

立法會
Legislative Council

LC Paper No. CB(2)1947/99-00

Ref : CB2/BC/7/99

**Paper for the House Committee meeting
on 12 May 2000**

**Report of the Bills Committee on
Securities (Amendment) Bill 1999**

Purpose

This paper reports on the deliberations of the Bills Committee on Securities (Amendment) Bill 1999.

The Bill

2. The Bill seeks to strengthen the regulation of short selling in Hong Kong to safeguard the markets from the failure of price-discovery and lack of transparency brought about by non-compliance with the disclosure rules of short selling.

3. The Bill proposes to increase the penalties against illegal short selling under section 80 of the Securities Ordinance (Cap. 333). It also proposes three new sections (sections 80A, 80B, 80C) to provide for new definitions such as "short selling order" and "securities borrowing and lending agreement", as well as an obligation of both the seller and the market intermediary to confirm and disclose short sale. Rule-making power under section 146(1) is also extended to provide for the reporting of purchasing orders for covering short sales and the keeping of documents and records by lenders of securities to enhance the transparency of the stock market.

Background

4. Short selling is a common practice in many major overseas stock markets and is an integral part of a well-developed stock market. While covered short selling activities are legal in Hong Kong, it is widely accepted that there should be sufficient surveillance measures to ensure fairness and

transparency of such activities and the market efficiency. The strengthening of the regulation of short selling activities is one of the measures proposed in the Financial Secretary's 30-Point Programme in early September 1998 to improve market discipline.

5. Uncovered (or naked) short selling is illegal under existing law. Moreover, only certain securities are permitted for short selling at or through the Stock Exchange of Hong Kong (SEHK). Section 80 of the Securities Ordinance provides that a person shall not sell securities at or through 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. Contravention of the provision is an offence liable on conviction to a fine of \$10,000 and to imprisonment for six months.

6. There is at present no legislative requirement on reporting and disclosure of short selling, but members of SEHK are bound by the Rules of SEHK to report a short selling order. The Rules of SEHK however do not have the force of law and breaches could only result in disciplinary actions of SEHK leading to suspension and in the extreme case, removal of membership.

7. The Administration considers that non-reporting of covered short sales would circumvent the regulation of short selling and would have the same effects as "naked" short selling from the market regulation point of view. To maintain market discipline, the Administration proposes to put unreported covered short selling on par with "naked" short selling and to impose heavier penalty against "naked" short selling to enhance the deterrent effect.

The Bills Committee

8. At the House Committee meeting on 7 January 2000, a Bills Committee was formed to study the Bill. Chaired by Hon Ronald ARCULLI, the Bills Committee have held five meetings to discuss with the Administration and have also invited industry representatives, legal professionals and concerned organizations to give their views on the Bill.

9. The membership list of the Bills Committee is in **Appendix I**. The list of organizations consulted is in **Appendix II**.

Deliberations of the Bills Committee

10. Acknowledging that Hong Kong is a small and open market vulnerable to market manipulation and price instability, members are generally in support of the proposal to strengthen the regulation of short selling activities to enhance

market transparency and market efficiency. However, some members have reservations about imposing criminal liability on market participants with regard to the assurance and disclosure requirements, and the effectiveness of such requirements in addressing the systemic risks of the securities market. Members have discussed with the Administration and deputations the need for statutory reporting requirements, the implications on the operation of the industry and ways to balance the industry's practical concerns with the need for prudential control and greater market transparency.

11. Members note that the industry has strong views on some of the provisions in the Bill, in particular the definition of short selling order, the requirement for documentary proof for a short selling order and the criminalization of unreported short selling. A number of these issues have been clarified or resolved after discussion. The industry will continue discussion with the Securities and Futures Commission (SFC) on the provision of additional documentary proof which will be prescribed in the rules of SFC made under section 146 of the Securities Ordinance.

