SUBMISSION TO THE BILLS COMMITTEE ON THE SECURITIES (AMENDMENT) BILL 1999

This submission is produced by the group of financial institutions named below (the "Group") and summarises a number of concerns for securities dealers, stock lenders, fund managers and institutional investors relating to the Securities (Amendment) Bill 1999. A summary of this submission, in Chinese, is enclosed.

As a preliminary comment, we are of the view that the short selling market in Hong Kong is already adequately regulated. This is borne out by the typically smooth functioning of the market with a high degree of transparency. We note that the SFC found very few violations even during the abnormal market conditions in August/September 1998. Accordingly, we do not consider that the proposed amendments are necessary. If, however, there are to be changes our comments are as follows.

Scope of the Bill

"Uncovered" short selling (i.e. selling securities where you do not own them or have arrangements in place, such as a stockborrowing, to settle the transaction) is already a criminal offence, under Section 80(1) of the Securities Ordinance.

Under the Bill, the penalty for a breach of Section 80(1) is increased to a fine of HK$100,000 and 2 years imprisonment. We have no comments on this change. We note that the Bill does not otherwise amend Section 80(1) and we understand that the Administration has confirmed to the Bills Committee that the changes made in the Bill are not intended to broaden the interpretation of Section 80, which is to be welcomed. We also welcome the fact that the SFC intends to issue a guidance note to the industry to provide further clarification on the scope of the section.

The new Sections 80A-80C include a wide definition of "short selling order", applying where a person has a presently exercisable and unconditional right to vest the securities in the purchaser, but where that right has arisen through a stock borrowing or in various other ways. At the time of effecting a "short selling order" the seller must provide an assurance (in documentary form) that he does have a presently exercisable and unconditional right to the securities, and certain other information (including information to be prescribed by the SFC under rules yet to be published). The stockbroker through whom the securities are sold must retain the document for at least a year, and make it available to the SFC on request. The broker must also ensure that the sale order is input as a short selling order for execution on the SEHK, so that it will be subject to the "up-tick" rule. Failure to provide, receive or retain the relevant information, or to input the order as a short sale, would be a criminal offence, punishable with a fine of HK$50,000 and imprisonment for 1 year.

As a general comment, we question the need for creating a new criminal offence for failures to report "covered" short selling. Hong Kong regulated persons are already subject to regulatory requirements to enquire whether sales are short and to record short sales as such. The regulators have wide powers to investigate and take action, and the Group would not object to the regulators having powers to impose additional administrative sanctions such as a financial penalty in respect of any unreported short sale. Imposing criminal liability appears draconian, particularly as the definition of "short selling order" is highly technical, the broker in Hong Kong will often be relying on information from third parties to assess whether a sale is "short" and in the trading environment errors can all too easily be made.

Unfortunately, while the creation of a criminal offence for failing to report will discourage reputable and risk-averse institutions such as pension funds and their fund managers from engaging in stock lending, or even dealing in Hong Kong securities altogether, it will be unlikely to have any impact on any party who was deliberately short selling and failing to report the order as a short selling order. However, the Hong Kong broker who inadvertently executed such orders for the short seller could be guilty of an offence.

The main areas of concern are as follows:

Scope of the definition of "short selling order"

The Bill as drafted appears substantially to expand the kind of activity that would be reportable as short sales, as compared to the current short selling rules in the Eleventh Schedule to the Stock Exchange Rules. Many of the situations mentioned below are not, in economic terms, cases where the seller has a "short" position, and in practice it may be very difficult for the seller to ascertain whether the transaction is one that falls within the scope of the definition. Complying with the new requirements could add substantially to the costs of doing business and create inefficiencies in the Hong Kong securities and futures markets.

1 Part (a) of the definition of "short selling order" includes a sale of securities to which a seller has a presently exerciseable right by virtue of having entered into a securities borrowing and lending agreement with another person.

