

立法會
Legislative Council

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**Bills Committee on
Securities (Amendment) Bill 1999**

**Minutes of Meeting
held on Wednesday, 16 February 2000 at 8:30 am
in Conference Room A of the Legislative Council Building**

- Members Present** : Hon Ronald ARCULLI, JP (Chairman)
Hon Eric LI Ka-cheung, JP
Hon NG Leung-sing
Hon CHAN Yuen-han
Hon SIN Chung-kai
Hon Jasper TSANG Yok-sing, JP
Hon FUNG Chi-kin
- Member Absent** : Dr Hon David LI Kwok-po, JP
Hon Christine LOH
Dr Hon Philip WONG Yu-hong
- Public Officers Attending** : Mr Bryan CHAN
Principal Assistant Secretary for Financial Services
- Miss Hanny LAM
Assistant Secretary for Financial Services
- Mr Mark DICKENS
Executive Director of Supervision of Markets
Securities and Futures Commission
- Ms Stella LEUNG
Director of Supervision of Markets
Securities and Futures Commission
Ms Stella CHAN

Government Counsel, Department of Justice

Clerk in Attendance : Mrs Constance LI
Chief Assistant Secretary (2) 2

Staff in Attendance : Mr KAU Kin-wah
Assistant Legal Adviser 6

Miss Betty MA
Senior Assistant Secretary (2) 1

I. Election of Chairman

Mr Ronald ARCULLI was elected Chairman of the Bills Committee.

II. Meeting with the Administration

[LegCo Brief issued by the Financial Services Bureau (File Ref : C9/29C)]

2. At the invitation of the Chairman, Principal Assistant Secretary for Financial Services (PAS(FS)) briefed members on the objectives of the Bill as detailed in the Legislative Council Brief (File Ref : C9/29C).

3. PAS(FS) said that covered short selling was legal in Hong Kong subject to section 80 of the Securities Ordinance (Cap. 333) (the Ordinance) and the Rules of the Stock Exchange of Hong Kong (SEHK). While the Administration had no intention to discourage legal short selling in Hong Kong, it was widely accepted that there should be sufficient surveillance measures over such activities. The Securities (Amendment) Bill 1999 (the Bill) sought to strengthen the regulation of short selling activities to improve market transparency and discipline and to prevent circumvention of the SEHK reporting requirements. The major proposals in the Bill were to increase the penalty for illegal short-selling under section 80 of the Ordinance, and to incorporate the reporting requirements in the Exchange Rules to the law. This was part of the 30-Point Programme announced by the Financial Secretary in early September 1998. He stressed that the proposed provisions followed basically the existing requirements in the Rules of SEHK and the Code of Conduct issued by the Securities and Futures Commission (SFC).

Concerns raised by the industry

4. The Chairman noted that the securities industry had raised much concern about the legislative proposal. He inquired about the reasons for such concerns if the Bill had proposed no change to the existing requirements.

5. PAS(FS) responded that the Administration had discussed with the industry and was aware of their concerns. The Administration had already clarified some of their misunderstandings in respect of the scope and effects of the Bill. PAS(FS) said that the industry's concerns were mainly as follows -

(a) *Scope of section 80*

The industry was concerned whether the scope of lawful short sale as currently provided under section 80 of the Ordinance would be expanded by the Bill. The Administration had explained to the industry that it had no intention to modify section 80, except for the proposed increase in the penalty for breaches. There would be no change to the existing requirement that a person should not sell securities at or through SEHK, unless at the time he sold them, he or his principal had, or reasonably and honestly believed that he or his principal had, a presently exercisable and unconditional right to vest the securities in the purchaser.

(b) *Relationship between section 80 and the proposed section 80B*

The industry had raised concerns whether the proposed section 80B would have any implication on section 80. For example, a dealer who failed to receive or retain the assurance required under the proposed section 80B might be regarded to have breached section 80. In this connection, the Administration had explained that the proposed section 80B did not in any way modify the requirements under section 80. It only made it clear that a dealer was required to make enquiry with his principal as to whether the latter had a presently exercisable and unconditional right to have the securities vested in him. The Administration had also clarified that if a dealer had obtained assurance from his principal under the proposed section 80B and had a "reasonable and honest belief" that his principal had the unconditional right to sell the securities, it would constitute a defence for the dealer.

