

立法會
Legislative Council

LC Paper No. CB(2)2525/99-00
(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 Friday, 25 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
Hon NG Leung-sing
Hon Christine LOH
Hon SIN Chung-kai
Dr Hon Philip WONG Yu-hong
Hon FUNG Chi-kin

Member Absent : Dr Hon David LI Kwok-po, JP
Hon CHAN Yuen-han
Hon Jasper TSANG Yok-sing, JP

Public Officers Attending : Mr Bryan CHAN
Principal Assistant Secretary for Financial Services

Miss HINNY 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

Ms Stella CHAN
Government Counsel, Department of Justice

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

Ms Pauline Ashall
Partner, Linklaters & Alliance

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)1172/99-00(01) and (02)]

The Chairman welcomed representatives of deputations to the meeting.

Hong Kong Stockbrokers Association

[Paper No. CB(2)1172/99-00(01)]

2. Members noted that the Hong Kong Stockbrokers Association (HKSA) had tabled a submission at the meeting. At the invitation of the Chairman, Mr Paul FAN representing HKSA highlighted that members of HKSA were very concerned about the proposed criminalization of the disclosure and reporting requirements in respect of lawful short selling activities. They were worried that if they forgot to take any of the following steps in a transaction, they would have committed an offence leading to a fine and imprisonment -

- (a) making enquiry with the seller as to whether it was a short selling order;
- (b) obtaining documentary evidence from the seller that he owned the shares or had made arrangements for the delivery of the shares before the day of settlement;
- (c) informing other market participants that the order was a short sale; and
- (d) inputting into the trading system of the Unified Exchange to show that the transaction was a short sale.

3. Mr Paul FAN said that stockbrokers were only intermediaries carrying out instructions of their clients, and their conduct was already governed by the Securities Ordinance, the Rules of the Stock Exchange of Hong Kong (SEHK) and the Code of Conduct issued by the Securities and Futures Commission (SFC). Stockbrokers considered that the proposed criminalization was too severe for inadvertent mistakes made in the course of transaction, as this would ruin their reputation and career. They hoped their concern could be addressed in the Bill.

Group of 14 financial institutions and Hong Kong Securities Industry Group (HKSIG) and Pan Asia Securities Lending Association (PASLA)

4. Ms Pauline ASHALL representing the "Group of 14", HKSIG and PASLA informed the meeting that, as suggested by the Chairman, they had further discussed with the Administration on 24 February 2000. A letter summarizing their views on the discussion was tabled for members' information

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(the letter was subsequently issued to members vide LC Paper No. CB(2)1200/99-00). She said that the Administration had yet to take a decision whether the definition of short selling in the Bill would cover the sale of securities already loaned out and transactions such as equity swaps and repos. The industry considered it important to have clarification of the issue. Ms ASHALL pointed out that if institutions which had given lending authority to their custodians were at risk of criminal liability under the Bill for failing to report sale transactions as "short sales" and were subject to the "uptick rule", they would be unwilling to participate in the lending programmes. This would have a drastic impact on the availability of stock for borrowing and would reduce the trading volume and liquidity in the market.

5. On providing documentary assurance at the time when placing a short selling order, Ms Pauline ASHALL said that the current drafting of the Bill created practical difficulties for the industry. She was of the view that it was not possible to obtain information in the form as required by the Bill from the clients over the phone. Although tape recording was accepted as documentary assurance, it would be more flexible for the sellers to decide the form of documentary evidence to be maintained (i.e. in writing or by tape) which should be available by the end of the trading day. The Group therefore proposed that brokers would be required to ask the seller whether the sale was short at the time when placing an order, and if so, whether the seller had arranged for the delivery of the securities before the settlement date. The broker could then decide how to confirm the sale orders, for example, keeping the tape of the instruction or requiring the sellers to provide written confirmation afterwards.

Discussion

6. Mr Eric LI agreed that a mandatory disclosure and reporting requirement of short selling activities would be necessary so as to ascertain whether an erroneous transaction was made by stockbrokers inadvertently or deliberately. He considered that there should also be a mechanism to provide remedy to inadvertent mistakes made in the transactions.

7. The Chairman asked HKSA representatives what remedial measures were being taken when a broker made a mistake in the transaction, such as omission to input to the trading system of the Unified Exchange that the order was a short sale.

8. In response to the Chairman, representatives of HKSA said that stockbrokers were required under the SEHK Rules to report to SFC any mistakes made in the transactions as well as omissions in disclosing short selling orders. Each securities institution maintained an error account which would be made available for inspection by SFC and SEHK. SFC would examine these reports

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and might consider taking disciplinary actions against the stockbroker concerned having regard to the circumstances of each case.