This appears to apply where the seller has lent out the stock, even though the seller has the right to recall the loan at any time and therefore can settle the sale transaction. For example, a fund manager who is responsible for buying and selling securities for a fund will not usually know whether the fund's custodian or prime broker has lent out the securities.

The sale of loaned securities in this way does not amount to "short selling" under the laws of other major international markets. Extending the short selling laws to this situation would, in our view, have an extremely damaging effect on the availability of stock for lending in the Hong Kong market. It is not practicable for sellers such as fund managers to investigate, each time prior to selling stock, whether it had been lent out and, if so, to issue a recall notice prior to placing the order. The risk of criminal liability for failing to report (and the application of the up-tick rule) would make institutions very reluctant to lend Hong Kong securities, and the impact on the market as a whole would be considerable. See Appendix 1 to this paper.

This part of the definition also appears to apply where a person sells Hong Kong securities to which he had received outright title as collateral for a stock loan he had made. Again, we do not believe that such a sale should be treated as a "short selling order". Where a securities dealer is dealing in securities that it owns, it may be very difficult for a trader to identify whether the particular securities concerned were obtained through an outright transfer of collateral, rather than any other form of outright acquisition. The records available to the trader will simply show the total number of securities held.

We believe that part (a) of the definition should be amended so that it only applies to the borrower of securities, and this is reflected in the markup of the Bill which the Group sent to the Financial Services Bureau, the SFC and the Department of Justice last month, a copy of which is attached as Appendix 2 to this submission.

2 Part (b) of the definition applies (inter alia) to a sale of securities to which the seller has a present right by virtue of having entered into an agreement under which the seller .... is required to return the securities or pay their equivalent value.

This appears to apply where the securities that are being sold are owned by the seller, but were acquired as an outright transfer of collateral or pursuant to an equity swap or an equity repo. Again, we see no reason why the sale of securities in these circumstances should be treated as a "short selling order" and in practice where a sale is being effected, it could be very difficult to identify whether some or all of the securities being sold were such as to fall within (b).

We understand that the Administration has confirmed to the Bills Committee that the Bill is not intended to cover equity swaps and repos where title has been transferred outright to the seller. However, there is a suggestion that, instead of amending the definition so that it does not cover these situations, the SFC should issue guidance that no enforcement action would be taken. Since a breach of the law would be a criminal offence, and since guidance issued by the SFC has no legal effect and could be changed at any time, we consider it essential that the definition is changed. In our view, there is no need to include (b) in the definition at all, and (as reflected in our markup of the Bill) it should be deleted, which would address the concern.

3 Part (c) of the definition of "short selling order" applies where the seller has a present right to the securities by virtue of owning other securities that are convertible into or exchangeable for the securities being sold. Part (d) applies where the right arises by virtue of an option to acquire the securities.

This appears to apply to the following situations, even though, at the time of the sale order, the seller has made an irrevocable request to obtain the relevant securities:

- the seller holds ADRs relating to Hong Kong listed securities, and sells the securities
- the seller holds call options traded on the Stock Exchange's Traded Options Market, and sells the securities underlying the options
- the seller holds subscription warrants relating to the securities, and sells the securities
- the seller holds TraHK units, and is selling the underlying basket of securities
- the seller holds an underlying basket of securities, and sells TraHK units
- the seller holds convertible securities, and sells the securities underlying the convertible securities.

There seems no justification for applying the onerous requirements of Sections 80B-80C to such transactions.

The Administration has confirmed to our Group and, we understand, to the Bills Committee, that the Bill is not intended to apply in these circumstances. However, since Section 80B imposes criminal liability in respect of short selling orders, it is essential that the scope of the definition is clear, and that it is practical for the seller to ascertain, at the time of placing the order, whether it falls within the definition. We remain convinced that a drafting amendment to the Bill is essential. Our preferred solution would be to delete (b)-(f) of the definition altogether. However, as a compromise we proposed an amendment in our mark-up of the Bill (see Appendix 2) which would clarify that (c)-(f) do not apply where the seller has made a request to obtain the underlying securities.

