sale; and
- c) an obligation to disclose short sale.

11. Clause 5 of the Bill revises the rule making power of the SFC under section 146(1) to provide the SFC with the additional power to request information from investors to enhance the transparency of the stock market. SFC will also be enabled to make rules to require a lender under a SBL agreement to keep such records in such manner as prescribed by the rules.

12. Extracts of the relevant provisions in the SO are at Annex B for ease of reference.

## **PUBLIC CONSULTATION**

13. The proposal to increase the penalty for naked short selling and to criminalize unreported short selling is part of the 30-point programme unveiled by the Financial Secretary in September 1998 which has been widely publicised thereafter. The SEHK at the executive level has been consulted and their views have been taken into account in the course of the preparation of the legislative proposal. That notwithstanding, some stockbrokers and market intermediaries may have mixed reactions to the proposal. Although they have already been subject to similar requirements under the applicable Exchange Rules and Code of Conduct issued by the SFC, some brokers and intermediaries may object to the higher penalties as well as the criminalisation of unreported short selling. However, on balance and bearing in mind the potential risk and disorder that unregulated short selling may bring on the market, it is considered that the proposal is necessary.

14. Separately, the SFC has also consulted the stock lending and borrowing industry on the practical implementation of the proposed rules. We do not think any further public consultation is necessary.

## **BASIC LAW IMPLICATIONS**

15. The Department of Justice advises that the proposed legislation does not conflict with those provisions of the Basic Law carrying no human rights implications.

## **HUMAN RIGHTS IMPLICATIONS**

16. The Department of Justice advises that the proposed legislation is consistent with the human rights provisions of the Basic Law.

## **BINDING EFFECT OF THE BILL**

17. The amendments will not affect the current binding effect of the existing provisions of the Ordinance covered by the Bill.

## **FINANCIAL AND STAFFING IMPLICATIONS**

18. The proposal has no financial and staffing implications for the Government.

### **ECONOMIC IMPLICATIONS**

19. The proposed measures will help enhance the transparency and integrity of the securities market, and hence will be conducive to healthy development of the market.

### **LEGISLATIVE TIMETABLE**

20. The legislative timetable as approved by the Executive Council is as follows -

Publication in the Gazette	17 December 1999
First Reading and commencement of Second Reading debate	5 January 2000
Resumption of Second Reading debate, committee stage and Third Reading	to be notified

### **PUBLICITY**

21. A press release will be issued on 15 December 1999 and the Bill will be published in the Gazette on 17 December 1999. A spokesman will be available for answering media enquiries.

### **ENQUIRIES**

22. For any enquiries on this brief, please contact Mr. Bryan Chan, Principal Assistant Secretary for Financial Services at 2528 9161.

Financial Services Bureau  
File Reference: C9/29C

A BILL

To

Amend the Securities Ordinance.

Enacted by the Legislative Council.

**1. Short title**

This Ordinance may be cited as the Securities (Amendment) Ordinance 1999.

**2. Calls by registered dealers**

Section 73(4) of the Securities Ordinance (Cap. 333) is amended by repealing “售賣人” and substituting “賣方”.

**3. Short selling restricted**

Section 80(2) is amended by repealing “of \$10,000 and to imprisonment for 6 months” and substituting “at level 6 and to imprisonment for 2 years”.

**4. Sections added**

The following are added -

**“80A. Interpretation for purposes  
of sections 80A to 80C**

In this section and sections 80B and 80C -

“assurance” (保證) means an assurance under section 80B(1), (2) or (3);

“securities borrowing and lending agreement” (證券借貸協議) -

- (a) means an agreement whereby a person borrows or lends securities pursuant to an arrangement where the borrower undertakes to return securities of the same description to the lender or pay the equivalent value of the securities;
- (b) includes a stock borrowing within the meaning of section 19(16) of the Stamp Duty Ordinance (Cap. 117);

”short selling order” (賣空指示) means an order to sell securities in respect of which a seller or a person, for whose benefit or on whose behalf the order is made, has a presently exercisable and unconditional right to vest the securities in the purchaser of them by virtue of having -

- (a) entered into a securities borrowing and lending agreement with another person;
- (b) entered into an agreement with another person under which the seller or the first-mentioned person is required to return the securities or pay the equivalent value of the securities to which the order relates;
- (c) a title to other securities which are convertible into or exchangeable for the securities to which the order relates;
- (d) an option to acquire the securities to which the

order relates;

(e) rights or warrants to subscribe to and to receive the securities to which the

order relates; or

(f) entered into with another person an agreement or an arrangement of a

description as is prescribed under section 146.

