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**Bills Committee on Securities (Amendment) Bill 2000
Meeting on 25 February 2000**

**Comparative Study on the Regulatory Regimes
for Short Selling Activities in Selected Securities Markets**

INTRODUCTION

This paper briefly outlines the regulatory regimes for short selling activities in various international securities markets including Australia, the US, Canada, Japan and the UK. It also sets out the existing regulatory regime in Hong Kong and that proposed under the Securities (Amendment) Bill 2000.

DETAILS

Overviews

2. Short selling means the sale of a security which the seller does not own. It is a common practice in many major overseas stock markets and an integral part of a well-developed stock market. Short selling adds liquidity to the market and can balance the inflationary effect of securities margin trading, thus contributing to price stability. It is however widely accepted that there should be sufficient prudential and surveillance measures to ensure the fairness and transparency of such activities and the market efficiency they provide.

Australia¹

3. Short selling in Australia is governed by the Corporations Law, under which a person shall not sell securities to a buyer unless, at the time of the sale:

- (a) the person has or, where the person is selling as agent, the person's principal has; or
- (b) the person believes on reasonable grounds that the person has, or where the person is selling as agent, the person's principal has,

¹ Source: Australian Corporations Law and Australian Corporations & Securities Law Reporter published by CCH Australia Limited.

a presently exercisable and unconditional right to vest the securities in the buyer. The law also stipulates that where the sale is made on the securities exchange and arrangements have been made before the time of sale that will enable delivery of securities of the class sold to be made to the buyer by the settlement day, the sale is subject to a tick rule². In addition, the seller, when requesting his dealer to execute the sale of securities, is required to inform the dealer that the sale is a short sale. A dealer so informed, or a dealer who is selling as a principal and prior arrangements have been made to enable delivery of securities, is further required to endorse on any document evidencing the sale that the sale was a short sale. Contravention of the provisions is an offence and is liable to a fine of A\$2,500 (about HK\$12,000) and imprisonment for 6 months for the first instance and to a fine of A\$10,000 (about HK\$50,000) and imprisonment for 2 years for a later offence.

4. In addition, the Business Rules of the Australian Securities Exchange permit the Exchange to designate securities as "approved securities" for the purposes of the short selling rules and also provide for the disclosure of gross short selling positions and short covering information via its market dissemination facilities.

The United States³

5. The US Securities and Exchange Commission ("the SEC") is authorised under the Securities Exchange Act of 1934 to regulate short sales of securities traded on a US national securities exchange to protect investors. Under the Rule 10-1(a) of the SEC Rules, a person shall not, for his own account or for the account of any other person, effect a short sale below the price of the last sale or at the last sale price unless it is above the next preceding different price⁴. In addition, the Rule also specifies that a broker or dealer shall not mark any order to sell a security on a securities exchange as "long" unless the security to be delivered after sale is carried in the account for which the sale is to be effected or such broker or dealer is informed that the seller owns the security ordered to be sold and can deliver it to the account without undue inconvenience or expense. In other words, for a sale of security that the seller does not own, the sale has to be reported as "short".

6. Willful violation of any provision of the Securities Exchange Act

² The Australian "tick" rule stipulates that a short sale of security shall not be executed at a price below the price at which the immediately preceding ordinary sale was effected.

³ Source: US Securities Exchange Act of 1934 published by CCH Inc.

⁴ Except Nasdaq.

or any rule or regulation made thereunder (including SEC Rules) is an offence and is liable on conviction to a maximum fine of US\$1,000,000 (about HK\$7.8 million) and imprisonment for 10 years. It may however be noted that no imprisonment penalty will be imposed for violation of any rule or regulation if the defendant proves that he had no knowledge of such rule or regulation.

7. Stock exchanges in the US also require disclosure of short open interest information.

Canada⁵

8. In the Ontario Province of Canada, short selling, whether covered or not, is permissible under the Securities Act of Ontario, provided that the seller who through an agent places an order to sell declares to his agent that he does not own the security. Contravention of the provision is an offence and on conviction is liable to a fine of C\$1 million (about HK\$5.3 million) and imprisonment for 2 years.

9. Short selling effected on the Toronto Stock Exchange is also subject to a "tick" rule, whereby a short sale shall not be executed at a price below the price of the last board lot sale of the security. The Exchange Rules further require that an employee or other person accepting an order on behalf of a broker of the Exchange shall ascertain at the time of the acceptance of any sale order whether the order is a short sale order and if the employee or such other person is informed or knows that the sale is a short sale, he shall mark the order as such. In addition, brokers are also required under the Exchange Rules to report the aggregate short position of individual client, non-client and principal accounts to the Exchange.

Japan⁶

10. Under the Japanese Securities and Exchange law, no person shall effect a sale of securities which such person does not own in violation of a cabinet order. Any person who is a securities intermediary and contravenes the provision shall be punished by a non-penal fine of not more than ¥300,000 (about HK\$45,000).

11. There is also requirement that a member of a securities exchange shall, in conducting sales of securities at the securities market provided by the

⁵ Source: Ontario Securities Act published by Bowne & Co. Inc.

⁶ Source: International Securities Regulations-Japan

securities exchange at its own or its customer's account, disclose whether it is selling the securities which it owns or which it does not own. Where the sale of securities which are not owned by the member or its customer for its own or such customer's account is made, the sale is subject to a "tick" rule whereby the short sale shall be made at a price which is at the same price as or above the price existed immediately preceding such sale.

The United Kingdom

12. In the UK, short selling is largely unregulated. However, the Financial Services Authority has been considering some possible transparency arrangements for short selling.

