

年利達律師事務所的信頭

Letterhead of LINKLATERS & ALLIANCE LINKLATERS

3 March 2000

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Our ref PAA

Your ref

Bryan Chan
Financial Services Bureau
Government of The Hong Kong Special
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Dear Bryan

Securities (Amendment) Bill

As discussed at the Bills Committee meeting last Friday, we have, on behalf of the “Group of 14”, PASLA and the Hong Kong Securities Industry Group, prepared a fresh redraft of the Bill, which in our view would remove some of the more fundamental problems with the Bill as currently drafted. This redraft of the Bill is offered in substitution for the earlier redraft which was sent to Rebecca Lai on 21 January 2000, and was included with our submission to the Bills Committee on 21 February 2000.

Please note the following points on the attached redraft.

Terminology

The new definition of “entitlement” is not meant to make any substantive change, but to assist in clarity by avoiding the need to keep referring throughout the legislation to a person having a “presently exercisable and unconditional right to vest the securities in a purchaser of them”.

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The references to “stockbrokers” have been replaced by “exchange participants” simply because the Exchanges and Merger (Clearing Houses) Ordinance has now been enacted. Again, there is no change of substance.

Our previous redraft proposed that the term “short selling order” be replaced by “reportable sale order”. As long as the definition is amended as we propose, to make clear that it does not apply to transactions which are not currently treated as “short sales” for the purposes of the Stock Exchange Rules, we have no particular objection to continuing to use the term “short selling order”.

Scope of “short selling orders”

The scope of this definition is fundamental to the practical impact of the legislation. The proposed redraft is very similar to that we proposed earlier. It seeks to clarify that a sale order will not be a “short selling order” where, for example, the seller holds an option relating to the underlying securities and has submitted a notice to exercise that option. It has been accepted in the discussions with the Administration that this is a “long sale” not intended to fall within the new legislation. The redraft also seeks to ensure that the short selling regime would not apply to sales of stock acquired through financing arrangements such as equity swaps, loans and repos.

In relation to the sale of stocks which have been loaned out, we believe that to treat such sales as short sales would have a very drastic impact on the availability of stock for borrowing, and therefore on legitimate market activities such as hedging and arbitrage, resulting in reductions in trading volumes and loss of liquidity in the market. To address any concerns the Administration may have, we propose that the definition of “short selling order” is amended to provide (in paragraph (b)) that a sale of loaned stocks would be a short selling order **unless** the loan has been effected pursuant to a stocklending agreement, under which the lender has the right to recall stock at any time (to be delivered within the normal settlement cycle for the relevant stock).

We have proposed the deletion of paragraph (f) of the definition (arrangements prescribed under Section 146) since the scope of the definition has been exhaustively debated and we do not believe it is appropriate for the SFC to have power to extend that definition by regulations made under Section 146.

Seller’s obligations

As you know, we do not believe it is practicable in all circumstances for the seller to be able to provide, at the time of placing the order, the documentary assurance that the sale is “covered”, together with the additional assurances and information required under the draft Bill and/or in regulations to be made by the SFC under Section 146.

As outlined in our letter of 25 February, we propose that the seller’s obligation, at the time of placing an order, should be to indicate that the sale is a short sale and that it is “covered”. Where the order is placed with an exchange participant, the person placing the order will have to provide evidence, either at the time of placing the order or at latest by T+2, that the order was “covered” at the time the order was placed.

In practice, this evidence would take the form of a “hold number” provided by the stock lender, and it would be possible for the Hong Kong regulators to ask the lender to provide information on the time when the “hold number” was issued. Therefore, although the seller could provide the “hold number” at any time up to T+2, the regulators would still be able to ascertain by reference to the time the “hold number” was issued whether the borrowing had been arranged prior to the time when the order was placed.

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In practice, the evidence could take the form of one or more taped telephone calls between the seller and the exchange participant. Alternatively, it could take the form of one or more electronic or written communications sent to the exchange participant by the seller. This could be spelled out in regulations made under Section 146 by the SFC.

Criminal liability

As previously discussed, the current draft of the Bill makes the seller and the exchange participant strictly liable for failures to report short sales, and failure to retain the evidence of the "cover". The Administration has confirmed that this was not the intention, but is proposing that there should be a defence of "honest and reasonable belief".

We understand that the Administration is primarily concerned to impose criminal liability on sellers who deliberately fail to report short selling, contrary to the existing requirements in Hong Kong. The seller may well be outside the territorial scope of the Hong Kong laws but it is thought that, if a criminal offence had been committed, the Hong Kong regulators could enlist the support of regulators in the seller's home jurisdiction to take action against the seller.

We believe that co-operation from overseas regulators is much more likely to be forthcoming where the offence was committed deliberately or knowingly, rather than through inadvertence or negligence. We also consider that it is contrary to principle to impose criminal sanctions on a person for an inadvertent mistake, even if it was not "reasonable". Accordingly, we propose that the seller should only be guilty of an offence where the seller knew that the order was a short selling order. Also, unless the exchange participant knows that the sale is a short sale, his failure to input the order as a short and to receive and retain the information received from the seller, should not be a criminal offence.

Furthermore, where a seller or an exchange participant knows that an order is a short sale, making an inputting error, or forgetting to pass on an order as a short selling order, even if careless, should not be a criminal offence. Therefore, we propose that the offences should only be committed if the failure was intentional or reckless. This would be consistent with the position in the United States, where a breach of laws made under the Securities Exchange Act is only a criminal offence if committed wilfully. In the case of a Hong Kong registered person and its representatives, careless errors could still lead to disciplinary action being taken under the SFC Codes or the Stock Exchange Rules.