**80B. Obligation to confirm short sales**

(1) A person, where he is selling as a principal, shall not convey a short selling order at or through the Unified Exchange unless he provides to his agent -

(a) an assurance (which shall be in the form of a document) that -

(i) he has a presently exercisable and unconditional right to vest the securities to which the order relates in the purchaser of them; and

(ii) where paragraph (a), (b) or (f) of the definition of “short selling order” is applicable, all the relevant parties to the agreement or arrangement concerned referred to in that paragraph will provide the securities to which the order relates; and

(b) such information (which shall be in the form of a

document), if any, as is prescribed under section 146.

(2) A stockbroker, where he is selling as a principal, shall not convey a short selling order referred to in paragraph (a), (b) or (f) of the definition of “short selling order” at or through the Unified Exchange unless he -

(a) has received an assurance (which shall be in the form of a document) from all the relevant parties to the agreement or arrangement concerned referred to in that paragraph that they will provide the securities to which the order relates; and

(b) possesses such information (which shall be in the form of a document), if any, as is prescribed under section 146.

(3) A person, where he is selling as an agent, shall not accept or convey an order to sell securities which is a short selling order at or through the Unified Exchange unless he has received from his principal or other person, for whose benefit or on whose behalf the order is made -

(a) an assurance (which shall be in the form of a document) that -

(i) his principal or that other person, as the case may be, has a presently exercisable and unconditional right to

vest the securities to which the order relates in the purchaser of them; and

(ii) where paragraph (a), (b) or (f) of the definition of “short selling order” is applicable, all the relevant parties to the agreement or arrangement concerned referred to in that paragraph will provide the securities to which the order relates; and

(b) such information (which shall be in the form of a document), if any, as is prescribed under section 146.

(4) The stockbroker or other person who receives or possesses the document containing the assurance and the information shall -

(a) subject to paragraph (b), retain it for not less than 1 year from the date upon which it is received;

(b) provide it to the Commission upon request made at any time within that year by an employee of the Commission.

(5) An assurance shall in any proceedings be admissible as prima facie evidence of the matters specified in subsection (1), (2) or (3) to which the assurance relates.

(6) A person who contravenes subsection (1), (2), (3) or

(4) shall be guilty of an offence and shall be liable on conviction to a fine at level 5 and to imprisonment for 1 year.

**80C. Obligation to disclose short sales**

(1) A stockbroker or stockbroker's representative who knows or is informed that an order to sell securities is a short selling order shall -

(a) when passing the order to any other person with a view that the other person shall input the order into the trading system of the Unified Exchange, inform such other person that the order is a short selling order;

(b) when inputting the order into the trading system of the Unified Exchange, indicate such matters as may be required under the applicable rules of the Unified Exchange to show that the order is a short selling order.

(2) For the purposes of this section, "stockbroker's representative" (股票經紀代表) means a registered dealer's representative of a stockbroker.

(3) A person who, without reasonable excuse, contravenes subsection (1) shall be guilty of an offence and shall be liable on conviction to a fine at level 5 and to imprisonment for 1 year."

## 5. Regulations

Section 146(1) is amended -

(a) in paragraph (ra), by repealing “seller is derived from such an arrangement” and substituting “purchaser is derived from such an arrangement, and requiring such person, having sold such securities pursuant to such an arrangement, who purchases securities at or through the Unified Exchange in satisfaction, in whole or in part, of the obligations of that person under such arrangement to notify the stockbroker through whom such purchase or purchases are being effected of that fact”;

(b) by adding -

“(raa) providing that a lender under a securities borrowing and lending agreement within the meaning of section 80A shall keep such records or documents and in such manner and form as may be prescribed by the rules;”.

### Explanatory Memorandum

The main purpose of this Bill is to amend the Securities Ordinance (Cap. 333) to provide a measure of protection to investors in securities by regulating the activities of those persons who carry on short selling activities (see the definition of “short selling

order” in new section 80A at clause 4).

2. Clause 4 adds 3 new sections -

(a) new section 80A defines the terms “assurance”, “securities borrowing and lending agreement” and “short selling order” used in the new sections;

(b) new section 80B provides that -

(i) a person, where he is selling as a principal, shall not convey a short selling order unless he provides to his agent -

(A) an assurance that -

(I) he has a presently exercisable and unconditional right to vest the securities in the purchaser of them; and

(II) where paragraph (a), (b) or (f) of the definition of “short selling order” is applicable, all the relevant parties to the agreement or arrangement concerned referred to in that paragraph will provide the securities to which the order relates; and

(B) such information as is prescribed under

section 146;

(ii) a stockbroker, where he is selling as a principal, shall not convey a short selling order referred to in paragraph (a), (b) or (f) of the definition of “short selling order” unless he -

(A) has received an assurance from all the relevant parties to the agreement or arrangement concerned referred to in that paragraph; and

(B) possesses such information as is prescribed under section 146;

and

(iii) a person, where he is selling as an agent, shall not accept or convey a short selling order unless he has received from his principal or other person, for whose benefit or on whose behalf the order is made -