Section 80B obligations

Section 80B requires a documentary assurance (together with additional information to be specified in rules to be made by the SFC) to be provided and received at the time a short selling order is placed with the broker.

While we accept that the broker should ascertain, at the time of taking an order, whether it is a short selling order, it is extremely onerous to require the seller to provide, and the broker to receive, an assurance (and other information as specified by the SFC) in documentary form, and which may need to be fairly detailed, at the time the order is taken.

The Administration has confirmed to our Group that a telephone call which is recorded, or a Bloomberg message, would constitute a "documentary assurance". However, we do not believe that this is a practical solution, because taping technology is not entirely reliable, and the broker taking the call should not be at risk of criminal liability if there was a problem with the recording of a particular call. Also, depending on the amount of information required to be obtained, it may be impracticable to obtain the information over the phone or Bloomberg. Furthermore, in the case of telephone calls, retaining tapes for at least 12 months would be very burdensome. It should be sufficient that the seller confirms (orally or in any other manner) that he has a present right to vest the securities in the purchaser and that the broker who receives the order promptly makes, if necessary, and retains a documentary record of the assurance as provided by the seller. If additional information is required, it should be acceptable for this to be supplied (orally or in documentary form) by the seller after the order has been placed. See our markup of the Bill in Appendix 2 to this submission.

We also have substantial concerns in relation to the wording of the assurance. Where the order falls within certain paragraphs of the definition (e.g. the stock has been borrowed) the seller's assurance must include an additional assurance that the other party or parties to the arrangements will provide the securities to which the order relates. The language as currently drafted would, in our view, preclude a seller from placing a sale order where a "hold notice" has been given, but the borrowing has not yet been made and settled. The Administration has confirmed to our Group and, we understand, to the Bills Committee, that this is not intended, but the Bill will need to be amended in this respect. In addition, if the securities had been borrowed in advance and were now held by the seller, the language of the additional assurance does not make sense.

In principle, the additional assurance referred to in Section 80B(i)(A)(II) and (ii) and (iii) (A)(II) of the definition does not add anything to the general requirement that the seller has a present right to vest the securities in a purchaser. In our view, the provisions of the Bill requiring the additional assurance would impose onerous administrative burdens without doing anything to further the objectives of the Bill, and should be deleted.

As a drafting point, the application of Section 80B is unclear where a person (e.g. a fund manager) is selling securities as discretionary agent. Section 80B(3) appears to require the agent to obtain a documentary assurance from its principal before "conveying" the order to a broker. The Administration has confirmed to our Group and, we understand, to the Bills Committee, that this is not intended, and we consider that a drafting amendment should be made to clarify this.

It is also unclear what assurance a broker is required to obtain when accepting a sale order from an agent such as a fund manager. Section 80B(3) provides that the assurance must be received from "his principal or other person, for or on whose behalf the order is made". It is not clear whether an assurance from the fund manager is sufficient, or whether it needs to be obtained from the underlying beneficial owner, which would be impractical.

Again, we made proposals for how the drafting could be amended to address our concerns, in the mark up of the Bill attached as Appendix 2.

Strict liability

Section 80B as drafted creates offences of strict liability both from the point of view of the seller and the broker. For example, an investor may inadvertently place a sale order for securities which are not immediately available for delivery, because of an error in information received from his custodian. This is not an offence under Section 80(1) because the investor would have a reasonable belief, in reliance on the information received from the custodian, that he had the relevant securities to sell. However, there is no similar defence in Section 80B for the broker.

Similarly, a broker who takes a sale order is required under the Stock Exchange Rules to enquire whether it is a short sale. If the seller confirms that it is not, the broker should not commit an offence under Section 80B if it turns out that this is not the case. However, the broker would still seem to be guilty of an offence under Section 80B(3) as currently drafted.

We understand that the Administration is prepared to amend the Bill so that an intermediary who honestly and reasonably believes that the seller had a presently exerciseable and unconditional right to the securities will have a defence under Section 80B.

