Securities (Amendment) Bill 1999
Comments of the Securities Law Committee of The Law Society of Hong Kong

Introduction

We understand that the objectives of the Bill are:

- to increase the penalties for the existing offence of “uncovered” short selling in Section 80(1) of the Securities Ordinance and
- to impose notification and record-keeping requirements for “covered” short sales and to impose criminal penalties for failure to comply with those requirements.

It is beyond the scope of the Securities Law Committee to comment on the extent to which, as a matter of policy, short selling in the financial markets should be regulated, and the scale of the penalties which should be imposed for non-compliance with the relevant regulations. However, we do have some concerns on the drafting of the Bill. In particular, in view of the very wide definition of “short selling order” in Section 80A and the lack of any defences in respect of the offences in Section 80B, it appears that an offence may be committed under Section 80B (by investors, intermediaries or brokers) through inadvertence, through relying on information received from third parties or simply through error. Particularly where the offence is a serious one which may attract a fine and imprisonment, we strongly believe that it is wholly inappropriate to impose such no-fault criminal liability, which is out of keeping with the normal approach to criminalisation of conduct in modern and liberal regimes.

The Government’s objectives should be equally well served if the new offence is only committed by a person who knowingly places a “short selling order” without complying with the requirements. Creating the risk of criminal liability for inadvertence may, if anything, discourage investors from dealing in Hong Kong securities altogether, rather than encouraging compliance with the short selling regulations.

Some more detailed comments on the scope of the draft legislation are set out below.

Definition of “short selling order”

The definition in Section 80A is extremely wide, and includes a number of situations which would not amount to a short sale under Section 80, or under the Eleventh Schedule to The Stock Exchange Rules as currently drafted. For example, if a person holds TraHK units, issues a redemption notice and at the same time gives an order to sell the underlying basket of securities, the sale can be settled on T+2. Nevertheless, the seller placing the sale order with the broker will need to identify the sale as a short sale, and provide a documentary assurance to the broker, together with such other information as the SFC may prescribe.

In view of the potential criminal liability for failure to identify a sale as a “short selling order”, it is essential that scope of the definition is beyond doubt. However, we have a number of comments on the definition:

- it would appear that (a) and/or (b) of the definition would apply to securities which have been transferred outright to the seller by way of collateral pursuant to the ISDA Credit Support Annex, a repo or a stock lending agreement. Is this intended?

- it also appears that the definition may apply where a fund has a "long" position in securities, but the fund's custodian has discretionary authority to lend out securities from the portfolio (subject to the securities being capable of recall if the fund manager sells the securities) and, unknown to the fund manager, the particular securities which are the subject to the sale order have been so lent.

In our view, the width of the proposed definition of "short selling order" raises a number of concerns:

- as the definition captures a number of situations where the seller is not, in economic terms, "shorting" the market, the seller (particularly if the seller is an international investor) will be unlikely to realise that the sale is regarded, in Hong Kong, as a "short selling order". While the Hong Kong broker will ask the seller to confirm whether the trade is a short selling order, it does not seem practicable for the broker to ensure that the seller understands the scope of the definition. It is not practicable to expect the broker to advise the seller on whether the transaction falls within the definition, because the broker would entirely rely on the seller to provide all the necessary information about the transaction. It is highly unsatisfactory that the seller and the broker may be at risk of criminal liability resulting from a genuine misunderstanding by the seller of the width of the Hong Kong requirements.
- even if the seller has understood the scope of the definition of "short selling order", it may be very difficult, if not impossible, for the seller to ascertain whether the transaction is in fact a "short selling order". For example, it may be impracticable for a fund manager to check, at the time of placing a sale order, whether the relevant securities have been lent out by the fund's custodian. Also, if a securities house is operating a global trading book, the individual dealer will know the amount of securities which are available to be sold, but may not know whether those securities represent an outright transfer of collateral to the securities house and/or securities received under an equity repo or other OTC derivative.

Another concern with the breadth of the definition of "short selling order" is that many institutional investors, such as pension funds and mutual funds, are not permitted by applicable laws or regulations (or by their constitutional documents) to engage in short selling. The meaning of "short selling" for this purpose will usually not be clearly defined. Therefore, if a sale order would be a "short selling order" for the purposes of Hong Kong law, the prudent legal advice would be that the investor was not permitted to place the order for the transaction. This would appear to preclude many institutional investors from engaging in legitimate investment activities in relation to Hong Kong securities (which do not, from an economic perspective, involve "shorting" the market at all).

For example, mutual funds authorised by the SFC for public marketing in Hong Kong are prohibited from effecting short sales which would result in the fund's liability to deliver securities exceeding 10% of its total net asset value. It would appear that this restriction would apply in respect of orders constituting "short selling orders" for the purposes of Section 80B.

The relationship between the obligations imposed under the Bill, and the requirements set out in the Eleventh Schedule to the Stock Exchange rules requires clarification. Currently "short selling" is more narrowly defined in the Eleventh Schedule than in the Bill. Since Section 80C requires that a "short selling order" as defined in Section 80A be input as a short selling order to the Exchange, we assume that the Eleventh Schedule to the Rules will be amended. On the other hand, it does not seem appropriate to impose all the restrictions in the Eleventh Schedule to all transactions which fall within the Section 80A definition of short selling order. In particular, we see no reason why "short selling orders" as so defined should be confined to Designated Securities, and why the up-tick rule (Eleventh Schedule, para (15)) should apply.