(A) an assurance that -

(I) his principal or that other person, as the case may be, has a presently exercisable and unconditional right to vest the securities in the purchaser of them; and

(II) where paragraph (a), (b) or

(f) of the definition of “short selling order” is applicable, all the relevant parties to the agreement or arrangement concerned referred to in that paragraph will provide the securities to which the order relates; and

(B) such information as is prescribed under section 146;

(c) new section 80C provides that a stockbroker or stockbroker’s representative shall -

(i) when passing the order to any other person with a view that the other person shall input the order into the trading system of the Unified Exchange, inform such other person that the order is a short selling order;

(ii) when inputting the order into the trading system of the Unified Exchange, indicate such matters as may be required under the applicable rules of the Unified Exchange to show that the order is a short selling order.

3. Clause 5 revises the regulation making power under section

146(1) (ra) to provide the Securities and Futures Commission with the additional power to request information from investors to enhance the transparency of the stock market.

Chapter: 333	Title: SECURITIES ORDINANCE	Gazette
		Number:
Section: 73	Heading: <b>Calls by registered dealers</b>	Version Date: 30/06/1997

(1) Subject to subsection (3), a dealer shall not during, or as a consequence of, a call on any person, whether at his place of residence or his place of employment or otherwise, enter into any contract for the sale of securities unless he-

- (a) calls on the person at the invitation of that person; and
- (b) before entering into the contract provides the person with a written statement containing all the information which he would have been required to give to that person if the contract had been entered into as a result of an offer made under section 72.

(2) Any dealer who contravenes subsection (1) shall be guilty of an offence and shall be liable on conviction to a fine of \$10000 and to imprisonment for 2 years.

(3) Subsection (1) does not apply to-

- (a) any contract for the sale of securities of a corporation with a person who already holds securities of that corporation;
- (b) any contract for the sale of securities by a dealer with a person with whom the dealer has transacted the sale or purchase of securities on at least 3 occasions during the period of 3 years immediately preceding the date of the contract; or
- (c) any contract for the sale of securities with-
  - (i) a person whose business involves the acquisition or disposal or holding of securities;
  - (ii) a solicitor or professional accountant;
  - (iii) any other person who belongs to a class of persons prescribed in regulations for the purpose of this paragraph.

(4) Where any contract for the sale of securities is entered into in contravention of subsection (1), the purchaser may, subject to the rights of any bona fide purchaser of the securities for value, rescind the contract by giving notice in writing to the seller within 28 days after the date on which the contract was entered into.

(5) In this section “call” (造訪) includes a visit in person and a communication by telephone.

Chapter: 333	Title: SECURITIES ORDINANCE	Gazette Number:
Section: 80	Heading: <b>Short selling prohibited</b>	Version Date: 30/06/1997

(1) A person shall not sell securities at or through the Unified Exchange unless, at the time he sells them- (Amended 58 of 1985 s. 56)

- (a) he has or, where he is selling as agent, his principal has; or
- (b) he reasonably and honestly believes that he has or, where he is selling as agent, that his principal has,

a presently exercisable and unconditional right to vest the securities in the purchaser of them.

(2) Any person who contravenes subsection (1) shall be guilty of an offence and shall be liable on conviction to a fine of \$10000 and to imprisonment for 6 months. (Amended L.N. 57 of 1988)

(3) For the purposes of subsection (1)-

- (a) a person shall be deemed to be selling securities if he-
  - (i) purports to sell the securities;
  - (ii) offers to sell the securities;
  - (iii) holds himself out as entitled to sell the securities; or
  - (iv) instructs a dealer to sell the securities;
- (b) a person who, at a particular time, has a presently exercisable and unconditional right to have securities vested in him or in accordance with his directions shall be deemed to have at that time a presently exercisable and unconditional right to vest the securities in a purchaser of them; and
- (c) a right of a person to vest securities in a purchaser thereof shall not be deemed not to be unconditional by reason only of the fact that the securities are charged or pledged in favour of some other person to secure the repayment of money.

(4) Subsection (1) does not apply to or in relation to-

- (a) a person acting in good faith in the reasonable and honest belief that he has a right, title, or interest to or in securities that he purports to sell, offers for sale, or holds himself out as capable of selling;
- (b) a dealer acting in good faith for or on behalf of some other person in the reasonable and honest belief that such other person has a right, title, or interest to or in securities that he purports to sell, offers for sale, or holds himself out as capable of selling;
- (c) a sale of securities by a stockbroker acting as principal when he acts as an odd lot specialist in accordance with the rules of the Exchange Company, being a sale made solely for the purpose of- (Amended 58 of 1985 s.56)
  - (i) accepting an offer to purchase an odd lot of securities; or
  - (ii) disposing of a parcel of securities that is less than one board lot of securities, by means of the sale of one board lot of those securities; or (Amended L.N. 57 of 1988)
- (d) a sale of securities falling within a class of transaction prescribed by regulations for the purposes of this paragraph.

