

**立法會**  
***Legislative Council***

LC Paper No. CB(2)2497/99-00  
(These minutes have been seen by  
the Administration and cleared  
with the Chairman)

Ref : CB2/BC/7/99

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

**Minutes of Meeting  
held on Tuesday, 22 February 2000 at 4:30 pm  
in the Chamber of the Legislative Council Building**

- Members Present** : Hon Ronald ARCULLI, JP (Chairman)  
Hon Eric LI Ka-cheung, JP  
Dr Hon David LI Kwok-po, JP  
Hon NG Leung-sing  
Hon CHAN Yuen-han  
Hon SIN Chung-kai  
Dr Hon Philip WONG Yu-hong  
Hon Jasper TSANG Yok-sing, JP  
Hon FUNG Chi-kin
- Member Absent** : Hon Christine LOH
- 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

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Ms Stella LEUNG  
Director of Supervision of Markets  
Securities and Futures Commission

**Attendance by Invitation :** Group of 14 financial institutions and the Hong Kong Securities Industry Group

Ms Pauline ASHALL  
Partner, Linklaters & Alliance

Mr John KNOX  
Director, Jardine Fleming Securities Ltd

Ms Pamela ROOT  
Managing Director, General Counsel  
Goldman Sachs (Asia) Ltd

Pan Asia Securities Lending Association

Mr Roger DUNPHY  
Representative of Morgan Stanley Dean Witter Asia Limited

Mr Richard BENTSEN  
Representative of Northern Trust

Hong Kong Securities Professionals

Mr TONG Leung-sang  
Chairman

Mr CHAN Tsun-wan  
Vice-Chairman

Mr WAN Moon-chi  
Committee Member

**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

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**I. Meeting with deputations**

[Paper Nos. CB(2)1149/99-00(01) and (02)]

Group of 14 financial institutions and the Hong Kong Securities Industry Group  
[Paper No. CB(2)1149/99-00(01)]

At the invitation of the Chairman, Ms Pauline ASHALL representing the Group of 14 financial institutions and the Hong Kong Securities Industry Group (the Group) briefed members on the major concerns of the Group. She said that the short selling market in Hong Kong was already adequately regulated and that the Administration had not fully demonstrated the need for introducing the Securities (Amendment) Bill 1999 (the Bill). Her views were summarized below.

(a) *Scope of the definition of "short selling order"*

Although the Administration had advised that it had no intention to expand the scope of short selling activities under regulation, the Group was of the view that the types of reportable short sales activities had been expanded under the current drafting of the proposed sections 80A, 80B and 80C. As failure to report covered short selling would be a criminal offence under the Bill, the Group considered that short selling should be more clearly defined in the Bill instead of relying on the guidelines to be issued by the Securities and Futures Commission (SFC).

(b) *Documentary assurance*

The requirement for a seller to provide information, at the time of placing short selling orders, to prove that he actually owned the securities (or had the securities available for sale) was onerous and not practicable. It would be difficult for traders and sellers to comply with the proposed requirement without causing unnecessary delay in transaction and incurring additional cost. As regards the suggestion of keeping the tape recording as documentary proof, it might not be feasible to get the information from sellers over the phone nor was it technologically reliable sometimes. Moreover, the industry normally kept the tapes for no more than six months. The Group considered it sufficient for brokers to record short sales and report such transactions subsequently.

(c) *Criminal liability*

It would be an unusual practice to impose criminal sanction for failing to comply with administrative requirements such as failure to report covered short sales which were legal. Non-compliance with short sales reporting requirement was not a criminal offence in major overseas markets which usually imposed administrative sanctions under the codes of conduct of the respective regulatory regimes. The Group therefore considered it more appropriate to deal with inadvertent mistakes by administrative sanctions such as financial penalty. While the Government would consider providing a defence clause in the Bill where a dealer had reasonable grounds to believe that his client owned the securities or had made arrangements to ensure that the securities would be available for delivery on the settlement date, mistakes could still be made during busy trading days. The proposed criminalization would have a great impact on the market and the stock lenders and fund managers might then choose to move away from the local market to avoid the legal responsibility.

2. Ms Pamela ROOT, representative of the Group, said that stock lending played a vital role in a mature market. In the trading environment, the brokers were expected to execute orders immediately upon receipt of an order instead of waiting for the documentary proof. The risk of criminal liability would also make stock lending and borrowing activities in Hong Kong unattractive. The Bill therefore had significant impact on the industry, and would adversely affect the liquidity and volume of securities lending transactions in the local market.