12. The deliberations of the Bills Committee are summarized below.

Tightening regulation of short selling activities

13. As the industry has expressed concern that the Bill may have the effect of widening the scope of reportable short selling, members have sought clarification on the Government policy with regard to short selling and the legislative intent of the Bill. The Administration has advised that it recognizes the market functions of legal (covered) short selling and it has no intention to prohibit legal short selling in Hong Kong. The Bill seeks to put in place better regulation over such activities and to ensure compliance with the up-tick rule of the SEHK. As the SEHK Rules only bind its members, the Bill proposes to make the disclosure rule a statutory requirement which is extended to the seller and other market participants. According to the Administration, the requirements only mirror those which already exist in the SEHK Rules and the Code of Conduct of the SFC. The Bill has not proposed new obligations on the stockbrokers and market intermediaries, and the regulatory measures are in line with the practice of major international markets such as the United States, Canada and Australia.

14. SFC has informed members that the securities market in Hong Kong was seriously disrupted with massive short selling in 1998 and some 900 short sale transactions involving over one billion shares of securities were found not reported by the stockbrokers. Due to the lack of transparency, the market was guessing in the dark, which had spiral effects on market psychology. Furthermore, relying on good faith in short sale transactions had resulted in over-lending of securities due to over-promise by securities lenders. To prevent double-counting errors in short selling, the Bill proposes that the dealer

should seek assurance that the relevant securities are on hold for the borrower at the time of placing a short selling order.

15. Some members agree that statutory reporting requirement will enhance market transparency and safeguard the interest of investors. However, some other members are of the view that the short selling information is more for the benefits of the regulatory bodies than for the market participants. A member considers that the Bill cannot address the systemic risks that may arise from the securities lending and borrowing activities and derivatives trading outside Hong Kong.

16. The Administration has advised that it acknowledges that international securities lending and borrowing activities play a major role in short selling activities in Hong Kong. The Government's position is to encourage securities lending and borrowing in local market. As regards securities lending and borrowing activities overseas, international securities dealers should abide by the legislation of the respective jurisdiction and the SFC maintains close liaison with major overseas market regulators.

17. Members of the Bills Committee note that the industry does not raise any objection to the proposed increase in penalty for illegal short selling under section 80(1) of the Securities Ordinance. The new penalty will be a fine of \$100,000 and imprisonment for two years.

Definition of short selling order (section 80A)

18. With regard to the industry's concern that the proposed definition of short selling order may have widened the scope of reportable short selling, members have sought clarification from the Administration as to whether the definition covers transactions in the futures and derivatives markets and fund managers selling loaned securities under discretionary authority. The industry and some members have pointed out that these activities are currently not regarded as short selling in major markets and that inclusion of these activities as reportable short selling would subject these transactions to the price restriction rule of the SEHK. This will have significant impact on the operation of the industry and may lead to substantial shrinkage in the securities and derivatives markets in Hong Kong.

19. In response to these concerns, the Administration has clarified that it has no intention to expand the present scope of reportable short selling activities. It also confirms that the following are excluded from the scope of the definition -

- (a) fund managers and trustees who have discretionary authority to sell the securities on behalf of the clients or beneficiaries or to sell borrowed securities;

- (b) equity swaps and repurchase where the title has been transferred outright to the seller; and
- (c) the seller has issued an unconditional instruction to obtain the underlying securities in respect of call options, subscription warrants, TraHK Units and other convertible securities.

20. To remove any ambiguity in this respect, the Administration has agreed to introduce amendments to the definition.

Documentary assurance (section 80B)

21. Under the Administration's proposal, a person selling as a principal is obliged to inform his agent if the sale order is a short sale, and to provide to the agent an assurance that he has a presently exercisable and unconditional right in respect of the relevant securities. If the seller obtains such a right by virtue of entering into a securities borrowing and lending (SBL) agreement or other similar agreements, he must also provide an assurance that the counterparty to the agreement will provide the relevant securities to the purchaser of the securities. In addition, the SFC may also require the seller to provide any other information which will be prescribed by rules. The documentary evidence required for the purposes of the proposed sections 80A-80C will have to be kept for one year.

22. The Bills Committee notes that the industry has serious concern about the statutory requirement for providing documentary assurance at the time of placing an order, and the criminal liability for non-compliance. The industry considers it impractical to obtain such assurance before placing the order as the seller will expect prompt execution of a sale order, and the requirement for documentary proof such as a "hold" notice will cause delays to transactions. Members have therefore discussed with the industry representatives their trading practices, the types and time of documentary records being maintained in order to work out feasible solutions.