We do not believe there is a justification for imposing criminal liability for non-reporting of covered short selling at all. The proposal to introduce this defence does little to alleviate our concerns. Covered short selling is not illegal, and Hong Kong regulated persons who fail to report covered short sales are already subject to regulatory sanction. Although, as pointed out by the Administration, some other countries regulate short selling, failure to report would generally (for example in the U.S.) attract regulatory sanctions only and would not be a criminal offence.

In our view, criminal penalties should not be lightly imposed, but only where the protection of the public is at stake. Furthermore, in the financial services industry, any criminal conviction is likely to be treated with extreme seriousness by regulators in other markets. In the case of an intermediary, it and its affiliates would need to report the conviction to regulators worldwide and they could be disqualified from conducting certain types of business. In the case of an individual, conviction could lead to regulators internationally refusing to license the individual to conduct financial business, leading to loss of such person's career.

Therefore, where a person is prosecuted for non-reporting of short selling, the consequences of conviction could be out of all proportion to the conduct for which the person was prosecuted. At least where a criminal offence may attract imprisonment and a significant fine, an offence should only be committed in the case of deliberate or at least reckless misconduct. In our view, the defence proposed in Section 80C of the Bill, and the defence proposed to be introduced in Section 80B do not go far enough.

Even with the proposed defences, genuine mistakes may lead to prosecution, for example in the following circumstances:

- a broker forgets to ask a client whether the sale is a short sale;
- a fund manager is selling a basket of securities and, by mistake, places a sale order for the wrong number of stocks
- a broker fails to input an order as a short sale, through inadvertently pressing the wrong key.

In every well-managed financial institution some trading errors will occur every day. It may be difficult, however, to rely on a defence of honest and reasonable belief. A person who failed to check the position would find it difficult to say that he positively believed that he or his client owned

the stock. Furthermore, the onus would be on the defendant to show that the mistake was a "reasonable" one to have made.

If the Bill is to introduce criminal liability for non-reporting, we believe that an offence should only be committed if the non-reporting was intentional or reckless. See the mark up in Appendix 2.

Section 146 Regulations

Section 146 is to be amended to give the SFC power to make rules; requiring notifications to be made by stock lenders, and by short sellers in respect of short sales. We have no objection to rules being made which would create an audit trail in respect of "cover" for short sales. However, the rules may also require a short seller who purchases securities in order (for example) to return equivalent securities under a stock loan, to notify the broker of that fact. This would lead to additional compliance burdens for stock borrowers and brokers alike, and will provide a further deterrent to the lending and borrowing of Hong Kong securities as part of legitimate trading activities. The SFC and the Administration have indicated to the Group that no view has yet been taken on whether it is in fact necessary to make rules in respect of purchases made to cover "shorts". We see no reason for such rules, and it seems contrary to principle for a rule-making power to be given to the SFC in circumstances where the purpose for which rules would be made is unclear.

Likely effects of the Bill

The range of products and techniques, including derivatives, stock borrowing and short selling, available in Hong Kong to enhance market liquidity and volume, has contributed to the strength and resilience of the market even during the Asian economic crisis. If the Bill substantially reduces the amount of securities available for lending, the stock market, futures market, Traded Options Market and OTC derivatives market, and the ability to conduct arbitrage among these markets, could be seriously impaired. This would, in turn, lead to pricing inefficiencies and market illiquidity and drive away the stock lending market. The proposals are out of line with the trend in other markets, which is towards greater liberalisation of short selling rules. The proposals are also out of line with the aim of streamlining the process of dealing and settlement of Hong Kong securities to increase Hong Kong's competitiveness. The proposals are likely to encourage domestic companies to list outside Hong Kong, to make dual listing more difficult and, where companies are dual-listed, to result in migration of trading to overseas markets such as NASDAQ.

