



SECURITIES AND  
FUTURES COMMISSION  
證券及期貨事務監察委員會

## **Consultation Conclusions on the Securities and Futures (Short Selling Exemption and Stock Lending) Rules**

《證券及期貨(賣空豁免及證券借出)規則草擬本的諮詢  
總結》

Hong Kong  
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香港  
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## **A. Introduction**

1. On 24 May 2002, the Securities and Futures Commission (“the SFC”) released a consultation document inviting public comments on the draft **Securities and Futures (Short Selling Exemption and Stock Lending) Rules** (“the draft Rules”).
2. The draft Rules provide – (a) exemptions from the ‘naked’ short selling prohibition in section 170 of the Securities and Futures Ordinance (SFO) (No. 5 of 2002); (b) circumstances in which the reporting requirements in section 171 do not apply; and (c) reporting requirements for stock lending.
3. The consultation period ended on 21 June 2002.
4. A summary of the comments received on the draft Rules (“summary of comments”) is attached as Annex 1.
5. Taking into account the comments received, several amendments to the draft Rules were considered appropriate.
6. The purpose of this report is to provide an analysis of the main comments raised during the consultation process and the rationale for the Commission’s conclusions. This report should be read in conjunction with the consultation paper, the draft Rules and the summary of comments.

## **B. Public Consultation**

### **Background**

7. The draft Rules were prepared to provide exemptions to the short selling prohibition under section 170 for market makers when they perform market making activities or for hedging their market making positions. The existing exemptions under the Securities (Miscellaneous) Rules are largely reproduced in the draft Rules. The draft Rules also set out circumstances in which the reporting requirements in section 171 do not apply. Finally, it reproduces the current Securities (Stock Lending) Rules.
8. From a policy perspective, the draft Rules are intended primarily to –
  - (a) enable all categories of SEHK and HKFE registered market makers to short sell securities in performing their market making obligations as well as for hedging purposes. In this respect, the draft Rules rationalise the current exemptions available to some market makers, eliminate the inconsistencies under the current law and extend the exemption to all categories of market makers;
  - (b) enable the timely execution, as well as reducing the compliance burden, for sellers placing short selling orders which are covered by virtue of a stock borrowing and lending arrangement; and

- (c) provide record keeping requirements for stock lenders to ensure that proper audit trails are created. In this respect, the record keeping requirements reproduce the existing legislation and no new policy changes are introduced.

### **Consultation Process**

- 9. In addition to the press release regarding the consultation exercise which was issued on 24 May 2002, the consultation paper and the draft Rules were also posted on the website of the SFC and distributed to all registrants through FinNet.
- 10. Five submissions were received. The overall tone of the comments was positive. Commentators generally welcomed the draft Rules. Comments varied considerably in range and depth, with some focusing on broad principles and others on points of detail and clarification.

## **C. The Consultation Conclusions**

The following summarises the main comments received and the SFC's responses.

### **Clause 2**

- 11. One commentator expressed that certain definitions should be removed from the draft Rules and left to the interpretation of business professionals or case law.
- 12. The SFC believes that the definitions provide greater clarity and will assist industry participants in complying with the provisions. Clarity in the scope of the provisions is desirable especially since non-compliance may lead to criminal sanctions. In addition, there is little or no case law on many of these terms.

### **Clause 3**

- 13. It was suggested that the exemption should be given to all proprietary trades of exchange participants.
- 14. The SFC takes the view that market makers have a need to be able to conduct naked short sales when they are performing their market making functions. The present exemptions are for the purpose of facilitating market making which will help to increase the liquidity of the respective securities or futures contracts. Market makers recognised by the SEHK and HKFE are subject to strict eligibility criteria of the respective exchange which are approved by the SFC. The SFC will consider, at a later stage, reviewing the monitoring systems and risk management measures to see if it is appropriate to extend the exemptions to proprietary transactions of exchange participants.
- 15. One commentator expressed the view that the exemptions will not assist industry participants unless corresponding exemptions and tick rule exemptions are made to the Rules of the Stock Exchange of Hong Kong Limited (SEHK).