9. Mr Kenny LEE, HKSA representative, pointed out that small size dealers in Hong Kong seldom accepted short selling orders because it was difficult to buy back the securities for settlement. However, it was possible that stockbrokers might be misled by their clients that the latter had already acquired the shares when placing a sale order. Mr Dannis LEE, HKSA representative, added that during busy trading days, both the stockbrokers and clients might make mistakes. The legal responsibility for such inadvertent errors was considered too severe.

10. The Chairman inquired about the frequency of inadvertent mistakes and whether SFC had information on the error reports of stockbrokers. Executive Director of Supervision of Market, Securities and Futures Commission (ED/SFC) replied that the brokers provided these reports to SEHK.

11. Responding to the Chairman's remarks that securities brokers should not over-lend their stocks, Ms Pauline ASHALL said that according to the research carried out by PASLA, transactions involving securities on loan would not be regarded as short selling in other jurisdictions. It would be unique in the Hong Kong stock market if these were to be regarded as short selling as proposed in the Bill. She said that the industry had no difficulties in complying with the existing provision in the Securities Ordinance, if securities lenders had a presently exercisable and unconditional right to vest the securities in the purchaser under the securities lending and borrowing agreement.

II. Meeting with the Administration
[Paper No. CB(2)1200/99-00(05)]

Documentary assurance

12. The Chairman referred to the Administration's paper on the regulatory regimes for short selling activities in selected securities markets, and asked what the documentary assurance requirements were in other countries.

13. Principle Assistant Secretary for Financial Services (PAS(FS)) responded that the regulatory regime in Australia resembled that proposed in the Bill, and that intermediaries in Australia were required to endorse the evidence provided by their clients in short selling. ED/SFC supplemented that such requirement was no longer necessary after the transaction in Australia, while the Bill would require the dealer to endorse the evidence at real time and maintain a record of the assurance given by the client.

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14. The Chairman agreed that it was desirable to keep records on short selling transactions. He noted that the Administration considered the current market practice in respect of short selling records unsatisfactory. However, as the proposed documentary assurance requirement appeared to go beyond the current practice of some stockbrokers and dealers, he asked what kind of records would be considered acceptable by SFC or SEHK.

15. ED/SFC replied that the tapes on the client's verbal assurance when placing an order was a form of documentary evidence. ED/SFC further pointed out the current market practice made it difficult to pinpoint responsibility in case of unreported short sales. As the present transaction record did not bear any initial or signature of the client, it would be difficult to prove whether the non-compliance was caused by false information provided by the client or negligence of the stockbroker. The proposal in the Bill aimed to plug the loophole.

16. The Chairman commented that it would be for the court to decide, based on available evidence, whether a stockbroker should be held responsible for an erroneous transaction. ED/SFC said that the crux of the problem was that the current sale record kept by the stockbroker did not show whether a transaction was a short sale. When SFC became aware of the short sale afterwards, it was already too late to identify the responsible party. The parties involved were either unable to recall the details of the transaction or simply deny any allegation. No prosecution could therefore be taken in these cases.

17. Responding to the Chairman, ED/SFC said that the reporting requirement was only to enable the market to know the number of shares involved in short sales. PAS(FS) stressed that the Administration did not encourage or prohibit lawful short selling activities, but wanted to improve the regulatory regime on short selling. He stressed that there were similar reporting requirements for short sales in the United States and Australia. However, in view of the concerns expressed by the industry, the Administration was prepared to add a defence clause to the proposed section 80B for inadvertent mistakes made by brokers, in addition to the defence clause under the proposed section 80C in the Bill. He added that SFC had never prosecuted a broker for inadvertent mistakes such as pressing the wrong button.

18. As regards the documentary assurance requirement, PAS(FS) said that the Administration did not envisage much implementation problem. He pointed out that a similar requirement already existed for members of the Hong Kong Futures Exchange. According to the futures industry, the tape-recording would involve an additional operating cost of about \$4,000 a month, and storage space of some 100 square feet for keeping the tapes for three months. The Chairman remarked that the industry was concerned about the need for a sophisticated filing system for retrieval of such tapes when required by SFC. PAS(FS) responded that the taping technology nowadays could record date and time of a transaction

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automatically. The Administration therefore considered that the industry would be able to cope with the statutory requirements without much additional efforts.

19. The Chairman asked whether the Administration would be prepared to accept alternative forms of documentary evidence for short selling transactions. PAS(FS) stressed that from the enforcement point of view, the documentary assurance (such as tape recording) must be provided before a short selling order was executed.

20. Ms Pauline ASHALL pointed out that the industry was concerned about the details to be kept for the records. The proposal would create a huge problem for the industry as it changed that current practice by requiring the sellers to give evidence at the time when placing a short selling order and by creating a criminal liability on such requirements.

21. PAS(FS) responded that a sale order accompanied by a "hold" number given by stock lenders would be sufficient for complying with the documentary assurance requirement.