3. Mr John KNOX, representative of the Group, shared similar concerns. He said that the proposed definition of short selling order was not confined to reflecting its economic term, and would have the effect of covering all sorts of transactions in the futures and derivatives markets. He was also concerned about the procedures for providing documentary evidence in compliance with the up-tick rule.

4. The Chairman asked whether the Administration had already addressed some of the industry's concerns after recent discussions. Ms Pauline ASHALL responded that the Administration had held several discussions with the Group recently. The Group noted that the Administration might not necessarily propose amendments to the definition of short selling order and the requirement of documentary assurance, and might ask SFC to issue guidelines in this respect. The Group, however, considered that this was a fundamental issue that should be addressed in the Bill. With regard to the strict liability on market participants, the Administration had indicated its intention to introduce a defence clause in the proposed section 80B, in line with the provision in the proposed section 80C. However, even with the proposed defence clauses, the industry was concerned

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that mistakes caused by negligence or carelessness might still be liable to prosecution.

Pan Asia Securities Lending Association (PASLA)

[Paper No. CB(2)1149/99-00(02)]

5. Mr Roger DUNPHY representing the Pan Asia Securities Lending Association (PASLA) said that PASLA supported the Administration's proposal to improve regulation and transparency of the market to provide a level-playing field to all market participants. However, he would like to clarify some misconceptions about the industry standards in relation to securities lending -

- (a) lenders would not lend the same shares to multiple borrowers;
- (b) controls, documentation and risk management policies were in place and robust enough to comply with the capital controls in different markets;
- (c) securities lenders would keep adequate buffer to ensure that there would be sufficient stocks for settlement;
- (d) in major markets, a fund manager selling shares under a stock loan programme would not be regarded as short selling;
- (e) fund managers were not currently required to provide any documentary assurance or report on short sales. In most markets, a verbal confirmation of a "hold" was enough proof to permit the borrowers to sell the shares short and they had the legal obligation to return the shares for settlement within the prescribed period which was T+2 in Hong Kong; and
- (f) contravention of securities lending regulations was not a criminal offence in major markets.

6. Mr Roger DUNPHY further pointed out that securities lending was essential in an equity market to provide the necessary liquidity and hedging capabilities for efficient securities and derivatives markets. The securities market in Hong Kong would be impeded if -

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- (a) the scope of the definition of short selling would capture also the sales undertaken by fund managers;
- (b) the documentary assurance would add additional burden on the daily operation of the trade; and
- (c) a breach of the reporting and documentation requirements would constitute a criminal offence.

7. Mr Richard BENTSEN, representative of PASLA, added that fund managers did not disagree with the fundamental principles of the Bill which sought to improve regulation of the market. However, fund managers expressed concern that their clients would find the assurance arrangement unacceptable because time was a crucial factor in placing a short selling order. They were also concerned about the criminalization of the disclosure and reporting requirements in respect of covered short selling activities. The stringent requirements would discourage participation of institutional lenders in the custodian and securities lending market in Hong Kong. With regard to the retention of transaction records, fund managers were generally in support of the requirement for the purpose of providing an audit trail of short sale orders.

Hong Kong Securities Professionals Association  
[Paper No. CB(2)1164/99-00(01)]

8. Mr TONG Leung-sang representing the Hong Kong Securities Professionals Association (HKSPA) briefed members on its submission which was tabled at the meeting [Paper No. CB(2)1164/99-00(01)]. HKSPA supported the legislative proposal to strengthen the regulation of uncovered short sale and to enhance the transparency of short selling activities. The HKSPA raised no fundamental objection to the imposition of legal responsibility on the stockbrokers for deliberate non-compliance with the disclosure and reporting requirements. However, HKSPA considered that the Administration should distinguish clearly in the legislation the difference between deliberate non-compliance and inadvertent or technical breach of the reporting requirements.

9. Mr WAN Moon-chi, representative of HKSPA, reiterated support for regulation of illegal short sale activities to curb market manipulation and to provide a level-playing field for all market participants. The HKSPA also urged the Central Clearing House to assume the role of central securities lender and to disclose information on the gross short selling positions and cover transactions on a daily basis to enhance market transparency.