16. The SFC and SEHK are working on introducing these exemptions to their rules. The corresponding exemptions in the SEHK Rules will be introduced at around the same time as the exemptions proposed in the draft Rules.
17. A question was raised as to whether a dealer who effects a short sale on behalf of a Monetary Authority appointed market maker is required to comply with the requirements of section 170(1) of the SFO and the provisions of the draft Rules.
18. The provision repeats the existing exemptions which have been in place since 1999. HKMA-appointed market makers generally execute their trades on the exchange through their brokerage arm. For the purposes of greater clarity, Clause 3(1) has been amended by adding a new subsection which will exempt agents acting for HKMA-appointed market makers from section 170(1) as long as the agent has reasonable grounds to believe that his principal is effecting the short sale in its capacity as a HKMA-appointed market maker.
19. Several commentators expressed that it was unclear whether the market making exemptions are available to issuers or other persons who perform market making activities but are not exchange participants.
20. The policy intention is for the exemption to be applicable to any person whom the relevant exchange recognises as performing market making or liquidity providing services. These persons may not necessarily be exchange participants but should be 'registered' or otherwise recognised by the relevant exchange as market makers. The SFC believes that the draft Rules which were released for consultation were not clear in this respect and amendments have been made to Clause 2.
21. Commentators raised questions as to whether Clause 3(2) applies to the hedging of one security by short selling another security, where the security hedged and that sold both share the same, third, underlying security.
22. The policy intent is to allow genuine hedging activities where 2 securities are related. Where 2 securities share the same underlying security, which may be a third security, they will be considered to be related. The SFC agrees that the draft Rules which were released for consultation were not clear and an amendment has been made to Clause 3(2)(a)(ii) and (b)(ii).
23. One commentator noted that the exemption did not extend to pre-hedging activities and suggested that pre-hedged should also be included. The SFC does not believe that it would be appropriate at present to include pre-hedging as these activities are difficult to monitor and may be open to abuse.

24. Some commentators questioned how a market maker would acquire the right to vest the securities in the purchaser of them before the end of the next trading day so as to comply with Clause 3(2)(c).
25. This provision is based on the existing Securities (Miscellaneous) Rules which specify the method for acquiring such a right in respect of exchange traded funds. The SFC considered that as long as the market maker acquired the right within the next trading day, it does not matter the method by which he acquires such right. Accordingly, the draft Rules do not specify the method of acquiring the right. Market makers who borrow or buy the securities will comply with the clause. Similarly, in the case whether the security that is sold is a share in an exchange traded fund, the seller can place a creation order for the exchange traded fund shares.

#### **Clause 4**

26. One commentator expressed that the scope of Clause 4 should be extended to all short selling orders.
27. The draft Rules are aimed at facilitating the stock lending business. In addition, the SFC understands that a large majority of short selling orders are covered by stock lending arrangements. Accordingly, the SFC does not consider that it the scope of the exemption should be extended.
28. The commentator also raised an issue that sellers receiving the documentary record and time stamps it is required to include information under Clause 4(5) which goes beyond what is required under section 171.
29. Under the requirements in section 171 (and 172), an audit trail is produced so that covered short sales can be traced backwards from an input of an order. The SFC considers that in the absence of the information that sellers are required to retain under section 171 or the other routes in Clause 4, the information under Clause 4(5) is required so that the audit trail is not broken. In making this proposal, the SFC had consulted industry participants who gave the SFC a list of the information which they would normally obtain from their principal and record on a time-stamped order ticket when receiving a short selling order. The information required in Clause 4(5) is the same as that provided to the SFC by industry participants. The SFC believes that this route is likely to be used by conduit brokers who either act as stock lenders for their clients or arrange for stock lendings on behalf of their clients. Other brokers who feel that this proposed exemption does not suit their needs may elect to use the other proposed exemptions set out in the draft Rules.

#### **Clause 5**

30. One commentator suggested including capital, operational competence and risk management requirements on dealers who provide stock borrowing and lending services to clients.

31. As the purpose of the draft Rules is to create a proper audit trail for short selling and stock lending, the SFC believes it would be inappropriate to include the suggested requirements in the draft Rules. However, the SFC will consider whether it is necessary to include such requirements in the Code of Conduct for Persons Registered with the SFC.

**Others**

32. The draft Rules have been renamed to better reflect the substance of the rules.

**D. Commencement Date**

33. The Securities and Futures (Short Selling Exemptions and Stock Lending) Rules will become effective on the commencement of the SFO.

**E. Other Matters**

34. The SFC will publish a revised Guidance Note on short selling to provide industry participants with guidance on the application of these provisions before the commencement of these exemptions.
35. The SFC wishes to thank the commentators who have made valuable suggestions and comments.