We believe that our redraft would still address the "mischief" with which the Hong Kong regulators are concerned, i.e. deliberate disregard of the reporting requirements for covered short sales, without creating undue risk of criminal liability for inadvertent mistakes and errors.

We would welcome the opportunity to discuss our redraft with you. We are copying this letter and the redraft to the Chairman and Secretary of the Bills Committee as well as to the SFC.

Yours sincerely

Pauline Ashall

Encl

The Chase Manhattan Bank
Credit Lyonnais Securities (Asia) Limited
Credit Suisse First Boston (Hong Kong) Limited

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Deutsche Securities Asia Limited
Donaldson Lufkin & Jenrette Asia Limited
Goldman Sachs (Asia) L.L.C.
Jardine Fleming Securities Limited
JP Morgan Securities Asia Pte Ltd
Kleinwort Benson Securities (Asia) Limited
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/Constance Li - Legislative Council
Mark Dickens - Securities and Futures Commission

SECURITIES (AMENDMENT) BILL 1999

80A Interpretation for purposes of Section 80B

In Section 80B:

“entitlement” means, in relation to securities, a presently exercisable and unconditional right to vest the securities in a purchaser of them;

“exchange participant’s representative” means a registered dealer’s representative of an exchange participant;

“securities borrowing and lending agreement”

- (a) means an agreement whereby a person borrows or lends securities pursuant to an arrangement where the borrower undertakes to return securities of the same description or pay the equivalent value of the securities to the lender;
- (b) includes a stock borrowing within the meaning of section 19(16) of the Stamp Duty Ordinance (Cap. 117);

“short selling order” means an order to sell securities in respect of which a seller or a person, for whose benefit or on whose behalf the order is made, has an entitlement by virtue of having-

- (a) entered into a securities borrowing and lending agreement with another person, and having borrowed the securities to which the order relates or having obtained confirmation from that other person that the securities are available to lend to him;
- (b) a right to redelivery of securities of the same description as the securities to which the order relates, as a result of having loaned the securities to another person pursuant to a securities borrowing and lending agreement;
- (c) a title to other securities which are convertible into or exchangeable for the securities to which the order relates;
- (d) an option to acquire the securities to which the order relates; or
- (e) rights or warrants to subscribe for and to receive the securities to which the order relates

provided that:

- (i) with respect to (b), an order is not a short selling order where the seller (or the person for whose benefit or on whose behalf the order is made) has the right at any time under the securities borrowing and lending agreement to call for redelivery of securities of the same description as the securities to which the order relates, within the normal settlement period for settlement of sales of those securities; and
- (ii) with respect to (c)-(f), an order is not a short selling order where the seller (or the person for whose benefit or on whose behalf the order is made) has at the time the order is placed, given instructions or made requests, as required in the circumstances of the case, to obtain the securities to which the order relates.

80B Obligations in respect of short selling orders

- (1) A person, when selling securities listed on the Unified Exchange, whether as a principal or agent, shall not convey a sale order for execution at or through the Unified Exchange, knowing that the order is a short selling order, unless
 - (i) at or prior to the time of conveying the order, he informs the person to whom the order is conveyed that the order is a short selling order and confirms that he, or where he is acting as agent, the person for whose benefit or on whose behalf the order is made, has an entitlement to those securities; and
 - (ii) in the case of a person who conveys a sale order directly to an exchange participant, he provides the exchange participant, prior to the time when the transaction is due to settle, with evidence that he, or where he is acting as agent, the person for whose benefit or on whose behalf the order is made, had an entitlement to those securities at the time of placing the order.

The manner in which the evidence may be provided and the information to be included shall be prescribed in rules made under Section 146.

- (2) An exchange participant, when selling securities listed on the Unified Exchange as principal, shall not place a sale order for execution at or through the Unified Exchange, knowing that the order is a short selling order, unless he possesses such evidence as shall be prescribed in rules made under Section 146 that he has an entitlement to those securities.
- (3) An exchange participant shall, subject to sub-section (4), retain the evidence referred to in sub-section (2), and the evidence received pursuant to sub-section (1), for not less than one year from the date of the order to which it relates.
- (4) The exchange participant shall provide such evidence to the Commission upon request made at any time within that year by an employee of the Commission.
- (5) Such evidence shall in any proceedings be admissible as prima facie evidence of the matters thereby evidenced.
- (6) An exchange participant or an exchange participant's representative who knows that an order to sell securities listed on the Unified Exchange is a short selling order shall—
 - (a) when passing the order to any other person with a view that the other person shall input the order into the trading system of the Unified Exchange, inform such other person that the order is a short selling order;
 - (b) when inputting the order into the trading system of the Unified Exchange, indicate such matters as may be required under the applicable rules of the Unified Exchange to show that the order is a short selling order.
- (7) A person who intentionally or recklessly contravenes sub-section (1), (2), (3), (4) or (6) shall be guilty of an offence and shall be liable on conviction to a fine at level 5 and to imprisonment for 1 year.

Regulations

Section 146(1) is amended—

- (a) in paragraph (ra), by repealing “seller is derived from such an arrangement” and substituting “purchaser is derived from such an arrangement, and to provide such evidence of the arrangement to the exchange participant as may be specified in the rules.”;

- (b) by adding—
 - “(raa) providing that a lender under a securities borrowing and lending agreement within the meaning of section 80A shall keep such records or documents and in such manner and form as may be prescribed by the rules;”.