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# SFC Consults On Increased Short Selling Disclosure

The Securities and Futures Commission (**SFC**) published a Consultation Paper on 31 July 2009 (the **Consultation Paper**) setting out proposals to introduce transactional reporting requirements and/or positional reporting requirements in relation to short positions in order to increase transparency as to the extent of short positions in the market. The Consultation Paper sets out the relevant issues and possible options. The principal proposals put forward are, in summary:

1. Increased transactional reporting, namely the use of close out indicators which would operate in a similar way to the current reporting requirements for short selling orders. When placing a buy order, a person would need to inform his intermediary if the order is for closing out a short position. HKEx would publish the daily aggregated close out transactions in the same manner as the daily aggregated short selling turnover.
2. On the inclusion of derivatives in the short position reporting regime, the options proposed are: (i) the inclusion of single stock derivatives only; (ii) the inclusion of single stock, basket and index derivatives, unless excluded by law; or (iii) a phased approach which would include only single stock derivatives in Phase 1 and, in Phase 2, would additionally include basket and index derivatives.
3. Three possible options for short position reporting: (i) a threshold approach (thresholds being a percentage of listed companies' issued share capital and/or a dollar value) with initial and subsequent reporting; (ii) periodic reporting with or without a threshold level; or (iii) a flexibility approach adopting less onerous requirements under the threshold approach or periodic reporting in normal market conditions, but giving the SFC the ability to tighten the requirements in a contingency situation. In relation to the public disclosure of short position information, the SFC proposes that it publish the information on a delayed (e.g., weekly or bi-weekly) and aggregated basis without the identities of the holders of short positions.

This Note provides a summary of the SFC's proposals and the issues discussed in relation to the possible alternatives. The Consultation Paper is available on the SFC website at [*here*](http://www.sfc.hk/sfcConsultation/EN/sfcConsultFileServlet?name=incshtpostrans&type=1&docno=1). The SFC is seeking comments on the questions raised in the Consultation Paper, which are reproduced at Annex A to this note, and comments on any other relevant matters. The cut-off date for submission of responses is **30 September 2009**. Online submissions may be made to [*here*](https://www.sfc.hk/sfcConsultation/EN/sfcConsultMainServlet?name=incshtpostrans).

## Objectives Of Increased Transparency On Short Positions

The SFC considers that increased transparency, in the form of transactional reporting and/or positional reporting requirements, may bring the following advantages:

1. it would provide an early warning of a build up of large short positions that could disrupt the functioning or stability of the market. Regulators would then be in a better position to assess whether any action needs to be taken;
2. information on short selling would be readily available;
3. it would act as a deterrent to abusive short selling; and
4. it would provide evidence of assistance in any post event investigation and disciplinary action.

Transactional reporting requirements for short selling orders have been in place in Hong Kong since 2000. However, the current measures fail to achieve some of the important objectives of increased transparency. For example, the current reporting requirements do not require short sellers to report the closing out of short positions. Nor do they apply to over-the-counter transactions (**OTC transactions**) and derivatives. The SFC's concern is that these shortcomings prevent it from accurately assessing the outstanding short interest in the market which could interfere with its proper monitoring of systemic risks.

The current regulation and restrictions on short selling in Hong Kong are set out in sections 170 to 172 and Part XV of the Securities and Futures Ordinance (**SFO**). Hong Kong's short selling regime has been more stringent than that of other overseas markets for some time. It was not until September 2008 that a number of overseas markets imposed various emergency measures to regulate short selling (i.e. the UK, US, Canada, Germany, Netherlands, Singapore, France, Australia).

## Transactional Reporting - Close Out Indicators

Transactional reporting for short selling orders is already required under Section 171 SFO. The use of close out indicators would operate in a similar way to the current reporting requirements for short selling orders. Accordingly, a person placing a buy order would need to inform his intermediary if the order is for closing out a short positions and the exchange participant who inputs the buy order into SEHK's trading system would use a special input indicator for these transactions.

The limitations of close out indicators include that if they are not required for off-exchange transactions, close out transactions that are executed off-exchange would not be reported. Furthermore, as the indicators would apply only to cash market transactions executed on the exchange, the information obtained would exclude derivatives transactions. The identities of short position holders would also not be immediately available to the SFC.