Appendix 1 to this submission sets out our estimation of the potential impact of the Bill as presently drafted on the securities and futures industry in Hong Kong. While the amendments and clarifications proposed by the Administration would, if implemented, go some way to reduce the impact a number of major concerns would still remain, including:

- drying up of the availability of stock available for borrowing if the sale by a lender of loaned securities is treated as a short selling order
- onerous requirements for obtaining documentary information at the time of taking an order, which will impose heavy burdens on the industry and make the process of dealing in Hong Kong securities less efficient
- risk of criminal liability for inadvertent errors and omissions.

The Group would urge the Bills Committee to ensure that these concerns are addressed.

19 February 2000

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

APPENDIX 1

SECURITIES (AMENDMENT) BILL
POTENTIAL IMPACT ON HONG KONG SECURITIES AND FUTURES INDUSTRY

1. STOCKLENDING ACTIVITIES

Many institutions that have traditionally lent Hong Kong shares, such as U.S., European and regional pension plans and fund managers, may decide that the proposed legislation has made the business unattractive and that the incremental earnings made from stock borrowing is not sufficient in light of (i) the risk of criminal liability (see below), (ii) the cost associated with systems enhancement to comply with the proposed additional reporting/record keeping requirements, and (iii) affirmations required by borrower that the lender will deliver the shares. Even for those lenders that continue to lend Hong Kong shares, we expect that they will increase the "buffers" they maintain in Hong Kong shares to reduce the risk of mix-ups and mistakes. If lenders discontinue lending Hong Kong shares or increase their buffers, the amount of Hong Kong shares available to borrow will inevitably decrease and the cost of borrowing will increase. We estimate that the proposed legislation will severely damage the Hong Kong stock lending market, currently in the region of US$10-15 billion notional amount (market value) per annum of loans outstanding.

- We estimate reduction of 85%-90% in stock available for borrowing.
- Firms have already experienced a significant percentage decrease in the notional amount of outstanding Hong Kong stock loans following the intervention in August 1998 and the subsequent regulatory changes (including strict enforcement of T+2 and the proposed changes to stock lending in the third quarter of 1998).
- Given the significant decrease in Hong Kong stock lending since the summer of 1998, and the additional contraction in such lending that we anticipate the new legislation will engender, many stock lending departments will continue to pare down the number of people engaged in Hong Kong stock lending. The industry has experienced an overall reduction in staffing levels by relocating staff to other regional centres. Any further restrictions would probably lead to further staff reductions or complete relocation of the business elsewhere in the region.
- The Japanese stock lending market experienced a similar issue in 1998 when a regulatory interpretation affected sales by fund managers of loaned stock. The interpretation was very quickly withdrawn and the Japanese market has since doubled in size.

2. FUND MANAGEMENT ACTIVITIES

Fund managers are generally risk adverse. The legislation criminalizes failure to report activities that traditionally have not been viewed as short selling, including where a fund manager has sold shares that it owns but which were lent either by the fund manager or, more likely, its fund custodian. The administrative burden and systems enhancement requirements that will be required, the apparent application of the Hong Kong Stock Exchange's "up-tick rule" and criminal liability for inadvertent breaches of the reporting and record keeping requirements will discourage pension plans from lending their Hong Kong shares and/or from investing in the Hong Kong market. See "1" above for a discussion of the impact on the stock lending market.

3. ARBITRAGE AND DERIVATIVES ACTIVITIES

A shortage of Hong Kong shares for borrowing, increased borrowing costs for those Hong Kong shares available to borrow, the administrative burden caused by the reporting requirements, and the application of the Hong Kong Stock Exchange's "up-tick rule," will make it more difficult to buy and sell among Hong Kong shares and their derivative products, like TraHK units, Hang Seng futures and options and single stock Traded Options. Thus the legislation will undermine the efficiency of the Hong Kong derivatives markets represented by the Hong Kong Futures Exchange, the Traded Options Market and TraHK units, creating more pricing disparity and mispricings. Nor will the impact of the legislation simply stop at the Hong Kong derivatives markets. As volumes decrease on those markets, so too will trading volumes decrease in the cash market.