**Draft Securities and Futures (Short Selling Exemption and Stock Lending) Rules**  
**Summary of comments received and SFC's response**

<b>Item No.</b>	<b>Section Reference</b>	<b>Details of the Rules</b>	<b>Respondent's Comments</b>	<b>SFC's Response</b>
1.	general comment	N.A.	<p><i>Wocom:</i></p> <p>The short selling exemptions have been extended to all market makers. This should be accompanied by tighter scrutiny of market makers' role in providing liquidity. Examples were given as to market makers not fully complying with their market making obligations.</p>	<p>The proposed exemptions extend the scope of the current exemptions to all categories of market makers. The SFC believes that these exemptions facilitate the performance of market makers' market making functions and provide them with incentive to act as market makers.</p> <p>The SFC has requested HKEx to review market making obligations and market makers' performance to ensure that they fulfil the obligations.</p> <p>The Exchange has disciplinary power to penalize market makers who do not comply with their market making obligations.</p>
2.	general comment	N.A.	<p><i>Respondent A:</i></p> <p>It is a market practice that the related short selling transactions by the underwriters would be reported to the Exchange as cross trades. This practice, however, may have technically breached the requirements of the SEHK Rules which require short sales in Designated Securities to be automatically struck through the AMS and to be made at or above the best current ask price. (n.b. the references in the submission to sections 3 and 15 should correctly be references to Regulation 3 and 15 of the 11<sup>th</sup> Schedule of the SEHK Rules).</p>	<p>If the short selling transactions have technically breached the SEHK Rules, the appropriate avenue to address this is in the SEHK Rules rather than in the draft Rules. The SFC will follow up with the SEHK.</p>
3.	2	Clause 2 sets out the definitions used in the draft Rules	<p><i>SHK:</i></p> <p>The definitions for "blanket assurance" and "hold" should be removed from the draft Rules and left to the interpretation of business professionals or case law.</p>	<p>The SFC believes that it would be inappropriate to omit the definitions. Although securities practitioners should be familiar with these terms, there are few or no case laws on the exact meaning of them. The SFC believes that it is desirable to have the definitions to provide clarity to industry participants, especially where non-compliance with the provisions is a criminal offence.</p>
4.			<p><i>SHK:</i></p> <p>Most of the definitions in the current Stock Lending</p>	<p>The observation is correct. However, the reference to "documentary record" in the current Stock Lending Rules is</p>

Item No.	Section Reference	Details of the Rules	Respondent's Comments	SFC's Response
			Rules have been incorporated into the draft Rules. But the definition of "documentary record" has been removed.	replaced by "in the form of a document" in the draft Rules and the term "document" is defined in Schedule 1 of the SFO.
5.	3	Clause 3 sets out the exemptions from the naked short selling prohibition under section 170 of the Ordinance for market makers	<i>Linklaters:</i> The short selling exemptions are of limited use unless equivalent exemptions from the tick rule are also introduced. In addition, corresponding exemptions should be included in the SEHK Rules to permit exchange participants to conduct the types of naked short selling permitted by the draft Rules.	The SFC is working with HKEx to introduce corresponding exemptions under the SEHK Rules as well as relevant tick rule exemptions. The exemptions under the SEHK Rules are intended to be implemented at around the same time as those in the draft Rules.
6.			<i>Wocom:</i> By virtue of the definition of 'short selling order', market makers can already hedge their positions. If this is not sufficient, the short selling exemptions should be extended to all SEHK and HKFE participants irrespective of whether they are market makers.	The provisions relating to 'short selling orders' are in relation to 'covered' short sales whilst section 170 (and the current exemptions) are in respect of naked short sales.  The SFC takes the view that market makers have a need to be able to do naked short sales when they are performing market making functions. The SFC will consider reviewing the corresponding monitoring system and risk management measures to see whether it is appropriate to extend the exemptions to proprietary transactions of SEHK and HKFE participants in future.
7.			<i>SHK:</i> Exemptions given under the draft Rules should be replaced by the granting of some kinds of special permits, founded on a set of criteria and based on an objective assessment of the capability of the persons who can meet statutory requirements on capitalization, operational control, risk management competence, the ability to secure or otherwise provide an assurance of the "presently exercisable and unconditional" right to vest shares to the buyer, or the borrower.	The exemptions apply only to different categories of market makers recognized by the Exchanges. The Exchanges apply strict eligibility criteria which are approved by the SFC. These criteria, in general, relate to risk management, capital, operational control, expertise etc. Therefore although not specified in any legislation, the suggestion is already catered for in practice.  In addition, these market makers are either SFC registrants or persons whom the SFC has "regulatory reach" over <sup>1</sup> . Also, Exchange Participants (SFC registrants) who execute the market making transactions on behalf of these persons (who are not directly regulated by the SFC) are held responsible for the transactions.

<sup>1</sup> For example, designated specialists are regulated by their local regulator who has in place an MOU with the SFC. If there is any misconduct or impropriety by the Designated Specialist, the SFC can request the local regulator to take appropriate action. In addition, the Designated Specialists registration with the SEHK can be withdrawn.