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(c) *Assurance required*

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The industry had sought clarification as to whether a fund manager had to recall those securities that had been lent out before he could sell them. At present, a fund manager was not required under section 80 or the Exchange Rules to do so because he already had the right to recall the securities under the securities lending and borrowing (SLB) agreement. As the drafting of the proposed section 80B might be unclear on this, the Administration would further discuss with the SFC to address this issue. An amendment could be made to clarify the intention when the Administration and SFC had taken a view on the matter.

(d) *Protection of the intermediary*

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The industry also expressed concern that the proposed section 80B did not provide protection to the market intermediaries who might commit an offence inadvertently by relying in good faith on information received from the other party. As it was not the legislative intent to hold the intermediary liable for faults committed by the other party where the intermediary had complied with the requirements, the Administration would propose an amendment to the Bill to provide a general defence.

(e) *Discretionary fund managers and trustees*

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The Administration was of the view that the fund manager and trustee who were given absolute discretion in selling securities on behalf of the beneficiaries were not required to obtain assurance from their client every time, or to recall the securities which had been lent out, before placing an order for sale. To clarify the legislative intent, the Administration would propose an amendment to the Bill.

(f) *Documentary assurance*

The legislative proposal covered securities borrowing and lending activities. It sought to require that a market intermediary should only accept or convey a short sale order if he had obtained from his principal an assurance that the securities to which the short sale order related would be provided at the time when placing the order. Under normal circumstances, the intermediaries would have standing security borrowing agreements for legal short selling activities. However, there could be situations that a holder of

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securities might have over-promised several dealers, which could inflame the volume of short-sale orders. To plug the loophole, the Administration now proposed that the dealer should seek a "hold" notice from the securities lender as proof that the borrower had obtained a presently exercisable and unconditional right over the relevant securities. While the industry considered the requirement generally acceptable, they expressed concern that the drafting might not adequately reflect the intention. The Administration had agreed to consider whether the drafting could be improved, or to explain the intention in the guidelines to be issued by SFC.

(g) *Rules made by SFC*

At present, members of the SEHK were bound by the SEHK Rules to report a short sale order, but not a covering transaction. To further enhance transparency of short selling activities, the Bill proposed to add new powers to SFC so that it could make rules on other requirements such as disclosure of covering activities. Similar regulatory regimes could be found in the United States (USA) and Australia. However, as market participants in Hong Kong did not have consensus about the usefulness of such information, the Administration and SFC had yet to come to a decision regarding the disclosure of covering transactions. The new rules would not be made until SFC had consulted the industry. These rules would be subsidiary legislation subject to the negative vetting procedures of the Legislative Council.

6. PAS(FS) further said that the Administration had also consulted the intermediaries engaged in stock options. They had expressed concern about certain technical difficulties in complying with the tick rule of SEHK and the possible contravention of section 80 when exercising a call option. As some of these problems were outside the scope of the Bill, the Administration would relay the concerns to SFC for further consideration. As regards possible technical breach of section 80, the Administration would discuss with SFC the possibility of expressly excluding call options from the reporting requirement in section 80(4) of the Ordinance or in the SFC guidelines.

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Public consultation

7. The Chairman asked whether the Administration had consulted the banking industry on the legislative proposal. PAS(FS) responded that while the Hong Kong Association of Banks had not been specifically consulted on the Bill, the Hong Kong and Shanghai Banking Corporation and the Hang Seng Bank had made submission indicating that they were generally agreeable to the legislative proposal.

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8. To enable members to have a better understanding of the implications of the Bill on industry operation, Miss CHAN Yuen-han suggested inviting concerned parties to give views to the Bills Committee. Miss CHAN also suggested inviting public submissions as the Bill was to safeguard the interests of investors. Members agreed.

(Post-meeting note : A press release and invitations for submissions were issued on 16 February 2000.)

Tightening regulation of short selling activities

9. Mr Eric LI sought clarification on the legislative intent and the effect of the Bill. He asked about the Administration's policy on short selling activities. PAS(FS) responded that the Administration recognized that legal short selling was a common practice in stocks markets. The Administration did not seek to encourage or discourage short selling in Hong Kong. However, it was widely accepted that there should be sufficient regulatory and surveillance measures to improve market transparency and discipline. It was noted that overseas countries had different practices in the regulation of short selling activities, ranging from strict prohibition in Singapore (though it was relaxing its regulation) to almost no regulation in the United Kingdom. Nevertheless, most major international markets such as the USA, Canada and Australia allowed short selling activities subject to certain reporting and cover arrangements.