Obligation to notify short sales

As already discussed, Section 80B appears to create an absolute obligation on sellers, intermediaries and brokers to provide and/or receive and retain the assurance and additional information referred to in that section. Failure to do so is a criminal offence, which may result in imprisonment for one year and a fine of HK$50,000.

By way of example, criminal liability would appear to arise in the following circumstances:

(i) The custodian of a fund has sent a statement of account to the fund manager which contains an error as to the number of a particular type of securities in the portfolio. The fund manager then places a sale order for that number of securities, honestly and reasonably believing that they are available to settle the sale, in reliance on the information received from the custodian. Since the fund manager will not have treated the sale order as a "short selling order", both the fund manager and the broker through whom the transaction is executed would be guilty of a criminal offence.

(ii) If the seller knows the true facts but wrongly informs the broker that the sale is not a "short selling order", whether deliberately or due a misunderstanding of the wide scope of the definition, both the seller and the broker would commit a criminal offence for not providing and receiving the relevant information.

This no-fault liability contrasts with Section 80C (obligation to disclose short sales), which only applies where a stockbroker or stockbroker's representative knows or is informed that an order is a "short selling order", and also applies only where the person has failed to identify the order as a "short selling order" without reasonable excuse. At the very least, similar qualifications should be introduced into Section 80B.

Information required to be provided

Section 80B requires the seller to provide an assurance, in documentary form, before or at the time of placing the order with his broker or other intermediary. We note that this may preclude sale orders from being placed by telephone, and result in delays for investors in being able to sell Hong Kong securities. Since "document" is defined in the Securities Ordinance as including computer inputs or outputs, we assume that the assurance could be given by e-mail, but this does not necessarily solve the problem, since the seller may not have all the necessary information which needs to be provided, there may be delays in transmissions of e-mail, and the seller may be unwilling to provide the information by e-mail unless high levels of security are in place.

Where paragraph (a), (b) or (f) of the definition of "short selling order" is applicable, the seller needs, in addition to the general assurance, to give an assurance that all the relevant parties to the agreement or arrangement concerned, as referred to in that paragraph, will provide the securities to which the order relates.

In the case of a stock borrowing, we understand that it is market practice for the lender to give a "hold notice". This commits the lender not to loan the securities to a third party, but would permit the lender to withdraw the "hold" if it needs the securities for its own purposes. In these circumstances, since the lender could withdraw the "hold" it does not seem possible for the borrower to give an assurance that the lender **will** provide the securities to which the order relates (although the borrower will have an honest and reasonable belief that the lender will make the securities available, so that no breach of Section 80(1) will have been committed). Even if the borrower has a legally binding commitment from the lender which cannot be withdrawn, the borrower may still be reluctant to give the assurance, because whether the lender will perform its

contractual obligations is not a matter within the control of the borrower. If this requirement is to be retained, the wording should, at least, be qualified to provide that the relevant party reasonably and honestly believes that the other parties to the arrangement will provide the securities to which the order relates.

Furthermore, because of the width of the definition in paragraph (b) of "short selling order", the assurance does not seem appropriate in respect of some cases which appear to fall within (b). For example, if the seller has received the securities under an equity swap transaction, and has a future obligation to redeliver equivalent securities, the assurance appears meaningless. The seller already has the securities and is not dependent on receiving them from the swap counterparty in order to settle the transaction.

We question the need for the additional assurance in cases where Section 80A(a), (b) or (f) applies and if such assurance is to be required, we believe that its content needs to be reconsidered.

In a number of situations, it is not entirely clear who needs to give and receive the relevant assurance and additional information. We assume that Section 80B(1) (sale as principal) would not apply to a principal who has appointed a discretionary agent to act on his behalf, because the principal is not "conveying" the sale order. On the other hand, Section 80B(3) would apply where a person (e.g. a fund manager) is selling securities as agent in exercise of discretionary authority. Section 80B(3) appears to require the agent to obtain a documentary assurance from its principal before "conveying" the order to a broker. It would serve no purpose for the fund manager to have to seek an assurance from the trustees or the underlying beneficiaries of the fund, and it would be impractical to do so.

The type of assurance a broker is required to obtain when accepting a sale order from an agent such as a fund manager is also unclear. Section 80B(3) provides that the assurance must be received from "his principal or other person, for or on whose behalf the order is made". It should be made clear that an assurance from the agent is sufficient, since it would not be practical to obtain such an assurance direct from the underlying beneficial owner.

In any event, what is certain is that, if properly advised, brokers (for example) will be required to conduct a major exercise in documenting sale transactions and in retaining those documentary records. This exercise may involve an unacceptably high level of interference with daily trading operations.

The Securities Law Committee would welcome the opportunity to discuss the above issues with the Financial Services Bureau and/or with the Legislative Council.

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