Further, as no information is provided under the current regime on the initial outstanding short position, information concerning close out transactions may still not provide a clear picture of the overall outstanding short position. However the SFC expects that this is more likely to be an issue during the initial stage of implementing close out indicators, and that the information should gradually provide the SFC with better insight into the outstanding short positions of stocks in the exchange traded cash market.

The SFC sees the use of close out indicators as probably the most straightforward means of providing a more complete picture of the cash market short position. As SEHK and market participants already have systems in place to comply with the existing transactional reporting requirements for short selling orders, the introduction of a requirement for close out indicators is unlikely to require substantial systems upgrades.

If close out indicators are to be introduced, it is likely that HKEx would publish daily aggregated close out transactions in the same way as it publishes daily aggregated short selling turnover.

If more information on OTC trades is required, one option would be to require both the use of close out indicators and short position reporting, although this would increase the compliance burden on market participants.

## Short Position Reporting

### Scope of Reporting Requirement - Inclusion of Derivatives?

One of the initial issues to address is whether short position reporting requirements should apply to derivatives and other financial instruments creating short exposures with a similar effect to a short sale, whether traded on or off-exchange. A reporting regime that does not include these instruments would arguably provide an incomplete picture of the short interest in the market. This approach might also push more activity to the derivatives or OTC market as a way around the short position reporting requirements. Conversely, if these instruments are included, the information obtained would be more complete, but also more complicated.

Looking at overseas markets, there is no uniform practice as to the extension of short position reporting requirements to derivatives and similar financial instruments:

1. In the UK and some European countries, short position reporting requirements apply to all instruments giving rise to an exposure directly or indirectly, to the issued share capital of a company (i.e., an economic interest approach).
2. In the US, the reporting requirements on certain institutional investment managers apply only to certain specified equity securities.
3. In Japan, short position reporting requirements only cover equity stock short positions.
4. The Australian Securities Exchange has short selling related disclosure requirements that are generally limited to positions relating to trades executed on the exchange. The Australian government has however consulted on whether the short position reporting requirements should cover derivatives.
5. The Singapore Stock Exchange has consulted the market on short position reporting requirements and its proposals appear to cover only securities traded on the exchange.

### The Options

Recognizing the need to strike a balance between simple but incomplete information and complete but excessively complex information, the SFC and has put forward the following options for consideration:

1. *To only include single stock derivatives.*  
     
   To only require the reporting of single stock derivatives would however provide an incomplete picture of the short interest in the market since information would not be available as to the extent of short positions under index and basket derivatives. This approach might also lead to basket derivatives being structured to avoid reporting requirements. For example, a derivative with a basket of 2 underlying stocks where one underlying stock is very lightly weighted will have a substantial exposure to the more heavily weighted underlying stock. Such a derivative would not be subject to a short position reporting requirement applicable only to single stock derivatives.
2. *To include single stock, basket and index derivatives unless exempted/excluded by the SFC*  
     
   This approach should provide a more complete picture of market short positions and make it more difficult to avoid the reporting requirements. The SFC has suggested two ways of implementing the approach:
   1. Adopt a specific exemption for broad based basket and index derivatives in the law - similar to the current 'basket exemption' under section 308(5) of the SFO. That exemption applies to derivatives based on a basket of at least 5 stocks and where no one stock accounts for over 30% of the value of the entire basket. Should this approach be adopted, consideration would be given as to whether to use the same or different numbers of stocks and percentage levels as those in Part XV of the SFO; or
   2. Empower the SFC to exempt specific baskets (and indices) on a case-by-case basis. This would provide more flexibility than option (b)(i) above but might be more administratively burdensome and create regulatory uncertainty. The issue of regulatory uncertainty could be answered to some extent by specifying the SFC's criteria for the grant of an exemption. Those criteria would aim to ensure that baskets are sufficiently broad based and not structured solely for the purpose of circumventing the reporting requirements.
3. *Phased approach*  
     
   The gradual implementation of the above-mentioned approaches over several phases is also a possible option. For example, in Phase 1, only single stock derivatives would be included; after a certain period, Phase 2 (including non-exempt basket and index derivatives) would be implemented.  
     