10. The Chairman inquired whether the Administration had identified any problems in the stock market following the crisis in 1998, and whether there were difficulties in enforcing section 80 of the Ordinance.

11. PAS(FS) said that Government had reviewed the regulatory system for stock markets in early 1998 which led to the announcement of the 30-Point Programme by the Financial Secretary in September 1998. While Government recognized the functions of legal short-selling in the securities market, Government considered that the present regulatory mechanism should be strengthened. At present, there were different interpretations of the provision under section 80(1)(b) for an agent to sell securities based on "reasonable and honest belief" that his principal had a presently exercisable and unconditional right to vest the securities in the purchaser. Moreover, the SEHK Rules only applied to its members but not to their clients. The Administration therefore proposed to make the disclosure rules a statutory requirement which was extended to the seller and other market participants. He reiterated that the Bill did not add any new obligation on stockbrokers and market intermediaries in this respect.

12. Executive Director of Supervision of Markets, Securities and Futures

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Commission (ED/SFC) said that the crisis in 1998 was the result of a combination of factors. However, it had come to Government's attention during the last stage of Government's market incursion in the stock market in 1998 that some 900 short sale transactions involving almost one billion dollar worth of securities were not reported by the stockbrokers. SEHK had subsequently disciplined the firms and brokers concerned. Moreover, relying on good faith in short sale transactions might have also resulted in over lending of securities because of over promise by lenders. At present, inadvertent acts of uncovered short sales were not in breach of the law, if the parties involved honestly believed that the principals had the unconditional right to sell the securities. The Bill therefore sought to prevent the recurrence of "double counting" error in short selling activities with the statutory reporting requirements. ED/SFC added that Pan Asia Securities Lending Association had also suggested SFC to make regulations, after enactment of the Bill, to reinforce the record-keeping practice in the industry, instead of relying on the good faith of individual principals. PAS(FS) added that SFC was conducting a survey on the short selling activities in 1998 and the findings would be available soon.

13. Responding to the Chairman, ED/SFC said that the securities market was basically seriously disrupted with massive short-selling in 1998. Due to the lack of transparency, the market was then guessing in the dark, which had spiral effects on the market psychology. PAS(FS) stressed that market transparency and discipline were particularly important to a small and open market like Hong Kong. The Bill intended to strike appropriate balance between legitimate short selling activities in Hong Kong and the enhancement of transparency through disclosure and reporting requirements. The proposal would improve market transparency and also ensure compliance with the SEHK "tick" rule.

14. Mr Eric LI expressed support for extending the reporting requirement to the principals. However, he had doubts on the usefulness of the short-selling information to market participants. He was particularly concerned about the proposed criminalization of non-compliance with the disclosure requirement on the part of the intermediaries. He enquired whether the Administration had observed any intermediaries circumventing the reporting rule of SEHK in 1998. Mr LI suggested that it might be more appropriate for the Administration to clarify with the industry any doubts in compliance with the reporting requirements under SEHK Rules, instead of imposing heavier penalty on the industry.

15. PAS(FS) responded that the Administration recognized that intermediaries played an important role in the regulation of short-selling activities. However, it would be unreasonable for the Administration to propose statutory requirements on the principals or clients without corresponding requirements on the intermediaries. During consultation, the industry did not oppose the proposal but only requested the Administration to spell out clearly in

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law those circumstances under which intermediaries would have legal responsibilities.

16. Mr Eric LI said that he remained to be convinced of the need for creating a new criminal offence, in addition to the existing disciplinary measures, for failure on the part of intermediaries to report covered short selling activities. He said that intermediaries were already required by SEHK Rules to make enquiries with their principals whether the sales were short and to record such sales. He considered that a proper defence clause should be provided in law for the intermediaries. He also pointed out that the disclosure and reporting requirements would add administrative work and cost on the industry. In this regard, the intermediaries were concerned that they would have additional legal responsibilities not commensurate with their returns.

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17. PAS(FS) responded that a defence clause was provided under the proposed section 80C in the Bill. The Administration would also add a defence clause to the proposed section 80B.

18. Mr FUNG Chi-kin said that the industry would not object to measures which could effectively reduce systemic risks of the securities market. However, he had doubts that the Bill could effectively tackle the problems as it would be difficult to pinpoint the culprits. He stressed that securities lending and borrowing was a common practice among banks and was an integral part of today's financial markets. He commented that most securities borrowing and lending activities were carried out overseas and the Bill could not regulate short-selling activities outside Hong Kong. The Chairman also inquired how the legislation could apply to securities borrowing and lending activities in international markets.