Chapter:	333	Title:	SECURITIES ORDINANCE	Gazette Number:	
Section:	146	Heading:	<b>Regulations</b>	Version Date:	30/06/1997

(1) The Commission may make rules for all or any of the following matters- (Amended 10 of 1989 s. 65)

- (a)-(b) (Repealed 58 of 1985 s. 28)
- (c) the class of persons in relation to whom, and the manner and circumstances in which, registered dealers, registered dealing partnerships and registered dealers' representatives may deal in securities; (Amended 58 of 1985 s. 28)
- (d) the class of persons in relation to whom, and the manner and circumstances in which, registered investment advisers, registered investment advisers' partnerships and registered investment representatives may carry on business as investment advisers or as investment representatives, as the case may be; (Amended 58 of 1985 s. 28)
- (e) prescribing the amount of deposit required to be made for the purposes of section 52, and providing for the application of deposits under subsections (3) and (4) of that section;
- (f) requiring registered dealers, registered dealing partnerships, registered investment advisers and registered investment advisers' partnerships to exhibit their certificates of registration at their places of business; (Amended 58 of 1985 s. 28)
- (g) prescribing the information to be notified for the purposes of section 63(1)(b);
- (h)-(j) (Repealed 58 of 1985 s.28)
- (k) prescribing the manner, time, or circumstances for retaining copies of circulars for the purposes of section 79(6); (Amended 58 of 1985 s. 28)
- (l) prescribing the particulars to be recorded in relation to accounts kept under section 84;
- (m) prescribing the particulars to be recorded in relation to the profit and loss account and balance sheet and the information to be contained in the auditor's report required to be lodged under section 88; (Replaced 62 of 1976 s. 34)
- (n) prescribing any matters for giving better effect to section 65B and, without derogation from the generality of the foregoing, may for that purpose-
  - (i) prescribe the returns to be made by registered dealers and registered dealing partnerships, the information to be included therein and the manner in which such information is to be verified;
  - (ii) provide for the manner in which any assets are to be valued and for the payment by any person of the costs of valuation;
  - (iii) provide for the manner in which records are to be kept of any assets which may be taken into account for the purposes of section 65B and the places at which such records are to be maintained; and
  - (iv) make separate provision for different classes or categories of registered dealer or registered dealing partnership; (Replaced 58 of 1985 s.86)
- (o) (Repealed 58 of 1985 s. 28)
- (p) (Repealed 10 of 1989 s. 65)
- (q) prescribing public offices for the purposes of section 122; (Amended 33 of 1988 s.3)
- (r) prescribing the procedure for the holding of investigations under Part XI, and providing for the reception of evidence, whether written or oral, and for the summoning and examination of witnesses, during the course of such an investigation;
- (ra) requiring a person of any description specified in the rules, when selling securities at or through the Unified Exchange and where his right to vest them in the purchaser (or, where he is acting as agent, his principal's right to do so) is derived from an arrangement of a type specified in the rules, to notify the stockbroker through whom the sale is being effected, of the fact that the right to vest the securities in the seller is derived from such an arrangement; (Added 63 of 1995 s.2)
- (rb) prescribing limits on, or conditions to be complied with in respect of, the number of

options contracts which may be held or controlled, directly or indirectly, by any person where such contracts are traded through the facilities of the Unified Exchange; (Added 63 of 1995 s. 2)

(s) prescribing anything which is to be or may be prescribed by regulations.

(2) Where rules are made by the Commission under subsection (1), the Governor in Council may make regulations providing that a contravention of specified provisions of the rules shall be an offence and may provide penalties therefor not exceeding a fine of \$2000 and imprisonment for 3 months. (Replaced 10 of 1989 s. 65)

(3) Except as otherwise provided in this Ordinance, regulations made under this section may be of general or special application.

(4) Regulations made under this section may provide that, subject to such terms and conditions as may be prescribed thereby, the provisions of Parts VI to IX, or such of them as are specified in the regulations-

- (a) shall not have effect in relation to any specified person or to any person who is a member of a specified class of persons-
  - (i) who is or may be a dealer or investment adviser by reason only of his doing anything that is incidental to another business;
  - (ii) who does not deal in securities for or on behalf of any other person; or
  - (iii) who is a dealer or investment adviser by reason only of his entering into any specified transaction or class of transactions;
- (b) shall not have effect in relation to a representative of any such person, or a member of any such class of persons, as is referred to in paragraph (a);
- (c) shall have effect in relation to any such person or member, or a representative of any such person or member, to such extent as is prescribed; or
- (d) shall not have effect in relation to a specified transaction or class of transactions entered into by a specified person or class of persons.