Ultimately the vibrancy of the Hong Kong cash and derivatives markets will directly affect the numbers of personnel employed in Hong Kong securities and futures businesses and may also cause migration of business overseas.

4 BROKERAGE ACTIVITIES

Agency brokers will be exposed to risk of criminal liability for errors committed by their personnel and by their clients if they fail to properly report a "short selling order," even if the client intentionally or erroneously made the mistake. We are not aware of any other jurisdiction in the world where a jail sentence could be imposed on someone who mistakenly hits the wrong key on an order entry terminal.

The Hong Kong Stock Exchange is seeking to attract issuers who have listed in other markets to dual-list their shares in Hong Kong. Legislation such as this will discourage many issuers from dual-listing their shares. Also, it is possible that some Hong Kong listed companies may seek to dual-list elsewhere to facilitate the trading of their shares in markets outside Hong Kong. The effect on the local brokerage industry could potentially be significant and adversely affect Hong Kong employment.

APPENDIX 2

SECURITIES (AMENDMENT) BILL 1999

80A Interpretation for purposes of sections 80A and 80C

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"reportable sale 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 a presently exercisable and unconditional right to vest the securities in the purchaser of them by virtue of having -

(a) entered into a securities borrowing and lending agreement with another person and having borrowed the securities, or having obtained a confirmation that such person has the securities available to lend to him;

(b) [deleted]

(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;

(e) rights or warrants to subscribe to and to receive the securities to which the order relates; or

(f) entered into with another person an agreement or an arrangement of a description as is prescribed under section 146

provided that, with respect to (b)-(f), an order is not a reportable sale 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 Obligation to confirm short sales

(1) A person, where he is selling as a principal, or as agent in the exercise of discretionary authority, shall not convey a sale order, knowing or being reckless as to whether it is a reportable sale order, at or through the Unified Exchange unless he provides to the person to whom the order is given —

(a) an assurance (which need not be in writing) to the effect that he has a presently exercisable and unconditional right to vest the securities to which the order relates in the purchaser of them; and

(b) by the end of the same day, such information, if any, as is prescribed under section 146.

(2) A stockbroker, where he is selling as a principal, shall not convey a sale order, knowing or being reckless as to whether it is a reportable sale order, at or through the Unified Exchange unless he possesses such information (which shall be in the form of a document), if any, as is prescribed under section 146.

(3) A person, where he is selling as an agent pursuant to an order received from another person, shall not accept or convey a sale order, knowing or being reckless as to whether it is a reportable sale order, at or through the Unified Exchange unless the person from whom the order is received—

(a) has provided to the seller an assurance (which need not be in writing) to the effect that such person, or such other person for whose benefit or on whose behalf the order is made, has a presently exercisable and unconditional right to vest the securities to which the order relates in the purchaser of them; and

(b) by the end of the same day, provides the seller with such information, if any, as is prescribed under section 146.

(4) The stockbroker or other person who receives the assurance and the information prescribed under section 146, if any, shall—

(a) subject to paragraph (b), retain evidence of such assurance and such information, if any, for not less than 1 year from the date upon which it is received; and

(b) provide such evidence to the Commission upon request made at any time within that year by an employee of the Commission.

(5) An assurance shall in any proceedings be admissible as prima facie evidence of the matters specified in subsection (1), (2), or (3) to which the assurance relates.

(6) A person who contravenes subsection (1), (2), (3) or (4) shall be guilty of an offence and shall be liable on conviction to a fine at level 5 and to imprisonment for 1 year.

80C Obligation to disclose reportable sales

(1) A stockbroker or stockbroker's representative who knows that an order to sell securities is a reportable sale 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 reportable sale 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 reportable sale order.

(2) For the purposes of this section, "stockbroker's representative" means a registered dealer's representative of a stockbroker.

(3) A person who intentionally or recklessly contravenes subsection (1) shall be guilty of an offence and shall be liable on conviction to a fine at level 5 and to imprisonment for 1 year.