19. PAS(FS) responded that the Administration was aware that international securities borrowing and lending activities played a major role in the short selling activities in Hong Kong. The Administration's position was to encourage securities borrowing and lending in the local market. He said that SFC maintained close liaison with major overseas market regulators, and that reputable international securities dealers would abide by the legislation of the respective jurisdiction.

20. Mr SIN Chung-kai expressed support for enhancing market transparency and disclosure of short sales information which would help maintain a healthy market. He said that market participants would try to maximize profits from the price differences in international securities markets. Being a small and open market, Hong Kong was vulnerable to price manipulation and market disruption. To address the industry's concern about the possibility of inadvertent errors made by stockbrokers, Mr SIN asked about the feasibility of adjusting the computer system of SEHK to provide a mandatory field for the broker to report

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short sale transactions.

21. Responding to members' concerns, PAS(FS) said that although deregulation was a global trend, the recent financial crisis had aroused much discussion on the capital flow in international markets, and the need for more effective regulation. He said that the Administration was in a difficult position. While the Administration did not want to stifle the market by prohibiting legal market activities, it had to address the concerns of risks in the securities market. It was against this background that the Financial Secretary announced the 30-Point Programme in 1998. The Administration would endeavour to work out a regulatory proposal that was acceptable to all parties as far as practicable. PAS(FS) reiterated that the Bill proposed no change to the current market operation of legal short sales.

22. On the technical issue raised by Mr SIN, PAS(FS) said that the SEHK computer system already provided a field for stockbrokers to indicate short sale transactions. The stockbrokers would only need to press a button, and the SEHK tick rule would be activated automatically. The stockbrokers could complete the ledgers on the details of the transactions and the cover arrangements afterwards.

Definition of short sales

23. Responding to the Chairman, PAS(FS) said that in the case of securities borrowing, the fund manager or dealer had to obtain a "hold notice" from the lender. The requirements would apply to borrowing from the local market or overseas markets. However, depending on the nature of a SLB agreement, if a fund manager was not required to give notice to recall the securities that had been lent out, the transaction would not be within the meaning of short sale. The Administration envisaged no enforcement difficulties in this respect as the Pan Asia Securities Lending Association had been consulted on the proposal.

24. Mr FUNG Chi-kin sought clarification on whether derivatives commodities and re-purchase arrangements (which were widely transacted in banks) were covered by the Bill. He opined that if such activities were not regarded as short sales under the Bill, it would not be able to address the problems identified in the 1998 crisis.

25. PAS(FS) responded that the Administration understood that the industry currently did not regard re-purchase and equity swaps as short sales. The Administration was now discussing with SFC ways to deal with these activities and would report to the Bills Committee later.

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26. Mr Eric LI asked whether the TraHK units were within the meaning of securities and subject to the regulation of short sales. PAS(FS) clarified that section 80 of the Ordinance was applicable to all securities transacted through

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the SEHK. Currently, SEHK only permitted short-sales for about 200 stocks. If a dealer placed a short sale order for securities which he held a SLB agreement, he was not in breach of the law even though the securities were not permitted for short sale. In this case, the dealer had only violated the SEHK Rules. However, the dealer would have committed an offence if he had not acquired a SLB agreement at the time he sold the securities. As for TraHK units, they were subject to section 80 of the Ordinance as well as the SEHK Rules and were now permitted for short sales.

Admin 27. To facilitate members' consideration of the need and effects of the Bill, Mr NG Leung-sing requested the Administration to provide information on any known cases of deliberate and inadvertent non-reporting of short-selling orders and the extent of the problem. ED/SFC agreed to provide the information. PAS(FS) pointed out that although a defence clause would be provided in the Bill for the intermediaries, the Administration was of the view that brokers should be responsible for errors caused by their negligence, and that each case would be considered on its merits.

Admin 28. At the request of the Chairman, the Administration agreed to provide the relevant SEHK Rules regarding disclosure of short sale orders and the penalties for non-compliance. PAS(FS) also agreed to provide a response to the industry's concerns.

Admin 29. Mr SIN Chung-kai noted that the Administration would propose amendments to the Bill. He urged the Administration to expedite the drafting of the proposed amendments for early consideration by the Bills Committee.

Date of next meeting

30. Members agreed to meet deputations on 22 and 25 February 2000 at 4:30 pm.

31. There being no other business, the meeting ended at 10:25 am.

Legislative Council Secretariat

6 July 2000