23. Some members share the concern of the industry that obtaining documentary assurance such as a "hold" notice at the time of placing an order is impracticable since orders can be placed over the telephone or by electronic means. In this connection, the Administration has reminded the industry that "document" as defined in the Securities Ordinance includes tape recording and any form of computer input or output or other material produced by whatever means. However, the industry has reservations about keeping tape records of the verbal assurance as evidence supplied by the seller, and the practicality of keeping such tapes for twelve months for inspection by the regulating bodies.

24. The Bills Committee notes the Administration's position that some form of audit trail is necessary to enable the regulatory body to verify the assurance

given by the seller and to pinpoint responsibility in the case of an erroneous transaction. However, as the industry may have operational difficulties in obtaining documentary evidence such as a "hold" notice from the seller when placing an order, some members agree with the industry that this can be supplied afterwards. These members consider that it will be sufficient for the dealer to obtain a verbal assurance from the seller and make a documentary record of such when placing a short selling order, subject to the provision of the documentary proof by the close of the trading day.

25. In response, the Administration has advised that the dealer is already required under the Eleventh Schedule of the SEHK Rules to obtain the assurance from the seller at the time an order is placed. Such assurance can be provided verbally and recorded in the form of tape or other documentary records. Nevertheless, the Administration has accepted a proposal that the supporting documentary proof required by the SFC for a short selling order could be provided within such time as determined by the SFC. The Administration has agreed to move an amendment to section 80B to provide such flexibility.

26. Members note that the provision of documentary evidence will be prescribed in the SFC rules which are subsidiary legislation subject to the negative vetting procedure of the Legislative Council. The industry will further discuss with the SFC the detailed arrangements.

27. Regarding the application of the documentary assurance requirements to fund managers and trustees, members have also sought clarification as to whether a fund manager selling securities as discretionary agent will need to obtain documentary assurance from its principal before conveying the short selling order to a broker. The Administration has clarified that fund managers and trustees with discretionary authority will be regarded as acting as principals and will not be subject to the requirements under section 80B(1) and (2). To remove any doubt in this respect, the Administration will introduce an amendment to expressly exclude persons who sell securities under discretionary authority (such as fund managers) from the requirements of the proposed sections 80B(1) and (2).

28. As regards the application of the proposed section 80B(3) to fund managers acting as agents and conveying short selling orders to brokers, the Administration has confirmed that the proposed section 80B(3) also applies to fund managers acting as agents.

Offences under sections 80B and 80C

29. Industry representatives have expressed much concern that inadvertent mistakes or technical breaches of the reporting rules and disclosure requirements made by market intermediaries will be criminal offences under

sections 80B and 80C in the Bill, whereas they are currently subject only to the disciplinary measures under the Rules of SEHK. Members have noted that the proposed section 80B has not provided a defence for inadvertent mistakes, while section 80C provides a defence of "reasonable excuse".

30. Some members share the concern of the industry that market intermediaries should not be held criminally liable for careless mistakes or errors that may occur in the chain of transactions through no fault of the broker. In this respect, the industry representatives have cited examples such as mistaken input of the stock number, and erroneous calculation of the number of shares or availability of the shares where several markets are involved. Some members consider that disciplinary measures should suffice for inadvertent mistakes or technical breaches.

31. The Administration has responded that there are similar statutory reporting requirements in some major markets. However, to address the concerns over inadvertent mistakes or errors made through no fault of the broker, the Administration has agreed to provide a defence of reasonable excuse for offences under section 80B. An amendment will be introduced to this effect.

