

**LETTERHEAD OF FINANCIAL SERVICES BUREAU, GOVERNMENT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION**

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YOUR REF.:

27 January 2000

Distribution List

Dear All,

Securities (Amendment) Bill 2000

Meeting on 18 January 2000

Thank you all for attending the meeting on 18 January 2000 regarding our legislative proposal to strengthen the regulation of short selling. We have found the meeting most helpful and wish that you feel the same. We and the SFC hope that we have clarified for you the purpose and policy underlying the Bill and removed some of your concerns about it. We and the SFC would certainly continue to reflect on the outstanding issues raised at the meeting. Meanwhile, I attach a copy of the summary record of the meeting for your reference and retention. If you have any further views on the matter, please feel free to let us know.

With regards,

Yours sincerely,

(Bryan P. K. Chan)
for Secretary for Financial Services

Att.

Distribution List:

Ms. Beverly Yan, Department of Justice
Mr. Mark Dickens, Securities and Futures Commission
Ms. Stella Leung, Securities and Futures Commission
Mr. Anthony Galliano, Citibank N.A.
Mr. Mike McCoy, Credit Lyonnais Securities Asia Limited
Ms. Chow Yuen-ye, Credit Suisse First Boston (HK) Limited
Ms. Karen Kemp, Exchange Fund Investment Limited
Ms. Pamela Root, Goldman Sachs Asia LLC
Mr. Paul Fan, Hong Kong Stockbrokers Association
Mr. Dannis Lee, Hong Kong Stockbrokers Association
Mr. J. P. Latham, HSBC Investment Bank Asia Holdings Limited
Mr. Andrew Lo, Invesco Asia Limited
Mr. John Knox, Jardine Fleming Securities Limited
Mr. Christopher Seaver, JP Morgan Securities Limited
Ms. Pauline Ashall, Linklaters & Alliance
Mr. Andy Ching, Macquarie Equity (Asia) Limited
Mr. Anthony Stalker, Merrill Lynch (Asia Pacific) Limited
Mr. Roger Dunphy, Morgan Stanley Dean Witter Asia Limited
Mr. Clifford Levy, Nomura International (HK) Limited
Mr. Steve Everett, Northern Trust Company of Hong Kong Limited
Mr. Dominick Falco, Salomon Smith Barney Hong Kong Limited

**Records of Meeting with the Industry on 18 January 2000
On the Securities (Amendment) Bill 2000**

(A) Background

A meeting with members of the securities industry, chaired by the Deputy Secretary for Financial Services, Mrs. Rebecca Lai, was held on 18 January 2000 to discuss the industry's concerns about the Securities (Amendment) Bill 2000. Attendance is at Annex.

(B) The Intention of the Bill

2. The Chairman reiterated the Government's position that it recognized the market functions of legal (covered) short selling and had no intention to prohibit legal short selling in Hong Kong. She added that short selling could add liquidity to the market and balance the inflationary effect of securities margin trading, and hence contribute to price stability. However, short selling, without regulation, could be subject to abuse by market manipulators and detrimental to the market. The Bill therefore sought to put in place better regulation over such activities to improve market transparency and discipline and to prevent abuse. She stressed that this was particularly important to a small but open market like Hong Kong.

3. The Chairman further explained that uncovered (or "naked") short selling was already illegal under existing law and the Bill sought to close the gap in respect of the reporting and disclosure of covered short selling.

(C) Deliberation on the Concerns Raised by the Industry

4. Representatives of the industry submitted their views and concerns to the Financial Services Bureau for consideration prior to the meeting, which were discussed at the meeting in fuller detail. The gist and outcome of the discussion are summarised as below -

(a) Existing section 80

There were comments that the existing section 80 of the Securities Ordinance (Cap. 333) was unclear regarding its parameters and

interpretation. Administration's clarification was sought as to whether the following scenarios were caught by section 80 -

- (a) where a fund manager sells securities, and those securities had been lent out by the fund's custodian and therefore need to be recalled in order to settle the sales;
- (b) where a dealer sells securities where he has obtained a "hold notice" from a lender, even though the hold notice is not a binding commitment by the lender to lend the securities;
- (c) where a trader is selling a basket of securities and, through making an error as to the exact composition of the basket, sells slightly more shares than he actually owns.