   To avoid excessively complicated reporting requirements, the SFC proposes that the reporting regime would not apply to financial products such as credit default swaps which do not create a direct exposure to the stock of a listed company.  
     
   A further issue raised by the SFC is whether, if derivatives are included in the reporting regime, they should be included in the net exposure calculation based on a delta adjusted approach.  
     
   Covered short selling is only allowed in securities designated by SEHK as eligible for short selling (**Designated Securities**). If the short position reporting regime includes off-exchange transactions and derivatives, the SFC suggests that there may be some rationale for extending the reporting requirement to short positions in non-Designated Securities so that the reporting requirement covers short positions in all listed corporations' securities and not only those in Designated Securities.

### Triggering the reporting requirement

There are 2 principal approaches as to how short position reporting requirements should be triggered: the threshold approach and periodic approach.

Under the threshold approach, adopted in the UK, Japan and some European countries, reporting requirements are triggered once a person holds a certain percentage (**initial threshold**) of a listed company's issued share capital. If the person's short position subsequently crosses one or more threshold levels or drops below the initial threshold, further reporting must be made. Japan currently applies a 0.25% threshold on exchange traded cash market short positions while Singapore is consulting on the implementation of a 1% threshold again on exchange traded cash market short positions.

Although it expired on 1 August 2009, the US employed a periodic approach when it imposed reporting requirements as part of the emergency measures adopted during the financial crisis. The requirements applied only to institutional investment managers with discretionary powers in relation to accounts holding certain classes of equity securities with a fair market value of US$100 million or more. These investment managers were required to file weekly reports to the SEC unless the short position was less than 0.25% of the issued securities and its fair market value was less than US$1 million.

### The Options

The SFC is proposing the following approaches:

1. *Reporting of all short positions with no threshold*  
     
   The SFC acknowledges that whilst this may be a simple approach, it would be administratively burdensome for both the SFC and persons filing reports.
2. *Threshold approach*  
     
   While the exclusion of small positions from the reporting regime would reduce the administrative burden, it would reduce the overall completeness of the information provided. The key issue is setting the threshold at a level which will exclude insignificant positions but catch all substantial positions. If the threshold is set too low, the regime will be administratively burdensome and could ultimately defeat the purpose of the threshold. On the other hand, if the threshold is too high, substantial positions will not be caught.  
     
   The SFC proposes that the threshold level should not be higher than 0.25% of the issued share capital, the level adopted in London and New York. Before reaching this figure, the SFC analysed stock loan estimates of about 320 Hong Kong stocks as at the end of February 2009. It found that there were no short positions of 0.50% or more in any of those stocks: so that a threshold level of 0.50% would not have required any short position reporting. The results also showed that even at a threshold of 0.25% of issued share capital, short selling would be below the threshold level in about 36% of stocks.  
     
   The SFC states in the Consultation Paper that the short selling/turnover ratio in Hong Kong is considerably lower than that in London and New York. It also found the short exposure/market capitalisation ratio in Hong Kong (at or below 1% as at 30 August 2009) to be much lower than that in New York (approximately 4.7% at the same date).
3. *Periodic reporting*  
     
   As an alternative, the SFC suggests adopting a periodic approach, either with or without a threshold level (that could be a percentage of a listed company's issued share capital and/or a dollar value amount). Arguments in favour of periodic reporting include that substantial short positions tend to be accumulated over a period of time, thus making it more effective, and less onerous, to require reporting to be made periodically, for example, weekly.  
     
   To reduce the administrative burden, the SFC further suggests combining the periodic and threshold approaches so that reporting is required weekly when a person holds a short position above a certain threshold (set at a percentage of a listed company's issued share capital and/or a dollar value amount) and when the person's short position falls below the threshold. The shortcoming of periodic disclosure is however that it may fail to provide sufficiently timely information as to the true level of short positions in the market in crisis situations. This could be addressed by providing flexibility to increase reporting frequency in a crisis.
4. *Flexibility approach*  
     
   This option envisages adopting less onerous reporting requirements under either the threshold or periodic approach in normal market conditions, but with flexibility for the SFC to declare a contingency situation during which the reporting frequency would be increased (e.g., to daily reporting) and any threshold(s) would be tightened. The law would need to specify the circumstances which would constitute a contingency situation and the manner in which the SFC's determinations as to when a contingency situation exists and ceases to exist are communicated to the public. Market participants would also need to ensure that their reporting systems have the flexibility to switch from one set of requirements to another quickly in a crisis situation.