22. In response to the Chairman, Mr Roger DUNPHY representing PASLA said that the industry had been consulted on the use of a reference number for the "hold" notice as documentary proof in short sale transactions. He said that except in the United States, communication in securities lending and borrowing was conducted verbally and no certificate or "hold" number was used in major international stock markets.

23. Ms Pamela ROOT, a representative of the Group, commented that the use of a "hold" number in actual trading environment was not that simple. While a "hold" number was given by the securities lender to a person responsible for arranging the borrowing, the latter was not necessarily the one who sold the securities in the market. It would be impractical to delay a transaction so that the "hold" number could be checked, particularly in hedging and arbitrage transactions. The industry therefore recommended that the "hold" number, if adopted, to be provided at the end of a trading day.

Criminalization on non-compliance with the disclosure requirement

24. Mr FUNG Chi-kin said that while he supported the need for greater market transparency and documentary assurance requirements in respect of covered short selling, he questioned whether the situation of illegal short selling had been so serious that warranted criminalization of even inadvertent breaches. He pointed out that despite the reporting requirement, the actual volume of short sales would not be immediately available to other market participants at real time. He therefore did not see any reason that the documentary assurance from the seller must be provided at the time when placing a sale order. Moreover, if a

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seller failed to arrange for the delivery of shares for settlement, they already committed an offence under the existing legislation. As intermediaries only executed sale orders based on instruction and information from the clients, he did not agree that brokers should be held legally responsible for the erroneous or false information supplied by sellers in relation to a short sale. He therefore suggested that a warning should be issued to clients that illegal short selling was an offence, instead of requiring the broker to confirm with the seller each time when placing an order. He considered that short sales could be reported at the close of a trading day.

25. The Chairman commented that although the Bill did not intend to expand the definition of short selling, the proposed new sections 80A, 80B and 80C appeared to have enlarged the scope of reportable short selling.

26. PAS(FS) reiterated that it was not the intention to expand the scope of the reportable short selling activities. The Bill was only to make the current reporting requirement under the Eleventh Schedule to the SEHK Rules statutory, so that there would be more effective sanctions over non-compliance. He said that amendments could be made to the Bill to clarify any misunderstanding of the scope of reportable short selling.

27. The Chairman inquired how the proposed defence clauses under the new section 80B could address the industry's concern on inadvertent errors made in a short selling transaction.

28. PAS(FS) responded that there could be various reasons for making a mistake in the course of transactions and a defence clause would be introduced for a dealer who acted on "reasonable and honest belief" that their principals had a presently exercisable and unconditional right to vest the securities in the purchase. The tape record of the assurance given by the seller would be a form of documentary evidence.

29. The Chairman inquired whether there were viable alternatives to creating criminal offences for breaches of the reporting requirement, especially when the stockbroker had reasonable excuse for the inadvertent mistake made. He said that uncovered short selling was already prohibited under section 80 of the Securities Ordinance, and that a person should not sell securities unless he reasonably and honestly believed that his principal had a presently exercisable and unconditional right to vest the securities in the purchaser. At present, section 80 placed the onus of proof on the prosecution. However, the creation of a strict liability on documentary assurance and a lower threshold for evidence test under the new sections 80B and 80C in the Bill appeared to be a departure from the existing section 80. While agreeing that it would be necessary to have an audit trail in order to pinpoint responsibility, he wondered whether criminalization was

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the only way to enforce proper record keeping by the industry. He also inquired the practice of record keeping in other jurisdictions.

30. ED/SFC said that overseas markets adopted different standards in record keeping, and non-compliance with the requirements was a criminal offence in some jurisdictions. He stressed that the existing licensing regime in Hong Kong was not good enough for enforcing the reporting requirements as many major players in the local securities market were not registered in Hong Kong. It was therefore necessary to introduce a statutory requirement, in addition to the ethical standard, on record keeping to enable effective enforcement.

31. Mr Eric LI asked whether the Administration would consider adopting a gradual approach for imposing legal responsibilities on the intermediaries. To allay the industry's concern, he suggested that the Administration could introduce a trial scheme of financial penalty for non-compliance with the disclosure and reporting requirement. If the penalty scheme was ineffective, the Administration could then consider imposing criminal liability on the intermediaries.

32. Ms Pamela ROOT reiterated that the industry did not object to criminalization for wilful non-compliance with the reporting requirements. The industry was only concerned about the legal responsibilities on inadvertent mistakes.

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33. Responding to the Chairman, PAS(FS) said that the Administration would be able to provide a response to members' concerns and the proposed amendments to the Bill by early March 2000.

III. Any other business

34. The next meeting would be scheduled for 9 March 2000 at 4:30 pm.

(Post meeting note : At the Administration's request, the Chairman agreed to defer the meeting to 21 March 2000.)

35. There being no other business, the meeting ended at 6:05 pm.

Legislative Council Secretariat

26 July 2000