SFC on Short Selling

26 Sep 2008

The Securities and Futures Commission (SFC) reaffirmed today that in light of recent market developments overseas, it would continue to monitor closely the Hong Kong short-selling regime while also assessing uncertainties surrounding the global financial market.

Many markets around the world have made significant changes to rules regarding short selling in recent weeks. In particular, many regulators have moved to ban “naked” short selling (a practice that has been prohibited in Hong Kong since short selling was first introduced) or to completely suspend short selling for certain stocks.

“The current system in Hong Kong is robust and has proven itself to work well over the last 10 years. If, however, we consider Hong Kong has become a target for abusive short selling strategies, we will act quickly and firmly, to protect the integrity of the market,” said the SFC’s Chief Executive Officer Mr Martin Wheatley.

The SFC has agreed with the Hong Kong Exchanges and Clearing Ltd (HKEx) not to change the tick rule. This decision will be reviewed when the global environment is more stable and a clearer picture emerges on how short-selling activities will be regulated in other leading markets.

Today, the SFC also issued a circular, reminding intermediaries to strictly comply with short-selling rules and warned that any breach may constitute a criminal offence under the Securities and Futures Ordinance punishable by a fine and imprisonment. The SFC has also proposed to HKEx that the default fee charged by the Hong Kong Securities Clearing Co, Ltd for failed transactions be doubled. HKEx will make a further announcement later today.

Hong Kong’s short-selling regime was enhanced after the Asian financial crisis in 1998. Only covered short selling for certain designated securities, as prescribed by the Stock Exchange of Hong Kong Ltd (SEHK), is permitted. Moreover, short selling may be executed only on the SEHK’s trading system at or above the best current asking price (or the tick rule). The rules also require a full audit trail to be kept for covered short sales, meaning, for instance, that when clients place short selling orders, they must provide documentary confirmation to their brokers or agents that the sale is shorted and it is covered. Breaches of these statutory requirements may result in criminal prosecution.

Such regulations are stricter than those in place in many of the overseas markets that recently took the drastic measure to ban short selling temporarily, including those in the United States and Britain.

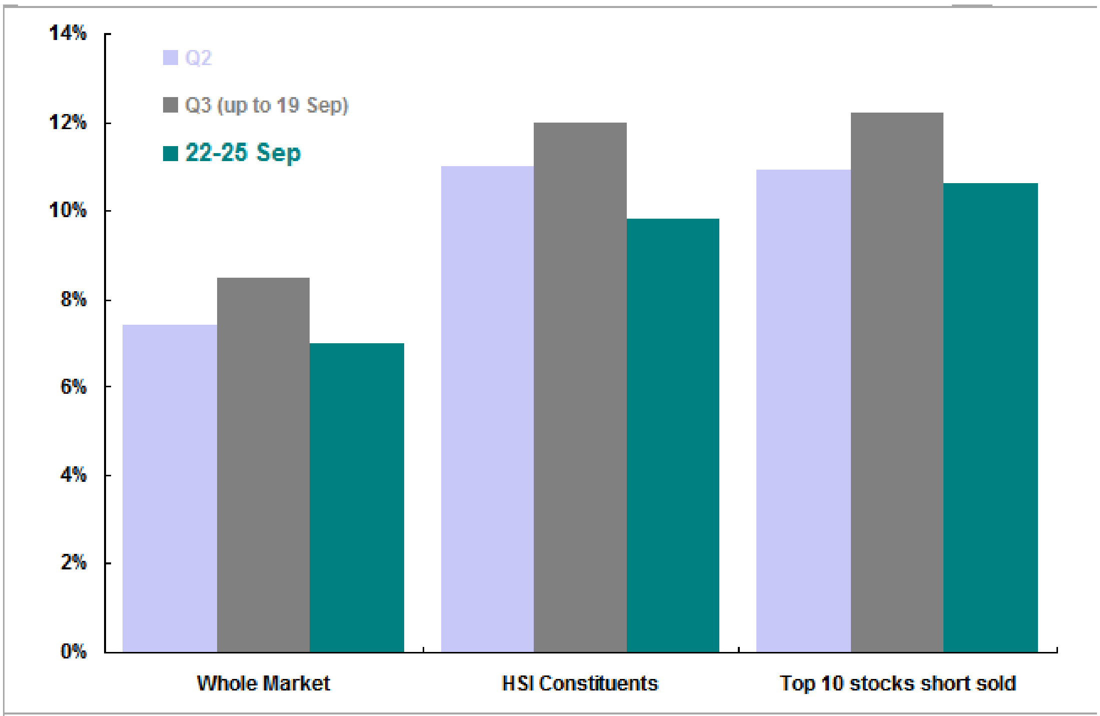
The SFC reiterates it will continue to closely monitor market activity (Note 1) and will not hesitate to take appropriate action to modify the current rules, if necessary.