### Reporting Frequency

How often reporting will be required will be largely dependent on which of the two approaches is implemented

1. *Threshold approach*  
     
   To ensure its effectiveness, reporting needs to be done as soon as practicable after the crossing of a threshold level. Given the potential compliance burden this may create for some holders of short positions, the SFC suggests that disclosure should be made within the business day following the day on which the short position exceeded the threshold(s). Further reporting would be necessary when the position falls below the initial threshold or each level of the subsequent triggers.
2. *Periodic approach*  
     
   If the periodic approach is adopted, the SFC suggests that weekly reporting should be required so that holders of short positions must report to the SFC their positions as at the close of the last business day of the week within the first business day of the following week.  
     
   If no threshold is adopted with the periodic reporting requirement, a short position holder will have to submit a report to the SFC weekly until the person ceases to hold a short position. The person must then file a report notifying the SFC that he no longer holds a short position.  
     
   If a threshold is adopted with a periodic reporting requirement, a report to the SFC will need to be made weekly once a person's short position exceeds the threshold, as well as when his short position first falls below the threshold.  
     
   The SFC may also be given the ability to require more frequent reporting and/or tighter thresholds in contingency situations.

### Who should be required to report?

The SFC considers that the ultimate legal responsibility for reporting short positions should be on the holders of positions, as they are in a better position than their agents to provide accurate information on their portfolios.

Agents (i.e. brokers or custodians) could be allowed to file a report on behalf of holders, but the holder would be accountable for any failure of this agent to comply with the reporting requirements.

1. *Funds*  
     
   The reporting requirement would apply to each fund. The fund manager would be able to report the positions on behalf of each of the funds it manages but it would not be permitted to aggregate or net positions between different funds.
2. *Global financial institutions*  
     
   The reporting obligation would be on individual legal entities within the group, with no aggregation. The SFC is aware of the possible risks, such as firms booking short positions just below the thresholds into different legal entities so as to avoid the reporting requirements. The SFC is however reluctant to adopt aggregation requirements to address this risk as it would make for a very complex reporting regime. It would also be difficult for market participants to comply with more frequent reporting in contingency situations, if the flexibility approach is adopted.

### Information to be reported

In addition to basic information relating to the person filing the report (e.g., the entity name, dates etc.) the SFC proposes that short positions reports should also contain the following:

1. the net short position - the aggregated cash and derivative positions which result in the short position reaching the threshold trigger, if adopted; and
2. the net position (long or short) that is established on the SEHK.

These are more stringent than the requirements of some overseas markets, which only require the reporting of one net short position, but the information will apparently allow the SFC to better carry out its market monitoring function. The SFC does not however intend to publish the broken-down information in detail. The SFC is also proposing to create a template so that short position reports can be submitted electronically through the SFC's website.

### Private reporting or public disclosure?

Public disclosure of short positions raises a number of concerns, such as:

1. that disclosing the proprietary trading strategies of holders of short positions may deter traders/investors from engaging in legitimate short selling activities which are generally beneficial to the market;
2. that disclosure may subject short sellers to the risks of being short squeezed when they cover their short positions; and
3. that disclosure could create a herding effect where investors blindly follow a big-name short position holder.

While public disclosure of the information could increase transparency to the public, it is arguable that the aggregated short selling turnover that the SEHK publishes daily already provides adequate transparency and that there is no additional need to require public disclosure of short positions and the identity of their holders.

As a compromise, the SFC is proposing that reporting should be made privately to the SFC. The SFC would then release the information to the public on a delayed (e.g., weekly or bi-weekly) and aggregated basis without disclosing the identities of the holders of short positions.

### Inclusion of the short position reporting requirements in Part XV of the SFO

The advantage of including the short position reporting requirements in the existing disclosure of interests regime in Part XV of the SFO (**Part XV**) is that it would allow existing compliance programmes for Part XV to be used saving the costs of building new systems for the short position reporting regime.

