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CONSULTATIVE PAPER

SHORT-SELLING PROPOSALS

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The Stock Exchange of Hong Kong Limited
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Hong Kong

February 1992

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1.1 Introduction

1.1.1 Short-Selling is defined as the sale of a security which at the time of the sale is not owned by the seller. It is a technique used to take advantage of an anticipated decline in the price of a security or alternatively to protect a long position.

1.1.2 In order to be able to effect settlement, the short-seller borrows securities he has sold short at the time of the short sale. Thus if he can buy that security at a future date at a lower price a profit will arise. Conversely if the price of the security rises a loss will result. It is this situation that these proposed Rules and Regulations seek to formalize and supervise (see Appendices II and III).

1.2 The Advantages and Disadvantages of Short-Selling

1.2.1 There are a number of perceived advantages in being able to short sell and briefly summarised the arguments in its favour are as follows: -

- (a) adds liquidity to the market;
- (b) helps smooth sharp market declines;
- (c) removes an existing inherent fault in the local futures index market in that it is one-sided;
- (d) provides a useful price stabilization mechanism;

- (e) enables proper disclosure, regulation and surveillance to be introduced in respect of an activity that already exists to a significant extent; and
- (f) brings Hong Kong into step with other major financial markets.

1.2.2 It should be noted that the Securities Review Committee in its Report published in May 1988 concluded that provided the necessary safeguards and regulations were introduced, short-selling should be allowed in Hong Kong.

1.2.3 Whilst it is recognised that there are potential dangers in short-selling, it is considered that these relate mainly to the dangers of potential abuse. In view of the fact that some forms of short-selling are already practised, its authorised introduction would enable better control.

1.3 The Legal Position

1.3.1 Sections 76 and 80 of the Securities Ordinance impact on short-selling.

1.3.2 Section 80 prohibits a person from selling securities unless at the time he sells the securities he has or reasonably and honestly believes that he has a presently exercisable and unconditional right to vest the securities in the buyer.

This extends to a dealer acting as agent for a client, in that he must reasonably and honestly believe that his client has a right to so vest the securities before executing the sale. If a dealer sells on behalf of a client without that belief he is deemed to commit short selling under Section 80.

1.3.3 Section 76(1)(b) prohibits a dealer from entering into a trade which is completed later than close of business of the trading day following the deal. A sale of securities which the seller does not have or cannot otherwise obtain by the settlement time required in Section 76 is in risk of contravening those requirements.

1.3.4 It is possible to avoid contravention of Section 80 by entering into a stock borrowing arrangement so that a person selling securities that he does not have can vest the borrowed securities in the buyer.

1.3.5 If the stock borrowing is within the terms of the Exchange's Rules and Regulations on stock borrowing and lending (Rules 413 and 563C and Schedule 6), by way of a Securities and Futures regulation under its powers in Section 146(1)(s) the provisions of Section 76 do not apply. In addition Stamp Duty is not payable on the stock borrowing and return and transaction levy and special levy are waived.

1.3.6 The result of these developments is that short selling is not prohibited by Section 80 if an effective stock borrowing arrangement is in place by or on behalf of the seller. Also whether a short sale

with or without an accompanying stock borrowing contravenes Section 76 needs clarification.

1.4 Scope of the Proposed Regulations

1.4.1 The Exchange in drafting the Rules and Regulations has been cognizant of the observations made at paragraph 5.12 of the Securities Review Committee's Report, which set out what are generally accepted international standards in relation to short-selling. In summary they are as follows: -

- (a) limitations on which securities could be sold short i.e. only a liquid stock with a sizeable number of its shares in public hands;
- (b) tight margin requirements, clear clients agreements, and "know your own client" rules;
- (c) limitations on how much of a particular security could be short-sold;
- (d) limitations on when a security might be sold-short e.g. an "up-tick" or "zero-plus tick" rule;

- (e) full disclosure of short sales;
- (f) proper and efficient monitoring of short selling activity by the Exchange; and
- (g) dissemination of short selling activity to the market-place.

1.5 The Exchange's Proposals

1.5.1 During the last few months the Division has had discussions with the Supervision of Markets Division of the Securities and Futures Commission with a view to formulating draft amendments to the Exchange's Rules and to draft appropriate Regulations to allow short selling of certain securities (see Appendices II & III).

1.5.2 It is emphasised that these Regulations: -

- (a) are in respect of a pilot scheme whereby only a limited number of securities could be short sold (see paragraph 1.5.6(b)); and
- (b) would require modification upon the introduction of the Exchange's Auto Matching System ("AMS").