End

Notes:

1. An overview of recent short selling activities in the Hong Kong markets is set out below and in the graph overleaf:
Between 22-25 September, the Hong Kong market’s short selling turnover was similar to levels recorded earlier in the third quarter and in the whole of the second quarter:

- The average daily short-selling turnover amounted to $4.7 billion on 22-25 September (7% of the total market turnover), compared to $5.7 billion (or 7.4% of total market turnover) for the second quarter and $5.4 billion (or 8.5%) for the third quarter up to 19 September.
- For HSI constituent stocks, the average daily short-selling turnover was $3.3 billion (9.8% of their underlying turnover), compared to $3.7 billion (11%) for the second quarter and $3.8 billion (12%) for the third quarter up to 19 September.
- For the top 10 stocks short sold, the average daily short-selling turnover was $2.1 billion (10.6% of their underlying turnover). The corresponding figures for the second quarter was $1.9 billion (or 10.9%) and $2.2 billion (or 12.2%) for the third quarter to19 September.



Short Selling Trading as % of Underlying Turnover

Source: SFC Research

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

Circular

26 September 2008

Circular to All Licensed Corporations and Registered Institutions (“intermediaries”)

Short Selling Requirements and Obligations under the Securities and Futures Ordinance

Many markets around the world have made significant changes to rules regarding short selling in recent weeks. In particular, many regulators have moved to ban “naked” short selling (a practice that has been prohibited in Hong Kong since short selling was first introduced) or to completely suspend short selling for certain stocks.

SFC is closely monitoring short selling activities. While we believe the existing regime (which has been enhanced in 1998) has served Hong Kong well, we have proposed to the Hong Kong Exchanges and Clearing Ltd (HKEx) that the default fee for settlement failure be doubled as soon as possible. Currently, the Hong Kong Securities Clearing Co, Ltd charges a penalty fee, known as default fee, under the Central Clearing and Settlement System Rules, of 0.25% of the market value of the failed transactions. HKEx will make a further announcement about this later today.

In addition, we have suspended the proposal to remove the tick rule.

We would also like to remind all intermediaries of the short selling requirements and obligations stipulated under the Securities and Futures Ordinance (“SFO”). A breach of any of these requirements or obligations may constitute a criminal offence under the SFO and is punishable by fines and/or imprisonment. The requirements and obligations are set out in summary below.

- Unless exempted, naked short selling is prohibited. The selling of securities at or through the Stock Exchange of Hong Kong Ltd (SEHK) is naked short selling unless at the time of the sale, the seller (or his client, if he is an agent) has a presently exercisable and unconditional right to vest the securities in the purchaser of them, or believes and has reasonable grounds to believe that he (or his client, as the case may be) has such a right.

- Covered short sales (i.e., “short selling orders”) are permitted provided that the reporting obligations are complied with. In summary, (i) the seller (whether acting as principal or agent) must, at the time of placing a short selling order, identify it as a short selling order and provide documentary assurance that the sale is “covered” and (ii) an intermediary who receives a short selling order must ensure that he has obtained a documentary assurance that the sale is “covered”.

- An exchange participant (or his representative), when inputting a short selling order into the SEHK trading system, must mark it as a short sale in accordance with the SEHK rules.

Supervision of Markets Division
Securities and Futures Commission

End

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