On the other hand, creating new subsidiary legislation under section 397(2) of the SFO may be more appropriate than inclusion in Part XV for the following reasons:

1. The definition of 'short position' in Part XV includes interests which the SFC does not wish to include for the short position reporting requirements, e.g. stock borrowings;
2. The Part XV disclosure obligations only apply when a person is already a substantial shareholder, i.e. a person with a long position of 5% or more;
3. The time period for disclosures under Part XV is 3 business days which is too long for short position reporting;
4. Derivatives are calculated by notional amount for Part XV, whereas the SFC would like to include derivatives for short position reporting on a delta adjusted basis;
5. There will be more flexibility to create a simpler and more effective set of rules governing short position reporting if Part XV is not used.

*The purpose of this Note is to provide a summary only of information included in the Securities and Futures Commission's "Consultation on increasing short position transparency (31 July 2009)". Its contents do not constitute legal advice and specific advice should be sought in relation to any particular situation.*

## Appendix A: List of Questions

Q1: Is the use of close out indicators an appropriate method to enhance transparency of short selling in the cash market to the SFC? Please provide reasons.

Q2: If you believe the use of close out indicators can be adopted, how can we address the limitations that are set out in paragraphs 13 and 14?

Q3: Should derivatives (both exchange traded and off-exchange transactions) be included in the short position reporting requirements? Please provide reasons.

Q4: If derivatives are included, which (if any) of the alternatives in paragraph 21 above is the most appropriate? Are there any other practical alternatives? Please provide reasons.

Q5: If any one of the approaches in paragraph 21 is adopted, should those derivatives be limited to ones that create direct exposures to the stock of the listed company? If so, what are the products that should be excluded (e.g., do you have any views on whether convertibles and other exchangables should be included?) How should the definition of such derivative be crafted? Please provide reasons.

Q6: If derivatives are included, should they be included on a delta adjusted basis? Please provide reasons.

Q7: Should the reporting requirements cover short positions in Designated Securities only rather than in all listed corporations' securities? Please provide reasons.

Q8: Which of the approaches above (i.e., threshold approach (with initial and subsequent reporting), or periodic reporting (with or without a threshold level) or either the threshold approach or periodic approach with flexibility to tighten the requirements during a contingency situation) would be the most appropriate for short position reporting? Do you have any other suggestions? Please provide reasons.

Q9: If a threshold approach is adopted, what is an appropriate threshold (and subsequent thresholds) for the Hong Kong market? If periodic reporting is adopted, should thresholds (either a percentage of a listed corporation's issued share capital and/or a dollar value amount) apply? If so, what are appropriate thresholds for periodic reporting? Please provide reasons. If you are a broker or custodian, it would be helpful if you could estimate how many of your clients would be required to file reports if the suggested threshold is adopted.

Q10: If you agree that short position reporting can be more relaxed during normal market situations and more frequent reporting with tighter threshold(s) may be required in the event of a contingency, what are the circumstances that may amount to a contingency situation (as this may need to be included in the legislation)? Please provide reasons.

Q11: Are there any reasons why systems for complying with reporting requirements cannot be adjusted in the manner described in paragraph 26(d) above? What are other operational issues that we should consider? Please provide reasons.

Q12: What are your views on the timing of reporting for the different approaches? Please provide reasons.

Q13: Should the obligation to report short positions be placed on holders of short positions? Please provide reasons.

Q14: Should agents be permitted to report information on behalf of holders of short positions with the holders of the positions being held accountable? Please provide reasons.

Q15: In the case of funds, should the reporting requirements apply to individual funds rather than to the fund manager? Please provide reasons.

Q16: Do you agree that aggregation requirements should not be imposed on different entities within the same group? Please provide reasons.

Q17: What are your views on providing in the report to the SFC the net short position and the net position established on the SEHK? Please provide reasons.

Q18: What are your views on the creation of a template to facilitate electronic reporting through the SFC's website? Please provide reasons.

Q19: Should the information reported to the SFC be disclosed publicly on an aggregated and delayed basis? Please provide reasons.

Q20: If the information is published on a delayed basis, what would be the appropriate 'delay' (e.g., on a weekly basis for positions as at the end of the preceding week)?

Q21: Should the SFC consider any exemptions from the reporting requirements? Please provide reasons.

Q22: Do you agree that the short position reporting requirements should not be homed in Part XV of the SFO or mirror the Part XV requirements? Please provide reasons.

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