Item No.	Section Reference	Details of the Rules	Respondent's Comments	SFC's Response
8.	3(1)(a)	Clause 3(1)(a) sets out the exemptions from section 170 for to HKMA appointed market makers. This provision repeats the current exemption under Rule 17 of the Securities (Miscellaneous) Rules.	<i>SHK:</i> In the case when Monetary Authority-appointed market maker elects to effect a “naked sales” through a dealer, it is not clear whether the dealer must comply with the requirements of subsection 170(1) of the SFO and the provisions of the draft Rules.	The provision repeats the existing exemption which has been in place since 1999. HKMA appointed market makers generally execute their trades on the exchange through their brokerage arm. For the purposes of greater clarity, clause 3(1) has been amended by adding a new subsection which will exempt agents acting for HKMA appointed market makers from the provisions of section 170(1) as long as the agent has reasonable grounds to believe that his principle is effecting the short sale in its capacity as a HKMA appointed market maker
9.			<i>SHK:</i> HKMA has relinquished its role to act as an arranger for the debts issued under the respective note issuance programmes of the MTRC, the HKAA, the HKMC and the KCRC. A deletion of the reference to “... arranged by the Hong Kong Monetary Authority” in the definition of the term “specified instruments” is suggested.	Agreed. The clause is amended to delete the reference.
10.	3(2)	Clause 3(2) sets out the types of transactions which constitute ‘jobbing business’ for the purpose of the draft Rules.	<i>Linklaters:</i> It appears that only Securities Market Makers and Futures Market Makers are able to rely on the exemptions. However, other parties, such as offshore affiliates who hedge the position and use the relevant market maker merely to execute the trade, would also be able to rely on the exemption.	The exemptions are intended to be available to any person who is registered with the SEHK or HKFE to perform market making or liquidity providing activities. These will include persons who may not be exchange participants but whom the relevant Exchange recognizes as performing market making or liquidity providing activities, e.g., Designated Specialists <sup>2</sup> or issuers of structured products under Chapter 15A of the SEHK Listing Rules <sup>3</sup> . The clause has been amended to better reflect the intention that the exemptions are available to any person whom the SEHK or the HKFE recognizes as performing market making or liquidity providing activities.

<sup>2</sup> These are overseas specialists who are clients of an Exchange Participant who is a registered market maker. Under the SEHK Rules, an Exchange Participant may allow such a person, who is its client, to register with the SEHK to perform market making functions. They are required to be regulated by their local securities regulator who must have a MOU with the SFC and SFC approval of the Designated Specialist is also required. These Designated Specialists are required to fulfil the market making obligations under the SEHK Rules.

<sup>3</sup> Issuers of products (like ELIs and derivative warrants) under Chapter 15A of the SEHK Listing Rules are required to appoint an exchange participant to act as its liquidity provider. Liquidity providing is performed, similar to market making obligations, by responding to quote requests or providing continuous quotes. The positions that are built up in the course of providing liquidity may be either the issuer's positions or the positions of an affiliate of the issuer. Hence, the exemptions have also been drafted to apply to such persons. It should be noted that the liquidity provider is required to report the liquidity providing transactions daily to the Exchange.

Item No.	Section Reference	Details of the Rules	Respondent's Comments	SFC's Response
11.	3(2)(a)	Where a Securities Market Makers short sells a listed security to hedge the risks of another listed security, where both securities are related is exempt from section 170. Securities Market Maker is defined in Clause 2.	<i>Respondent A:</i> Clarification was sought as to whether the exemption under Clause 3(2) would apply to an issuer of derivative warrants who will carry out the hedging and liquidity providing activities through the "Securities Market Maker". The exemptions would not be meaningful if the principal is not exempt from the requirements of section 170(1) of the SFO.	The exemptions are intended to apply to, amongst other persons, issuers of structured products. As issuers are not exchange participants, the clause has been amended to better reflect the intention that the exemptions are available to any person whom the SEHK recognizes as performing market making or liquidity providing activities.
12.	3(2)(a)		<i>Respondent A:</i> Clarification was sought as to the definition of "component" and whether hedging a stock options position or warrant position with a single stock is permitted.	The exemptions are intended to enable hedging a position in a listed security ("B") by short selling another listed security ("A") if either (1) A is an underlying stock of B or vice versa (Clause 3(2)(a)(i)) or (2) both A and B share the same underlying security (Clause 3(2)(a)(ii)). Clause 3(2)(a) has been revised to better reflect this. So, a market maker will be able to short sell the underlying securities of an option or a warrant to hedge a position he has acquired in an option or warrant over that security.
13.			<i>Linklaters:</i> The current drafting of the hedging sections under Rule 3 ("... a component of that other security") would not include an underlying of that other security. It is suggested that it should include an underlying of that other security.	The intention has always been to allow hedging by another security which has the same underlyings as the security being hedged. This was not clearly reflected in the draft Rules. Amendments have been made to Clause 3(2)(a) to clarify this.
14.	3(2)(a) and (b)	These provisions enable Securities Market Makers and Futures Market Makers to short sell securities to hedge against risks of market making positions which they have acquired.	<i>Linklaters:</i> The current drafting of the hedging sections does not permit pre-hedging. Pre-hedging should be permitted <sup>4</sup> .	The purpose of the exemptions is to extend the current exemptions which are only available to stock options and stock futures market makers (under Rule 17 of the Securities (Miscellaneous) Rules) to all categories of market makers. Under the current rules, pre-hedging is not permitted.  The SFC does not intend to widen the scope of the exemptions, at this time, to pre-hedging. This is because pre-hedging will be difficult to monitor and may be subject to abuse. E.g. where the market maker takes a directional view