## Discussion

10. Dr Philip WONG sought clarification from the Group on their reservation about the need of the Bill. Ms Pauline ASHALL said that apparently the Bill was introduced as a result of the market fluctuation and settlement failure caused by naked short-selling in 1998. However, the stock market in Hong Kong was one of the most efficient markets in terms of settlement. Mr Roger DUNPHY pointed out that there was a significant drop in market efficiency in Hong Kong when Government intervened in the market in 1998.

11. In response to Mr Eric LI, Ms Pauline ASHALL said that the Group had discussed with the Administration in January 2000 regarding the concerns about the definition of short sale orders and the criminalization of breaches of the reporting requirements. There were still some unresolved issues, for example, whether the funds managers had to recall securities they had lent out before placing a short sale order and whether the scope of the definition of short sale covered situations where stocks were acquired pursuant to transactions such as equity derivatives and repos. Although the Administration had stated that the intention was to exclude such activities, the industry considered that the intention should be clearly reflected in the Bill.

### *Market practice*

12. Responding to the Chairman, Mr Roger DUNPHY said that the fees for securities lending depended very much on the demand and supply for securities. During the market instability in 1998, the fees for securities lending were 5%-10% of the securities value.

13. Mr FUNG Chi-kin pointed out that stockbrokers in local markets were mainly concerned about the penalty for inadvertent non-reporting of short sales, while the Group and PASLA focused on the application of the provisions of the Bill to stock lending and short selling to provide hedging facilities in domestic and international markets.

14. Responding to Mr FUNG Chi-kin, Mr John KNOX said that securities lending transaction was normally made in relation to arbitrage, TraHK units, futures and options which were not regarded as short selling by the industry. Such transactions did not bear the same economic term in the market as the transaction of shares. As such, these transactions should be excluded from the scope of the Bill.

15. Mr FUNG Chi-kin asked representatives of the Group whether the securities lending activities transacted in overseas markets would be reported to SFC. Mr Roger DUNPHY responded that securities lenders had legal obligation

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to report such activities conducted in overseas markets. PALSA would make sure that its members observe the rules even though its members were only bound by a gentlemen's agreement. He pointed out that non-compliance with the reporting requirement was an exception rather than the norm among its members.

16. The Chairman inquired about the arrangements for securities lending between fund managers and custodian clients. Mr Richard BENTSEN said that a custodian client would be required to sign a securities lending agreement if he intended to participate in such activities. The fund managers would then buy and lend out securities for the benefit of their clients. As the securities of different clients would be pooled, the fund managers would not know, at the time of transaction, which account these securities belonged to. However, the fund managers would usually lend out only part of the securities at hand and there would be no over-lending. A queuing system was adopted to ensure all clients would participate equally in the market. The fund manager would reallocate the long position of securities and recall from borrowers whenever necessary to enable settlement of a sale order in a timely manner. Mr BENTSEN added that as securities lending activities took place round the clock, custodian clients would not know the exact amount of securities that had been lent out at real-time. There could be a time lag of 12 hours to 24 hours depending on the markets involved. Fund managers would report to their clients on the securities position on a daily basis. The custodian clients were in an indifferent position during the transactions as it was guaranteed that their sales orders would be settled in any event. Nevertheless, the clients still had the irrevocable right to retrieve their securities.

17. Mr Roger DUNPHY supplemented that fund managers would ensure that there were sufficient shares in reserve for settlement. If the settlement period was short, a higher buffer would be maintained. Mr DUNPHY further said that fund managers would not lend out securities to a third party if they were already committed to put the securities on hold to a borrower, even though it was a verbal confirmation. The hold would normally be valid for 24 hours.

*Criminal liability*

18. Mr Eric LI noted that the industry expressed strong objection to the proposal to impose criminal liability on market participants in relation to non-disclosure of covered short sales. He asked the deputations why the industry considered the proposed criminal sanction would put Hong Kong in a less competitive position in the international market and what were the alternative penalties acceptable to the industry.

19. Mr WAN Moon-chi of HKSPA said that the criminalization of non-reporting of short selling orders might be too severe if the mistake was made

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inadvertently. He considered that a stockbroker should be exempted from the legal responsibility if he had reported and provided satisfactory explanation to SFC before the settlement period once he discovered an erroneous short sale transaction. Disciplinary actions could be imposed in these cases.

20. Responding to Mr FUNG Chi-kin, Mr WAN Moon-chi of HKSPA said that the trading system of the Unified Exchange had incorporated a safeguard device to reject an input for short selling order if the stocks in question were not permitted for short sale. However, stockbrokers might still make other mistakes inadvertently such as inputting the wrong stock number.