32. On offences under section 80C concerning non-disclosure of a short selling order by a stockbroker, the industry is worried that inadvertent omissions by stockbrokers will be criminal offences under this section. In this respect, the Administration has clarified that it is not the policy intention to criminalize breaches of section 80C(1) due to inadvertence or carelessness and that a defence of "reasonable excuse" is provided under section 80C(3). However, industry representatives remain concerned that the court may not accept careless mistakes as reasonable excuse and that stockbrokers will still have criminal liability. The industry therefore proposes that section 80C(3) be amended so that the offence is committed only if the person "knowingly or recklessly" contravenes section 80C(1). After consulting the Department of Justice, the Administration has advised that it is very difficult, if not impossible, for the prosecution to prove the actual knowledge of the defendant. This will render the offence provision ineffective in creating any deterrence and will defeat the purpose of the proposed legislation.

33. To address the concerns of the industry, the Chairman of the Bills Committee has suggested incorporating a "lawful excuse" instead of "reasonable excuse" under section 80C(3) to include carelessness, inadvertence and negligence but exclude recklessness. The Administration has further consulted the Department of Justice on the suggestion and agreed to introduce amendments along such lines as suggested by the Chairman.

34. A member maintains the view that non-disclosure of legal short selling activities by a stockbroker should not be a criminal offence, and that the

offence provision under section 80C(3) should be deleted. The Administration has responded that the offence provision has to be retained to provide deterrence against non-disclosure of short selling.

35. On prevention of inadvertent omissions caused by mistaken computer input, a member has asked whether the computer system of the SEHK can be modified to provide a mandatory field requiring the stockbroker to indicate a short selling order. SFC has advised that the SEHK computer system already provides a mandatory field for this purpose, and the stockbrokers only need to press a button and the SEHK up-tick rule will be activated automatically. The stockbrokers can complete the ledgers on the details of the transactions and the cover arrangements afterwards.

Other amendments

36. The Administration has also proposed some minor and textual amendments such as amending the term "stockbroker" to "exchange participant" in line with current terms used in the Exchanges and Clearing Houses (Merger) Ordinance and other amendments consequential upon the enactment of Securities (Margin Financing) (Amendment) Ordinance.

Committee Stage amendments

37. The Administration has proposed amendments to address the concerns of the industry and the Bills Committee (**Appendix III**). The subsections under the proposed Section 80B will be re-numbered as a result of the amendments. The Bills Committee has not proposed any amendments.

Recommendation of the Bills Committee

38. The Bills Committee supports resumption of Second reading debate of the Bill on 24 May 2000.

Advice sought

39. Members are requested to note the Bills Committee's recommendation in paragraph 38.

**Bills Committee on
Securities (Amendment) Bill 1999**

Membership List

Hon Ronald ARCULLI, JP (Chairman)

Hon Eric LI Ka-cheung, JP

Dr Hon David LI Kwok-po, JP

Hon NG Leung-sing

Hon Christine LOH

Hon CHAN Yuen-han

Hon SIN Chung-kai

Dr Hon Philip WONG Yu-hong

Hon Jasper TSANG Yok-sing, JP

Hon FUNG Chi-kin

Total : 10 Members

Date : 16 February 2000

**Bills Committee on
Securities (Amendment) Bill 1999**

List of organizations consulted

1. Hong Kong Association of Banks
2. Hong Kong Bar Association
3. Hong Kong Investment Funds Association
4. Hong Kong Securities Professionals Association
5. Hong Kong Society of Accountants
6. Hong Kong Stockbrokers Association Ltd
7. Securities and Futures Market Reform Members' Concern Co-ordinating Group
8. The Institute of Securities Dealers Ltd
9. The Law Society of Hong Kong
10. The Chase Manhattan Bank
11. Credit Lyonnais Securities (Asia) Limited
12. Credit Suisse First Boston (Hong Kong) Limited
13. Deutsche Securities Asia Limited
14. Donaldson, Lufkin & Jenrette Asia Limited
15. Goldman Sachs (Asia) L. L. C.
16. Jardine Fleming Securities Limited
17. JP Morgan Securities Asia Ltd
18. Kleinwort Benson Securities (Asia) Limited
19. Merrill Lynch (Asia Pacific) Limited
20. Morgan Stanley Dean Witter Asia Limited
21. Nomura International (Hong Kong) Ltd
22. Salomon Smith Barney Hong Kong Limited
23. Warburg Dillon Road
24. Hong Kong Securities Industry Group
25. Pan Asian Securities Lending Association