<sup>4</sup> It should be noted that the hedging exemptions for stock options and stock futures market makers were introduced in 2001. During the course of drafting the 2001 exemptions, Messrs. Linklaters (then also representing by and large the same group of financial intermediaries) were consulted on the draft exemptions, which include the pre-hedging limitation. No comments were made then about the limitation.

Item No.	Section Reference	Details of the Rules	Respondent's Comments	SFC's Response
				on a security and short sells the security. Subsequently, if the position is not favourable, he can acquire a position in a derivative of the security and claim that the prior short sale is for the purpose of pre-hedging the position in the derivative product.
15.			<i>Linklaters:</i> Clarification was sought as to the evidence which the SFC would require to show that the short sale was for the purpose of hedging.	Under corresponding exemptions in the SEHK Rules, it is intended that special indicators will be required when the market making orders are input into AMS/3. This will enable identification of the market making transactions claiming the exemption. In addition, the SEHK is in the process of developing a monitoring and/reporting system for monitoring these exemptions - This may include filing of reports for complicated transactions.  Market making transactions and positions should be clearly set out/ reflected in the market making books of the market maker which should be separate from the other trading or proprietary trading books. The market making books would be the primary source of evidence.
16.	3(2)(c)	This provision enables short sales to be made by Securities Market Makers in performing market making obligations provided that they acquire the securities that are sold by the end of the next trading day.	<i>Linklaters:</i> Confirmation was sought as to whether a Securities Market Maker who has submitted a redemption application on an exchange traded fund has acquired the right to vest the securities in the purchaser of them from the time the redemption application is submitted, and therefore satisfies the test in Clause 3(2)(c).	Where a Securities Market Maker short sells shares of an exchange traded fund, he will satisfy the requirement under section 3(2)(c) if he places a creation order for the exchange traded fund shares by the end of the next trading day. If the Securities Market Makers short sells the underlying shares of an exchange traded fund, the requirement will be fulfilled if he places a redemption order for the underlying shares by the end of the next trading day.
17.			<i>Calvin Lee:</i> Request to clarify what constitutes "the Securities Market Maker acquires the right to vest the security in the purchaser of them before the end of the trading day following the day of the sale"	The Securities Market Maker should acquire the securities he sold by the end of the next trading day. For example, he can do so by buying back the securities, borrowing them, or in the case of where the security that was sold is an exchange traded fund, placing a creation order for them.
18.	4	Clause 4 sets out the circumstances in which the reporting requirements for 'short selling orders' in section 171 of the Ordinance	<i>Linklaters:</i> It appears that Clause 4 provides an alternative means of complying with the reporting requirements under Section 171 of the SFO but as drafted it appears to be mandatory to follow one of	Clause 4 has been amended to make it clear that only persons who comply with sub-sections (2) to (8) need not comply with the corresponding requirements in section 171(1), (3) and(5).