Mr. Mark Dickens of Securities and Futures Commission (SFC) confirmed that scenarios (a) and (b) should not be caught by section 80, provided that in the case of (a), the terms of relevant agreements enabled the fund manager to recall the securities lent out and in the case of (b), provided the short seller with the right of first refusal in respect of the securities on-held by his lending counterpart. In relation to scenario (c), it would depend on whether the seller had a reasonable and honest belief that he had such a right in respect of the relevant securities.

In this regard, SFC undertook to issue in due course a guidance note or policy statement to set out its view on the types of activities that might amount to illegal activities under section 80.

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

The industry had also raised concerns about the relationship between section 80 and the proposed section 80B. For instance, if a dealer failed to receive or retain the assurance required under the proposed section 80B, he would be in contravention of that provision and *might* have also breached section 80 as he did not have a "reasonable and honest belief" that his principal has the unconditional right to sell the securities. The Administration clarified that if a dealer had exercised his obligations under the proposed section 80B to obtain assurance from his principal, this should be a ground for defence for section 80(1)(b).

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

There were views that the definition of "short selling order" in the Bill might be too wide that it might capture situations which would not amount to a short sale at present either under section 80 or the 11th Schedule of the Rules of the Stock Exchange of Hong Kong (SEHK). In this regard, the Chairman clarified that the Bill did not intend to extend the scope of what was regarded as reportable short sale under the present Exchange Rules and in cases where the seller had issued an irrevocable request to obtain the securities (such as in cases where the short seller had bought the shares which had not been delivered; exercised a call option; or issued a request for redemption of TraHK units), the sale would be regarded as a long sale and not subject to the reporting requirement under the Bill. Representatives of the industry found this assuring but remained concerned if the drafting languages of this provision would inadvertently capture scenarios that were not intended for.

In view of the concerns expressed and to avoid any possible confusion, the Chairman advised the meeting that the Administration would propose to change the term to read "reportable sale order" and consult the drafting officer if the drafting of the Bill could be further improved to remove the uncertainties.

(d) **Sale of securities that have been lent out**

The industry was also concerned whether a sale of securities by a fund manager (and any proprietary owner) which had been lent out might amount to a "reportable sale order" and thereby subject to the tick rule of SEHK. Furthermore, if that was the case, the fund managers would have to confirm with their custodians as to whether their securities had been lent out before placing a sale order in relation to those securities, which might add impediment to the practice and discourage the fund managers from lending out the securities. In response, Mr. Dickens explained that under the current drafting of the Bill, such sale order would be "reportable" if the fund manager (or any securities lender) had not given a notice to recall the securities lent out, and thereby subject to the tick rule of SEHK.

The industry had strong views in this regard and advised the meeting that this might be against the common practice in the local market as well as other overseas markets. In this connection, they undertook to provide the Administration with further information about the regulatory practices in other jurisdictions for reference and further consideration. Separately, on a related matter, the industry raised their views that the present operation of the tick rule of SEHK might be too stringent and render short selling practically unworkable.

In response to the concerns raised, the Chairman agreed to give further consideration to the matters and assured the meeting that the Administration would bear in mind the regulatory costs involved. she also undertook to follow up with the Chief Executive of SEHK if any improvement could be made to the operation of the tick rule to address the concerns raised.

Separately, at the request of the meeting, the Administration would also give further thoughts to the position in the case of rehypothecation of collateral.

(e) **Proposed section 80B**

To address the concern that the provision, as presently drafted, might subject an intermediary or a short seller to strict criminal liability because of the act of a third party, the Administration undertook to propose to add a "reasonable excuse" or "reasonably and honestly believe" defence clause in the proposed section 80B(6).

On a separate issue, there was concern as to whether the proposed section would impose an additional obligation on the dealers to ask their clients if a sale order is a reportable one. In this regard, Mr. Dickens and Ms. Leung advised the meeting that the Bill did not add any new obligation on stockbrokers and market intermediaries regarding how they should seek and verify information from their clients currently contained in the relevant Rules of SEHK and Code of Conduct issued by the SFC. Instead, the Bill specified what steps (including seeking assurance and reporting) would be required of the intermediaries if it came to their knowledge that the sale order was a "reportable" one.