1.5.3 The Exchange's draft Rules 563D and 563E (Appendix II) and the Regulations contained in the Seventh Schedule (Appendix III) are designed to meet each of the problems set out in paragraph 1.4.1 above.

1.5.4 Rule 563D provides that short selling is permitted in "Designated Securities" (Regulation 1), and subject to the Regulations.

1.5.5 Rule 563E gives to the Exchange the absolute right to:

- (a) suspend the short selling of a particular security;
- (b) impose limits on the amount of a particular security which may be short sold;
- (c) impose open short-sold position limits on the amount of a particular security which a particular Member may sell short; and
- (d) require a Member to make full disclosure to the Exchange as to his or its open position.

The purpose of this Rule is to enable the Exchange to manage the risks attached to short-selling.

1.5.6 The draft Regulations provide that: -

- (a) any Member who wishes to short-sell must register with the Exchange (Regulation 2). This is so that those Members who do not wish to engage in short selling either as principal or on behalf of clients will not be required to file Returns and keep Ledgers on short selling;
- (b) Members may only short-sell "Designated Securities" (Regulation

3). For the pilot programme it is suggested that only those securities with a market capitalization of \$10 billion and \$5 billion in public hands would be eligible to be Designated Securities. At the moment about 20 stocks fall into this category. If after say 6 months, the pilot scheme was successful, further securities could become Designated Securities;

(c) Members are to maintain ledgers of short selling transactions and submit Returns by 7th and 21st of each month reporting short selling transactions in the previous two week period (Regulations 5, 6 and 7);

(d) Members are to record the date and time that a short selling instruction is received from a customer (Regulation 10) in order to initiate an audit trail;

(e) every short selling transaction is to be input into the Exchange's system within [120 seconds] of the transaction being struck, indicating that it is a short selling transaction by a marker to be input by a special key-stroke on the terminal (Regulations 12 and 13).

It is recognised that with the introduction of AMS, this Regulation will not be relevant, but during the pilot stage, it

is suggested that these requirements will provide an improved quality of market and transparency when compared to the existing 15 minute Rule in relation to other transactions. The underlying principle is that all trades should be reported as soon as possible. A very short period of 120 seconds has been suggested as a reference point for comments from Members and others.

The marker ["V"] will not appear on the trading screen but will appear in the Sales Journals and other transaction reports for audit trail purposes.

- (f) contract notes in respect of short-sales must indicate that the sale is a short (Regulation 15) in order to establish a client's liability and provide audit trail.
- (g) a proper emphasis of the "know your own client" Rule is made (Regulations 16 and 17) in order to protect Members from the deeming provisions of Section 80.
- (h) a tick Rule based on best current ask price (Regulation 18) is applied as a proxy suitable to the Exchange's Trading System for the "up-tick" or "zero or plus tick" rules in other Exchanges. These rules are designed to restrain shorting into a falling market which can lead to a snowballing effect in which short selling itself drives the market lower and lower.

- (i) arrangements must be made to ensure scrip is available for settlement day (Regulation 19). This is a particularly important Regulation in that if not complied with Section 80(1) of the Securities Ordinance is contravened;
- (j) short selling can only be undertaken in a Margin Trading Securities Trading Account, with a minimum credit margin of [125 per cent] (Regulations 20 and 21) so as to minimize credit risk to the market; and
- (k) marking to the market shall be undertaken at least daily (Regulation 23) to ensure that a short seller's exposure to the market is tracked accurately.

1.6 Conclusion

1.6.1 The Exchange intends to introduce short-selling following a consultation period. Accordingly comments are invited from Members of the Exchanges, listed companies and their advisers, and the investing community generally on the proposed Rules and Regulations.

1.6.2 Written comments should be received by 20th March 1992 and addressed to: -

The Executive Director - Compliance
The Stock Exchange of Hong Kong Limited
36/F Jardine House
1 Connaught Place
Hong Kong

Alternatively if you would like to discuss the proposals with the Exchange please contact any of the following: -

Paul Phenix 840 3699

Samuel Lee 840 3710

Nicholas Clement-Jones 840 3034

1.6.3 Following the consultation and on approval of the Rules and Regulations by the Exchange and the Securities and Futures Commission a series of public seminars will be held by the Exchange to explain the operation of the scheme.

APPENDIX I

2.0 Draft Stock Exchange Rules

2.1 Rule 563D

Short selling shall be limited to transactions in Designated Securities (as defined in the Seventh Schedule of these Rules) effected on the Exchange. Members and Dealing Partnerships who engage in short selling (as defined in the Seventh Schedule of these Rules) shall be registered and shall comply at all times with the Regulations contained in the Seventh Schedule regarding short selling, as approved by the Exchange from time to time.