Item No.	Section Reference	Details of the Rules	Respondent's Comments	SFC's Response
		do not apply.	the routes set out in the Rule.	
19.			<p><i>Linklaters:</i> The scope of Clause 4 is rather narrow as it only applies to short selling orders that are by virtue of a stock borrowing and lending arrangement. This differentiation would result in an obligation on sellers/broker to ascertain the type of short selling order they are placing/receiving and is impractical when the intention of the draft Rules is to provide a relaxed regime.</p> <p>The application of section 4 should be extended to all categories of short selling orders.</p>	<p>Under the Commission's rule-making power in sections 397 and 398 of the SFO, exemptions can only be made so as to apply to "a specified transaction of class of transactions entered into by any specified person or class of persons". As the suggestion to extend section 4 of the draft Rules to all categories of short selling orders would, in effect, negate the application of section 171, such suggestion is likely to be ultra vires.</p> <p>As 2 other alternatives are provided in the Clause 4, a seller may choose to use obtain a tape recording of the oral assurance. In such case, he will not need to ascertain this information.</p> <p>A majority of short selling orders are covered by stock lending arrangements. The SFC's intention is to facilitate the stock lending business, as such, the exemptions are only made available to short sales by virtue of stock lending transactions.</p>
20.	4(2)(b), 4(3)(b)(iii) & 4(4)(b)(iii)	Provisions relating to where an arrangement is made between the agent and principal so that one party will provide the document of the assurance at the end of the trade day	<p><i>Linklaters:</i> Clarification was sought as to what evidence SFC will require to substantiate "an arrangement" as mentioned in Rules 4(2)(b), 4(3)(b)(iii) and 4(4)(b)(iii).</p>	The SFC believes that ideally the arrangement should be set out in writing or otherwise documented. Please refer to the following comment/response for the reasons.
21.	4(4)(b)(iii)		<p><i>Linklaters:</i> It was queried what consequences there would be if the client did not send any documentary assurance at the end of the day.</p>	As the requirement under section 171 is placed on the agent, the agent would not be held liable if the client did not provide a documentary assurance by the end of the day PROVIDED that the agent had made an arrangement with the client that the client would do so. Hence, (see comment/response above) it would be in the agent's interest to ensure that the arrangement he has with his client is documented.
22.			<p><i>Linklaters:</i> It was queried whether an e-mail message from the client is sufficient to form "a confirmation of oral assurance in the form of a document".</p>	Yes, as long as the e-mail message contains all the information required under the assurance.

Item No.	Section Reference	Details of the Rules	Respondent's Comments	SFC's Response
23	4(5)	Clause 4(5) sets out the information that is to be included in the document provided at the end of the trade day	<p><i>Linklaters:</i>            If the person receiving the order makes a documentary record and timestamps it, that "document" has to include the information in Rule 4(5). This goes beyond what Section 171 requires in a documentary assurance. It should be unnecessary for the seller to provide details of the time the blanket assurance or hold has been given or a borrow has been entered into.</p>	<p>Under the requirements in sections 171 and 172, a chain of evidence is produced so that covered short sales can be traced backwards from input of an order (section 172) to the seller who placed the order (section 171(1)).            The SFC considers that in the absence of the information that sellers are required to retain under section 171 or the other routes in Rule 4, the information required under Rule 4(5) is required so that this chain of evidence is not broken.</p>
24.	5	Clause 5 sets out the record keeping requirements for stock lenders. This clause repeats the current Securities (Stock Lending) Rules.	<p><i>SHK:</i>            Dealers who are involved with the provision of securities borrowing and leading to clients should meet very high capital requirements, a satisfactory level of operational competence and maintain adequate risk management. Such requirements should be included in the draft Rules.</p>	<p>The purpose of the draft Rules is to create a proper audit trail for short selling and stock lending, it would be inappropriate to include the suggested requirements in the draft Rules.            However, the SFC will consider whether it is necessary to include the suggestions in its Code of Conduct for Registered Persons. (The Code will only apply to SFC registrants.)</p>

List of Respondents

<b>Dated Received</b>	<b>Respondent</b>
10 June 2002	Wocom Securities Limited (“Wocom”)
10 June 2002	Calvin Lee
21 June 2002	Sun Hung Kai Securities Limited (“SHK”)
21 June 2002	Linklaters & Alliance (“Linklaters”), submitting on behalf of Credit Suisse First Boston (Hong Kong) Limited, Deutsche Securities Asia Limited, Goldman Sachs (Asia) L.L.C., Merrill Lynch (Asia Pacific) Limited, Morgan Stanley Dean Witter Asia Limited, Salomon Smith Barney Hong Kong Limited and UBS Warburg
24 June 2002	A financial institution who wished to remain anonymous (“Respondent A”)

**SECURITIES AND FUTURES (SHORT SELLING AND  
SECURITIES BORROWING AND LENDING  
(MISCELLANEOUS)) RULES**

(Made by the Securities and Futures Commission under section 397  
of the Securities and Futures Ordinance (5 of 2002))

**1. Commencement**

These Rules shall come into operation on the day on which Part VII of the Securities and Futures Ordinance (5 of 2002) comes into operation.

