

**Letterhead of LINKLATERS & ALLIANCE**

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Our ref PAA

Your ref

Bryan Chan  
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Government of The Hong Kong Special  
Administrative Region  
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Hong Kong

Dear Bryan

**Securities (Amendment) Bill**

The "Group of 14", PASLA and the Hong Kong Securities Industry Group welcomed the opportunity to meet with the Financial Services Bureau and the SFC yesterday. I am writing to record the industry representatives' understanding of the position reached in the course of our constructive discussions.

**Scope of definition of "short selling order"**

You had already confirmed at our meeting in January that the definition is not intended to cover the case where a seller sells underlying securities, when that seller holds TraHK Units, ADRs, convertibles or options relating to the securities, and has taken the necessary steps to obtain the underlying securities. This is helpful, but we emphasised that we can only be satisfied that our concerns have been addressed as and when we see a revised draft of the Bill.

We understood that the Administration was sympathetic to our position that situations where the seller has obtained securities by outright transfer, but is under an obligation pursuant to security

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documentation, equity swaps, repos or similar documentation to return an equivalent number of securities at some future date to the counterparty (assuming the counterparty had performed its obligations) should not be caught by the definition of short selling order. We noted in that discussion that we did not think it would be helpful to provide you with examples of documentation used for financing transactions such as equity swaps, repos and prime brokerage arrangements etc to give to the draftsman at the Department of Justice. The structure of the transactions, and the documentation used, will vary considerably, and is often extremely complex. Rather than drafting "exemptions" in the definition of short selling order, reflecting the more standard types of financing transactions currently effected in the market (especially as they will change over time) we suggested that the drafting changes necessary to ensure that the types of financing transactions we are concerned with are not caught by the definition are quite straightforward. We would be grateful if you could let the draftsman see a copy of the markup of the Bill we provided to the Financial Services Bureau on 21 January.

You said that it was still under consideration, as a policy matter, whether the definition of short selling order should include the situation where a seller places an order to sell securities which have been loaned out. This is not a situation which is treated as short selling in any other jurisdiction so far as we are aware. As we have previously explained, particularly in the case where an institutional investor has given its custodian authority to lend stocks, it is not feasible for the fund manager who is managing the portfolio to know, on a real time basis, whether the stocks the fund manager is selling have been lent out. Indeed, as Richard Bentsen pointed out at the meeting, it would create potential market abuses, such as allegations of manipulation, if the fund manager recalled the stock before selling it. The recall would trigger buying activity in the market, and the fund manager would then be selling stock with the benefit of the market impact that the recall would have had.

If institutions who 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 "up-tick rule", they would simply not be willing to participate in lending programmes. This would have a very drastic impact on the availability of stock for borrowing and, hence, on legitimate market activities such as hedging and arbitrage, resulting in reduction in trading volumes and loss of liquidity in the market.

If you still have concerns about sales of loaned stock being treated as "long" sales, we suggest that you follow the same approach as was adopted in Japan last year. This is to provide that a sale of stocks which have been lent out will not be treated as a short selling order so long as the stock loan has been effected pursuant to a stocklending agreement, under which the lender has an absolute right to recall stock at any time (to be delivered within the normal settlement cycle for the relevant stock).

### **Documentary assurance**

We note that the SFC was concerned about short selling not being reported, whether the sales were uncovered sales or covered sales. If the broker was only required to obtain an oral assurance from the seller as to whether the sale was short (and, if so, that it was covered) and to make a record of this, it would be difficult to establish whether the seller or the broker was at fault if it turned out that a sale had been treated as a "long" sale when in fact it was a short sale.

While we sympathise with the concern to ensure that short selling does not go unreported, we still believe that the current requirements of the Bill for a detailed documentary assurance to be provided by the seller would be extremely difficult to comply with in practice. We do not think that the problems are necessarily solved by a "real time" tape-recording, fax or electronic message. First, the obligation under the Bill is on the seller to give a documentary assurance to the broker. Even if the seller knows that it is the broker's practice to tape calls, the seller can never be sure whether the call is in fact being recorded. Even if it is, it is difficult to regard the broker's tapes as a documentary assurance given by the seller. Furthermore, the amount of information required by the current drafting of the Bill

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(and perhaps by the rules proposed to be made by the SFC) is, in our view, impractical to obtain over the phone or where an order is placed electronically. Finally, tapes can be unclear, garbled or simply lacking in sufficient detail even to locate the particular conversation.

We believe that the policy on which the Bill is based would be fulfilled if the Bill was redrafted along the lines that:

- the seller must, when placing an order to sell, confirm to the broker whether the sale is long or short and, if short, that the seller has arranged cover (which could be in the form of a "hold" from a sender) and the broker must retain a copy of the confirmation received from the seller; and
- to the extent that additional information is required by the SFC, the seller should have until the end of the same business day to provide it.

Further details on the evidence the broker must obtain from the seller could be provided in guidance to be issued by the SFC. This could, for example, provide that:

- the confirmation must be obtained in written or electronic form, or by telephone and
- if the order is placed by telephone, either the broker must have confirmed generally to the seller (for example in the client document) that dealing orders are taped, or the seller must re-send the confirmation to the broker in written or electronic form by close of business on the same day.

We believe that proposals along these lines would achieve a reasonable compromise that should capture the information which the SFC considers that it needs for enforcement purposes.

### **Criminalisation**

As we stated at the Bills Committee meeting, we do not believe that it is in line with international market practice to create a specific criminal offence for non-reporting of covered short sales. You mentioned that, in the US, failure to comply with reporting obligations in respect of short sales could attract very substantial criminal sanctions. However, we understand that there are no specific criminal sanctions attached to the rules made under the Securities Exchange Act in respect of short selling. Instead, there is a "catch-all" provision in Section 32 of the SEA, under which a person can be prosecuted for wilful breach of the SEA and rules made under it. This would not apply to non-reporting of short sales unless this was a deliberate violation.

As a compromise, we would accept that non-reporting of covered short selling should be a criminal offence in Hong Kong, but only where non-compliance was deliberate or reckless.

We would welcome the opportunity to see the revised draft of the Bill as soon as it is ready, and to provide you with further comments at that stage.

Yours sincerely

Pauline Ashall

The Chase Manhattan Bank  
Credit Lyonnais Securities (Asia) Limited  
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Donaldson Lufkin & Jenrette Asia Limited  
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Jardine Fleming Securities Limited  
JP Morgan Securities Asia Pte Ltd  
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Merrill Lynch (Asia Pacific) Limited  
Morgan Stanley Dean Witter Asia Limited  
Nomura International (Hong Kong) Limited  
Salomon Smith Barney Hong Kong Limited  
Warburg Dillon Read  
and  
The Hong Kong Securities Industry Group

cc. The Hon Ronald Arculli - Legislative Council  
Mark Dickens - Securities and Futures Commission