(f) Discretionary fund managers and trustees

As to whether the proposed section 80B(3) (i.e. the requirement that an agent must obtain an assurance from his principal) would apply in the case of a discretionary manager selling on behalf of a fund or an individual, or a trustee selling on behalf of the beneficiaries of a trust, both the Administration and SFC were of the view that the fund manager and trustee and the end beneficiaries were not in an agency-principal relationship and should not be subject to the requirement. The Administration would seek further legal advice to ascertain the position and consider any necessary amendments for clarity sake.

(g) Documentary assurance

The Chairman told the meeting that the term "document" was defined in the existing Securities Ordinance and it carried a wide meaning including tape recording, e-mail or document of similar forms. The requirement in the Bill to obtain and keep documentary assurance should not create too much administrative burden on the intermediaries. Concerning the doubt as to whether the current drafting would enable the acceptance of a hold notice given by securities lender as a proof that the borrower (i.e. the short seller) had obtained a presently exercisable and unconditional right over the relevant securities, the Chairman confirmed that it was the intention of the Government and further legal advice would be sought to ascertain if the drafting language reflected such intention. In this regard, the industry had undertaken to provide their drafting comments to the Government for further consideration.

(h) Liabilities under proposed section 80C

There were concerns if a market intermediary would be prosecuted for any inadvertent mistake made under the proposed section 80C. The Chairman assured the meeting that the SFC, as the law enforcement agency, would exercise its enforcement power carefully. The standard of proof required in a criminal case was very high and there would be a defence of reasonable excuse for that purpose.

(i) **Rules made by SFC**

The Chairman said that the relevant amendments in the Bill were only enabling provisions which would empower SFC to make rules as necessary in respect of the reporting requirements of short covering information and record-keeping requirements of stock lenders. She assured the meeting that the SFC, in line with its usual practice, would consult the industry before making such rules. The meeting also noted that such rules would be subsidiary legislation and were subject to negative vetting by the Legislative Council.

Financial Services Bureau
27 January 2000

**Meeting with the Industry on 18 January 2000
On the Securities (Amendment) Bill 2000**

Attendance List

FSB and DoJ

Mrs. Rebecca Lai (Chairman)	Deputy Secretary for Financial Services Financial Services Bureau
Ms. Au King-Chi	Deputy Secretary for Financial Services Financial Services Bureau
Mr. Bryan Chan	Principal Assistant Secretary for Financial Services Financial Services Bureau
Ms. Beverly Yan	Senior Government Counsel Department of Justice
Ms. Hanny Lam (Secretary)	Assistant Secretary for Financial Services Financial Services Bureau

SFC

Mr. Mark Dickens	Executive Director, Supervision of Markets Securities and Futures Commission
Ms. Stella Leung	Director, Supervision of Markets Securities and Futures Commission

Industry

Mr. Anthony Galliano	Region Head of Asia Pacific Citibank, N.A. (Worldwide Securities Services)
Mr. Mike McCoy	Executive Vice Chairman Credit Lyonnais Securities Asia Limited

Ms. Chow Yuen-yee	Vice President and Compliance Director for North Asia Credit Suisse First Boston (HK) Limited
Mr. Karen Kemp	Deputy Chief Executive Exchange Fund Investment Limited
Ms. Pamela Root	Managing Director, General Counsel Goldman Sachs Asia LLC
Mr. Paul Fan	Chairman Hong Kong Stockbrokers Association
Mr. Dannis Lee	Committee Member Hong Kong Stockbrokers Association
Mr. J.P. Latham	Director and Head of Compliance HSBC Investment Bank Asia Holdings Limited
Mr. Andrew Lo	Managing Director Invesco Asia Limited
Mr. John Knox	Director, Derivatives Jardine Fleming Securities Limited
Mr. Christopher Seaver	Vice President, Head of Legal JP Morgan Securities Limited
Ms. Pauline Ashall	Partner Linklaters & Alliance
Mr. Andy Ching	Head of Compliance Macquarie Equity (Asia) Limited
Mr. Anthony Stalker	Managing Director and Head of Equity Sales and Trading Merrill Lynch (Asia Pacific) Limited
Mr. Roger Dunphy	Executive Director, Equity Finance Morgan Stanley Dean Witter Asia Limited
Mr. Clifford Levy	Director, Legal Nomura International (HK) Limited

Mr. Steve Everett

Managing Director
Northern Trust Company of Hong Kong Limited

Mr. Dominick Falco

Director
Equity Finance Salomon Smith Barney Hong Kong Limited