**2. Interpretation**

In these Rules, unless the context otherwise requires –

“blanket assurance” (概括性保證) means a confirmation from a lender to a borrower that the lender has a sufficient overall supply of a defined group of securities such that for a specific period of time as agreed on by the parties the securities concerned are available to lend to the borrower;

“borrow” (借用安排), in relation to a securities borrowing and lending agreement, means a borrowing of securities under the securities borrowing and lending agreement, irrespective of whether the borrowed securities have been delivered by the lender to the borrower;

“Exchange Fund” (外匯基金) means the fund established under section 3 of the Exchange Fund Ordinance (Cap. 66);

“Exchange Fund Bill” (外匯基金票據) means any instrument described as such which is issued by the Government for the account of the Exchange Fund under the Exchange Fund Ordinance (Cap. 66);

“Exchange Fund Note” (外匯基金債券) means any instrument described as such which is issued by the Government for the account of the Exchange Fund under the Exchange Fund Ordinance (Cap. 66);

“Futures Market Maker” (期貨莊家) means a person who is registered with the Futures Exchange Company for the purpose of performing, in accordance with rules made by the Futures Exchange Company under section 23 of the Ordinance, market making or liquidity providing activities in respect of futures contracts admitted to trading on the recognized futures market it operates;

“hold” (持有確認) means a confirmation from a lender to a borrower that for a specific period of time as agreed on by the parties, specific securities in a specific quantity are available to lend to the borrower;

“lender” (借出人), in relation to a securities borrowing and lending agreement, means a person who lends securities under the securities borrowing and lending agreement and if the person is lending as an agent for clients, that person instead of his clients shall be regarded as the lender for the purposes of these Rules;

“Listing Rules” (上市規則) means rules made by the Stock Exchange Company under section 23 of the Ordinance and known as the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited;

“Monetary Authority-appointed Market Maker” (金融管理專員委任的莊家) means a person appointed as a market maker by the Monetary Authority under a letter of appointment currently in force for the purpose of conducting market making activities in respect of Exchange Fund Bills, Exchange Fund Notes or specified instruments;

“Securities Market Maker” (證券莊家) means a person who is registered with the Stock Exchange Company for the purpose of performing, in accordance with rules made by the Stock Exchange Company under section 23 of the Ordinance, market making or liquidity providing activities in respect of securities listed or admitted to trading on the recognized stock market it operates or an issuer of any structured product listed on the recognized

stock market operated by the Stock Exchange Company under Chapter 15A of the Listing Rules;

“specified instrument” (指明文書) means any note issued by the MTR Corporation Limited, the Airport Authority, the Hong Kong Mortgage Corporation Limited and the Kowloon-Canton Railway Corporation under their respective note issuance programmes;

**3. Classes of transactions to which section 170(3)(e) of the Ordinance not to apply**

(1) The following classes of transactions are prescribed for the purposes of section 170(3)(e) of the Ordinance –

- (a) a sale by a Monetary Authority-appointed Market Maker of any of the following securities –
  - (i) Exchange Fund Bills;
  - (ii) Exchange Fund Notes; or
  - (iii) specified instruments;
- (b) a sale by an agent of a Monetary Authority-appointed Market Maker of any of the following securities –
  - (i) Exchange Fund Bills;
  - (ii) Exchange Fund Notes; or
  - (iii) specified instruments;

where the agent is acting in such capacity and believes and has reasonable grounds to believe that his principal is a Monetary Authority-appointed Market Maker of the security sold.
- (c) a sale of securities effected in the course of conducting jobbing business.

(2) The following sales of securities shall be regarded as a sale of securities in the course of conducting jobbing business –

- (a) the sale of a listed security (“A”) by a Securities Market Maker where the sale is for the purpose of hedging the risks of a position previously acquired in another listed security (“B”) and –
  - (i) A is a component of B or vice versa; or
  - (ii) where both A and B have a security as a common component;
- (b) the sale of a listed security by a Futures Market Maker where the sale is for the purpose of hedging the risks of a position previously acquired in –
  - (i) a futures contract in respect of the security or an index of securities which includes the same security; or
  - (ii) a futures contract in respect of another security which has a common component with the security that is sold; or
- (c) the sale of a listed security by a Securities Market Maker in performing market making or liquidity providing activities in respect of such security, where the Securities Market Maker acquires the right to vest such security in the purchaser of them before the end of the trading day following the day of the sale.

(3) In this section, “listed” means listed or admitted to trading on a recognised stock market operated by the Stock Exchange Company.