Hong Kong

13. Short selling activities in Hong Kong are presently governed by the Securities Ordinance (Cap. 333), the Rules⁷ of the Stock Exchange of Hong Kong ("the SEHK") and the Code of Conduct issued by the Securities and Futures Commission ("the SFC").

Requirements under the Securities Ordinance

14. Under section 80 of the Securities Ordinance, a person shall not sell securities at or through the SEHK unless, at the time he sells them, he or his principal (if he is selling as an agent) has or reasonably and honestly believes that he has or his principal has a presently exercisable and unconditional right to vest the securities in the purchaser of such securities (commonly referred to as a prohibition of "naked" or "uncovered" short selling). Contravention of the provision is a criminal offence and on conviction is liable to a fine of \$10,000 and imprisonment for six months. There is however no specific reporting or disclosure requirement for short selling under the existing Ordinance.

Requirements under the SEHK Rules

15. At present, Members of the SEHK are bound by the requirements under the Eleventh Schedule of the SEHK Rules, which, among other things, require that a short sale effected on the SEHK shall not be executed at a price

⁷ Rules 563D and 563E of the SEHK Rules enable the SEHK to designate securities that are eligible for short selling and to impose trading limits or conditions on securities designated for short selling. The Short Selling Regulations are stipulated in the Eleventh Schedule of the Rules.

below the best current ask price (i.e. the "tick" rule). Under the Schedule, "short selling" is defined as the sale of a security which -

- a) the seller does not own; or
- b) is consummated by the delivery of a security borrowed by or for the account of the seller,

where "to own a security" means -

- i) either directly or through an agent having an unconditional right, title or interest to or in the relevant security;
- ii) owning a security convertible into or exchangeable for the relevant security and having tendered such security for conversion or exchange or having issued irrevocable instructions to convert or exchange such security;
- iii) having or having written an option to purchase or acquire the relevant security and having subsequently exercised that option or that option subsequently having been exercised, as the case may be; and
- iv) having rights or warrants to subscribe to the relevant security and having subsequently exercised such rights or warrants.

16. The Eleventh Schedule also imposes certain reporting and record-keeping requirements on the Members of the SEHK. Under the Rules, an SEHK Member is required to enquire of its client whether, at the time of placing an order, such client owns the securities offered for sale or if such client is acting as agent, whether he knows his principal owns the securities offered for sale. The Member shall not place a short selling order for a client unless he has reasonable grounds to believe that the client has made arrangements to ensure that the securities will be available for delivery on the stipulated settlement date. In case where the Member is informed or he knows that an order to sell is a short sale, he shall, when inputting a short selling order, indicate on the trading system that the order is a short selling order.

17. An SEHK Member engaged in short selling is also required to maintain a ledger, which is kept up-to-date with such Member's short selling activity on his proprietary and client accounts and contains, among other things, the underlying securities borrowing transaction reference and when

the short sale is covered, the cover transaction detail. The ledger, which should be retained for not less than seven years, should be made available upon request to the SEHK, the Hong Kong Securities Clearing Company and the SFC for inspection. An SEHK Member who does not comply with any of the Short Selling Regulations will be subject to disciplinary actions by the SEHK.

Requirements under the SFC Code of Conduct

18. Pursuant to the SFC Code of Conduct, a registered person is expected to ensure at all times that he has satisfactory internal control procedures and financial and operational capabilities which can be reasonably expected to protect his operations, his clients and other registered persons from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions. The SFC has particularly issued further guidelines regarding the internal control procedures of the registered persons, including specific guidelines on the order handling procedures. Suggested procedures include the following -

- a) Orders are recorded, using standard order forms, and time-stamped promptly upon initiation or receipt and are required to be transmitted to the dealer, floor trader or operators of terminals for automated trading systems within a reasonable time period, normally immediately. This recording procedure may be modified to take into account the different types of orders in different markets so long as it provides an audit trail.
- b) Prior to executing a client order, the designated staff shall check the following -
 - i. the status of the account;
 - ii. applicable account limits, if any;
 - iii. the sufficiency of available funds or available credit in the relevant account;
 - iv. **in the case of a sell order, the sufficiency and availability of securities or the existence of necessary securities borrowing arrangements, if applicable;**

- v. the authority and applicable limitations thereon of the person placing the order;
- vi. where the order is received by facsimile or telex, such order is reviewed by senior staff and, if in doubt, the client is called to check the validity and authority of the order prior to execution;
- vii. the services and products the account is authorised to use/trade; and
- viii. any special conditions stated in the client agreement or reported by other operating departments within the firm.

Proposal under the Securities (Amendment) Bill

19. The Securities (Amendment) Bill 2000 seeks to increase the penalty levels for contravention of section 80 to a maximum fine of \$100,000 (level 6) and imprisonment for two years to increase deterrence and to close the gap in respect of the reporting and disclosure of covered short selling and extend the reporting requirements to other market participants in addition to SEHK Members. The proposed provisions stipulated in the Bill generally mirror the existing reporting and disclosure requirements under the relevant Rules of the SEHK and Code of Conduct issued by the SFC.

20. In addition, the proposed legislation is also in line with the regulatory spirit in other overseas international securities markets. We believe that the legislation is important to maintain an appropriate balance in the regulation of short selling in Hong Kong. This is particularly important to a small but open market like Hong Kong. We are willing to consider amendments to the Bill where unintended transactions or market operators were caught inadvertently, without compromising the effectiveness of the provisions.

Financial Services Bureau
25 February 2000