2.2 Rule 563E

(1) In this Rule the terms "Designated Security", "short selling", "Short Selling Member", and "Short Selling Customer" shall have the meanings ascribed to them in the Seventh Schedule of the Rules.

(2) The Exchange reserves the right at its absolute discretion: -

(a) to suspend, without giving prior notice, the short selling of a Designated Security;

- (b) to impose limits on the number of Designated Securities which may be short-sold;
- (c) to impose open short-sold position limits on the number of Designated Securities which a Short Selling Member may short-sell; and
- (d) to require a Short Selling Member to disclose to the Exchange the number of shares of a Designated Security in which the Short Selling Member holds an open position either on a Short Selling Member's own account or for the account of a Short Selling Customer.

APPENDIX II

3.0 Draft Short-Selling Regulations

3.1 Seventh Schedule Short-Selling Regulations ("Regulations")

(1) In these Regulations :-

"Designated Security" means a security which is from time to time designated by the Exchange as being eligible for short selling in accordance with these Regulations.

"Ledger" means a ledger recording the details of all short selling that is required to be maintained by Short Selling Members. The Ledger shall, unless otherwise approved by the Exchange, take the form of the Model prescribed by the Exchange, and annexed to these Regulations as Appendix 1.

"Margin" means the amount of money or securities to be deposited with a Short Selling Member in order to enter into a short selling transaction.

"Margin Securities Trading Account" means an account established with a Short Selling Member by a customer to record transactions in securities where a Member provides, extends, arranges or maintains credit facilities in respect of such transactions effected by the Member or Dealing Partnership on behalf of a Customer.

"Marking to the Market" means for the purposes hereof, the adjustment of the amount of Margin to be maintained with a Short Selling Member by a Short Selling Customer in respect to short selling transactions in Designated Securities to ensure that the valuation reflects as nearly as possible the current value of the Margin and is based on the prevailing market price thereof.

"Owning a security" means:

- (a) either directly or through an agent having an unconditional right, title or interest to or in a Designated Security, or
- (b) owning a security convertible into or exchangeable for a Designated Security and has tendered such security for conversion or exchange or having an option to purchase or acquire a Designated Security and has exercised such option, or having rights or warrants to subscribe to a Designated Security and has exercised such rights or warrants.

"Return" means the return required to be submitted to the Exchange by Short Selling Members reflecting the particulars of all short selling activity, and shall, unless otherwise approved by the Exchange, be in the form prescribed by the Exchange and annexed to these Regulations as Appendix 2.

"Short Seller" means a person who sells Designated Securities short.

"short selling" means the sale of a Designated Security which:

- (i) the seller does not own; or
- (ii) is consummated by the delivery of a security borrowed by or for the account of the seller.

"Short Selling Customer" means a customer of a Short Selling Member who short sells Designated Securities.

"Short Selling Member" means a Member or Dealing Partnership who is registered with the Exchange as a short seller of Designated Securities.

- (2) A Member or Dealing Partnership intending to engage in short selling must register with the Exchange as a Short Selling Member.
- (3) A Short Selling Member shall be permitted to short sell Designated Securities only on the terms and conditions set out in these Regulations.
- (4) A Short Selling Member who short sells Designated Securities is required to maintain a Ledger.
- (5) A Short Selling Member shall make the Ledgers available for inspection to the Exchange, and the Securities and Futures Commission upon the request of either body.

- (6) A Short Selling Member shall submit Returns each month by the 7th and 21st days of the month in respect of the 15th to the last day of the preceding month and the 1st to the 14th days of the current month respectively or at such other frequency and on such dates as the Exchange may from time to time determine.
- (7) A Short Selling Member is required to retain the Ledgers and copies of the Returns for a period of not less than seven (7) years after the date of completion of the short selling transactions to which they relate.
- (8) The Chief Executive of the Exchange may restrict or prohibit a Short Selling Member, from short selling Designated Securities provided he has first obtained the approval of the Chairman of the Council which may be given either orally or in writing.
- (9) A Short Selling Member whether acting on his or its own account or for the account of a Short Selling Customer, may only short-sell Designated Securities on the Exchange.
- (10) A Short Selling Member shall on receiving a short selling order from a Short Selling Customer record the date and time that the order was received from the Short Selling Customer.
- (11) A short selling transaction unless it is a direct business transaction may only be concluded: -
 - (i) in the Trading Hall; and
 - (ii) through the Internal Telephone System.