#### **4. Classes of persons and circumstances in which certain requirements of section 171 not to have effect**

(1) Section 171(1) of the Ordinance does not have effect in relation to a short selling order described in subsection (4), which is made by a person, where selling as a principal, and who at the time of conveying the short selling

order, provides his agent with an oral assurance that the counterparty to the securities borrowing and lending agreement in question has the securities to which the order relates available to lend to him provided such person –

- (a) (i) records such oral assurance in the form of a tape recording;
- (ii) enters into an arrangement with his agent whereby the agent has agreed to –
  - (A) record such oral assurance in the form of a tape recording; or
  - (B) at the time of his receiving a short selling order, record the particulars as described in subsection (5) to which the order relates on a time-stamped record; or
- (iii) confirms the giving of the oral assurance in the form of a document to the agent by the end of the day on which it was given; and
- (b) complies with the applicable requirements of subsection (6).

(2) Section 171(3) of the Ordinance does not have effect in relation to a short selling order described in subsection (4), which is made by an exchange participant, where selling as a principal provided that –

- (a) prior to conveying the short selling order, such exchange participant -
  - (i) has received from the counterparty to the securities borrowing and lending agreement in question an oral assurance that the counterparty has the securities to which the order relates available to lend to him; and
  - (ii) has –
    - (A) recorded the oral assurance in the form of a tape-recording;

(B) recorded the particulars as described in subsection (5) to which the order relates on a time-stamped record;  
or

(C) entered into an arrangement with the counterparty whereby the counterparty has agreed to –

(1) record the particulars as described in subsection (5) to which the order relates in the form of a document; and

(2) provide such document to the exchange participant by the end of the day on which the assurance was given; and

(b) complies with the applicable requirements of subsection (6).

(3) Section 171(5) of the Ordinance does not have effect in relation to short selling order described in subsection (4), which is made by a person, where selling as an agent provided such person–

(a) prior to conveying a short selling order -

(i) has received from his principal, or the other person for whose benefit or on whose behalf such order is made an oral assurance that the counterparty to the securities borrowing and lending agreement in question has the securities to which the order relates available to lend to him; and

(ii) has –

(A) recorded the oral assurance in the form of a tape recording;

(B) recorded the particulars as described in subsection (5) to which the order relates on a time-stamped record;  
or

(C) entered into an arrangement with his principal, or that other person (as the case may be), whereby his principal, or such other person (as the case may be) has agreed to provide a confirmation of the oral assurance in the form of a document to him by the end of the day on which the assurance was given; and

(b) complies with the applicable requirements of subsection (6).

(4) Subsections (1), (2) and (3) apply to a short selling order which is such order by virtue of paragraph (a)(i) of the definition of “short selling order” in section 1 of Part 1 of Schedule 1 to the Ordinance.

(5) For the purposes of subsections (1)(a)(ii)(B), (2)(a)(ii)(B) and (ii)(C)(1) and (3)(a)(ii)(B), particulars are –

(a) the securities or group of securities borrowed under the securities borrowing and lending agreement, available for borrowing and the quantity; and

(b) whether a blanket assurance or a hold has been given or a borrow has been entered into, and the time it was given or entered into (as the case may be).

(6) Any person who records an oral assurance, particulars as described in subsection (5) or a confirmation of an oral assurance in the form of a document (including a tape recording or time-stamped record) under subsections (1), (2) or (3) shall –

(a) retain such document for not less than one year from the date of recording, collecting or receiving such assurance or particulars (as the case may be); and

(b) upon request made by the Commission at any time within that period give the Commission access to and produce the document within the time and at the place specified by the Commission.

**5. Record keeping by lenders under securities borrowing and lending agreements**

(1) When a lender under a securities borrowing and lending agreement gives a blanket assurance or a hold to a borrower, or enters into a borrow, the lender shall keep records in the form of a document, containing the following particulars –

- (a) the name of the borrower;
- (b) the securities or group of securities borrowed, or available for borrowing and the quantity thereof; and
- (c) whether a blanket assurance or a hold has been given or a borrow has been entered into, and the time it was given or entered into, as the case may be.

(2) The lender shall –

- (a) subject to paragraph (b), retain the records referred to in subsection (1) for not less than one year from the date the relevant record was made; and
- (b) upon request made at any time within that year by the Commission, provide copies of any such record to the Commission.

(3) In this section, “securities” means securities which are listed on a recognized stock market operated by the Stock Exchange Company.

Chairman,  
Securities and Futures Commission

### **Explanatory Note**

These Rules are made by the Securities and Futures Commission under section 397 of the Securities and Futures Ordinance (5 of 2002). They prescribe for the purposes of section 170(3)(e) of the Ordinance the classes of transactions that are exempt from section 170(1) of the Ordinance. They specify the circumstances in which certain requirements of section 171 do not have effect. They also specify the record keeping requirements for lenders under securities borrowing and lending agreements.