21. Representatives of the Group and PASLA stressed that they had no objection to the proposal to increase the penalty for contravening section 80 of the Securities Ordinance. However, the proposal to create a specific criminal offence for non-reporting of covered short sales would be inconsistent with the practice in major international markets. The intermediaries and securities lenders were of the view that as they acted in good faith on behalf of their clients in securities transactions, they should not be held liable for errors made by the other party. They considered the proposed penalty too high as compared with the seriousness of the mistake or omission made, bearing in mind that covered short sales was a legal activity. Moreover, since securities transactions were conducted in global markets, there could be mistakes in the chain of transactions due to carelessness, such as an oversight in counting the settlement periods due to time difference of overseas markets. The industry considered that administrative sanctions such as fines and suspension of licence were more appropriate than criminalization. The threat of criminal liability might lead to significant shrinkage in the securities lending activities, and would have effects on the turnover of shares and liquidity of the market. Moreover, it would be very difficult and expensive to observe the up-tick rule under the new requirements.

*Documentary assurance*

22. The Chairman asked whether securities dealers used taping devices during trading to protect themselves in case there were subsequent disputes. Representatives of the Group pointed out that while tapes were used by some dealers, it was not a requirement under the Stock Exchange Rules although this was required by the Hong Kong Futures Exchange. Transactions were normally conducted orally over the phone, and the stockbrokers would ask their clients whether the sale orders were short and, if so, whether arrangements had been made to cover the short sales. The stockbrokers would then record the short sales orders using standard order forms. Where taping devices were used, the tapes would be kept for several months. It would be burdensome for the industry to retain the tapes for a long period. As there would be practical difficulties to obtain documentary evidence at the time of transaction, the Group suggested that a paper trail could be produced at the end of the trading day instead. The Group

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pointed out that under the existing legislation, the ledger recording transaction details should be retained for seven years for inspection by the regulatory bodies.

23. The Chairman asked whether the documentary proof could be provided by fax or by e-mail during or immediately after an order was placed. He said that as mistakes could be made either by the broker or client, some form of documentary proof would be necessary for the parties concerned and the regulatory bodies to verify the information recorded in the paper trail and to pinpoint responsibility in case of an erroneous transaction. Ms Pauline ASHALL said that the securities lenders would be most willing to provide as much information as possible upon request by the regulatory bodies. However, the industry was concerned about the practical difficulties in requiring a seller to provide documentary assurance at the time of placing an order. The Group considered that the documentary assurance required for a short sale transaction provided at the end of a trading day should suffice.

## **II. Meeting with the Administration**

24. The Chairman asked about the penalties for illegal short selling activities in other regulatory regimes. Principal Assistant Secretary for Financial Services (PAS(FS)) said that the Administration had done some research on the penalties in selected securities markets. In the USA, contravention of the provisions on short selling reporting and disclosure requirements was liable on conviction to a maximum fine of US\$1,000,000 and imprisonment for 10 years. The penalty was much higher than that proposed in the Bill. In Australia, the penalty was a fine and imprisonment for 2 years, which was similar to that proposed in the Bill. PAS(FS) added that the Bill also provided a defence clause for stockbrokers if they reasonably and honestly believed that the clients did have the stocks at hand when placing a short sale order. If the client provided false information and had not actually acquired the stocks when placing a short sale order, he would have committed an offence under section 80 of the Securities Ordinance.

25. As regards the criminal liability imposed on uncovered short selling, Executive Director of Supervision of Markets, Securities and Futures Commission said that the responsibility rest with the clients in the majority of these cases.

26. Mr SIN Chung-kai noted that the Group supported the proposed increase of penalty for offences under section 80 of the Securities Ordinance but that its concern was on the new sections 80B and 80C. While agreeing that Hong Kong was a small market susceptible to manipulation, Mr SIN expressed concern as to whether the proposed penalty in the Bill exceeded the international standard for similar offences. He therefore requested the Administration to provide a comparison of the legislation and the penalties in overseas markets to facilitate

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deliberation by members. PAS(FS) agreed to provide the information.

27. The Chairman said that the Bills Committee had scheduled another meeting for 25 February 2000. As there were still major areas of disagreement between the Administration and the industry, the Chairman urged the Administration to arrange another meeting with the industry to resolve the discrepancies before the next Bills Committee meeting.

**III. Any other business**

28. There being no other business, the meeting ended at 6:25 pm.

Legislative Council Secretariat

6 July 2000