- (12) A Short Selling Member shall on striking a short selling transaction input into the System, within [120 seconds], details of the short selling transaction.
- (13) Every transaction which is a short selling transaction shall be indicated as such on the System by means of the identifying mark ("V").
- (14) A Short Selling Member may short sell Designated Securities: -
- (a) on his or its own account;
 - (b) for the account of his or its Short Selling Customers.
- (15) A Short Selling Member on making out a contract note which is in respect of a short selling transaction, shall indicate on the contract note that the transaction is a short sale.
- (16) On receipt of an order for the sale of a Designated Security, a Short Selling Member shall enquire of the customer whether at the time of placing the order: -
- (a) the Short Selling Customer owns the Designated Security;
 - or
 - (b) if the Short Selling Customer is acting as agent, that he or it knows his principal owns the Designated Security.
- (17) A Short Selling Member shall try to ensure, in so far as it is reasonably possible, that the Short Selling Customer's disclosure pursuant to Regulation 16 is accurate.

- (18) A short sale of a Designated Security shall not be made on the Exchange below the best current ask price.
- (19) A Short Selling Member shall not place a short selling order in respect of a Designated Security either on his or its own account or on behalf of a Short Selling Customer unless he or it has made arrangements to ensure that the Designated Security is available to him or it to make delivery on the stipulated settlement date.
- (20) A Short Selling Member shall not accept from a customer a short selling order except in a Margin Securities Trading Account.
- (21) A Short Selling Member shall ensure that those of his Short Selling Customers who have an open short-sold position maintain at all times a minimum credit margin of not less than [125%]. The collateral for credit margin may be in any of the assets itemized at Rule 410(1), (4), (4a), (4b), (9), (10) and (13).
- (22) A Short Selling Member when short selling on his own account, shall maintain in a designated bank account, a minimum credit margin of not less than [125%] of his total open short-sold positions. The amount so maintained may be reduced by any amount provided as collateral to a lender to support a stock borrowing and lending arrangement in respect of the short sale.
- (23) A Short Selling Member shall Mark to the Market (at least daily) the Designated Securities sold short by a Short Selling Customer

and the Margin deposited by a Short Selling Customer, and shall further ensure that the minimum credit balances stipulated in Regulations 21 and 22 is at all times maintained.

In Marking to the Market a Short Selling Member shall when:

- (a) Marking to the Market only once daily, mark against the closing price of the Designated Security on the previous trading day as published in the Exchange's Daily Quotation Sheet; or
 - (b) Marking to the Market two or more times daily, mark on at least the first occasion, against the closing price of the designated security on the previous trading day as published in the Exchange's Daily Quotation Sheet.
- (24) A Short Selling Member shall be liable for any dividends or other benefits paid during the time he or it has in his or its account an open short-sold position in a Designated Security.
- (25) A Short Selling Member who fails to comply with these Regulations shall be subject to PART II of the Disciplinary Procedures contained in the Rules of the Exchange and may at the discretion of the Disciplinary Committee be removed from the register of Short Selling Members.

SHORT SELLING LEDGER

Stock Name : _____

Date of Transaction	Contract Note no.	Particulars			Underlying Stock Borrowing Transaction Reference	Short Selling Customer		Cover Transaction	
		Quantity	Unit Price	Total Value		Name	A/C No.	Date	Contact Note No.

3.3 Semi-Monthly Return

To : Compliance Division
The Stock Exchange of Hong Kong Ltd

**SEMI-MONTHLY RETURN OF SHORT SELLING TRANSACTIONS
FOR THE PERIOD ENDED**

Member Name : _____ Firm I.D. : _____
Membership No : _____

We hereby furnish this Return of short selling made during the above period :-

		Number of Transactions	Total value of Transactions
Open position brought forward from previous period	(a)	<input type="text"/>	<input type="text"/>
For the period	(b)	<input type="text"/>	<input type="text"/>
	(a) + (b) = (c)	<input type="text"/>	<input type="text"/>
Covered during the period	(d)	<input type="text"/>	<input type="text"/>
Open positions carried forward	(c) - (d) = (e)	<input type="text"/>	<input type="text"/>

We declare that to the best of our knowledge and belief all the statements contained in the Return are true and correct.

Broker's Chop

Signed : _____
Name : _____
Designation : _____
Date : _____

NOTES TO ASSIST IN COMPLETING THIS RETURN

- (1) This return must be submitted to the Compliance Division of the Stock Exchange of Hong Kong Ltd by any registered member who is registered with the Regulations forming the Seventh Schedule to the Rules of the Exchange.
- (2) The information must state the position at the end of each period and include all transactions which are required to be entered in the Short Selling Ledger during that period.
- (3) If there are no outstanding transactions brought forward from the previous return and no short selling transaction during the period covered by the return, then a "nil" return should be filed.