



## **SFC'S CONSULTATION PAPER ON INCREASING SHORT POSITION TRANSPARENCY**

### **LAW SOCIETY'S SUBMISSION**

#### **A. IMPORTANT GENERAL POINTS**

The current requirements in Part XV Securities and Futures Ordinance (SFO) are primarily for market transparency purposes (who the major investors are, and what their positions are). The Consultation Paper is envisaging a different set of purposes with the current proposals; there is nothing inherently wrong with that, but this change of philosophy and its implications needs to be examined with care.

##### **1. Complexity and achieving balance; potential for controversy**

Hong Kong's existing disclosure regime for interests and short positions in securities is one of the most complex in the world causing significant difficulty and expense for market participants and difficulties to practitioners with first hand experience of this. The SFC should not underestimate the importance of being sensitive to the perception and effects of increasing investors' burden in this regard.

We note there is an existing disclosure regime for short positions in Part XV of the SFO which has little consideration in the Consultation Paper. We do not understand why the defects in the existing regime have not been examined in order to achieve the SFC's goals in this consultation. The Law Society suggests the obvious way forward would be proposals to adjust the existing regime in Part XV rather than create an entirely new parallel regime.

The current conceptual frame work should be retained and if necessary a parallel sub-regime could be added. The SFC should minimise the potentially vast cost and disruption for market participants from having to create/modify their existing monitoring and reporting systems for the new requirements.

We believe there is real risk the current proposals will not produce the quality information and other goals of the consultation.

We note other jurisdictions have found it difficult to achieve the right balance between cost and utility and cite as an example the situation in Canada, where an embarrassing change of direction became necessary. The SFC will need to provide more assurances

that this exercise will produce truly useful information to justify imposing additional burdens on investors.

If the proposals are implemented such that there are two different, inconsistent regimes for reporting short positions the SFC may face potential embarrassment if dissatisfaction becomes significant.

## **2. Transactional reporting and short position reporting**

It will be inappropriate to have transaction reporting if the proposal on expanded position reporting is introduced as this is likely to be an unwarranted administrative burden because of the frequency of transactions.

## **3. Improve Part XV at the same time**

We recommend that Part XV be reviewed, and recommendations for amendments within the existing legislation would include:

- relaxing the criteria for the “non-aggregation” exemption: as currently drafted it is inapplicable in many situations where parties may reasonably be considered to be acting independently of their controllers, with the result that the exemption does not have the application in practice that it is intended to have.
- clarify the current definitions of “*equity derivative*” and “*short position*” which are opaque and do not support SFC’s claims on what they cover.

(See William Mackesy’s “*Disclosure of Interests in Securities of Hong Kong Listed Companies*”, 2004 on Part XV, and various submissions to the SFC over the last few years for more examples of problems with the existing regime.)

## **B. TRANSACTIONAL REPORTING**

**General:** transactional reporting appears to be only appropriate if:

- there is no separate expanded position reporting regime (it is otherwise excessive and an unnecessary duplication)
- it applies only to on-market transactions (and excludes derivatives other than HK listed instruments).

*Question 1:*

*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.*

**We query whether the additional compliance burden imposed by such reporting can be justified. We repeat the existing framework of Part XV should be improved.**

*Question 2:*

*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?*

**The drawbacks mentioned in paragraphs 13 and 14 are real, but are hard to avoid. A somewhat primitive system would probably result if this approach is adopted – but this may still be the best benefit/cost balance achievable.**

## **C. POSITION REPORTING**

### *Scope/derivatives*

*Paragraph 20: We query whether the UK requires derivative exposure reporting in the way the Consultation Paper implies. Is this just in the context of takeovers?*

We believe that the weight of current international practice is for short positions directly in stocks to be reported, but not short positions through derivatives.

*Question 3:*

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

**These are already included in the Part XV regime. So, yes, subject to the concerns discussed in Section A above.**

*Question 4:*

*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.*

**Paragraph 21(b) is to be supported, including its sub-paragraphs.**

*Question 5:*

*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 (eg., do you have any views on whether convertibles and other exchangeable should be included?) How should the definition of such derivative be crafted? Please provide reasons.*

**See our answer to Question 4 above.**

*Question 6:*

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

**We consider that and the Consultation Paper is insufficiently detailed on this aspect.**

**It would appear that inclusion of derivatives on a “delta adjusted basis” would provide a better indication of a person’s actual exposure. However, we submit consistency should be maintained with the current Part XV regime (by amendment to the Part XV regime, if necessary). We can see huge definitional problems in achieving this, and it may prove not to be practicable; we recommend that this issue is considered as a priority before decisions are made.**

*Question 7:*

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

**Assuming the primary focus of the SFC’s concerns is systemic market risk, we suggest the short reporting requirements could be limited to large-cap stocks. If the SFC also seeks to use reporting requirements as a means to prevent manipulation of individual stock prices, the reporting requirements would have to apply to all stocks. However, our view is that the additional compliance burden this imposes would not be warranted without further consideration of the extent such reporting would help prevent such manipulation.**

***Trigger***

**General:** the current trigger in Part XV is a 5%+ long position *and* a 1%+ short. This is not clear from the Consultation Paper.

*Question 8:*

*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.*

**A threshold approach would be consistent with the existing regime, and is strongly recommended to minimise regulatory inconsistency and confusion. Better still, periodic reporting combined with a threshold would be the “lightest touch” approach and should satisfy the SFC’s concerns if combined with powers to increase requirements in an emergency.**

*Question 9:*

*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.*

**We query whether the stock loan figures quoted at paragraph 26(b)(iv) of the Consultation Paper are correct (they appear rather low). The reporting requirements for long positions commence at 5%. A threshold of, say, 1% would appear to be appropriate for short positions as this should result in reporting of a**

large amount of data to the SFC. The threshold could be adjusted later if necessary.

*Question 10:*

*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.*

**We strongly support an approach whereby the requirements are as undemanding as possible during normal market conditions, but with the SFC having the ability to tighten requirements in an emergency. The provisions enabling the SFC to do so would need to be drafted to give it a wide discretion in the first instance. It would be appropriate for the SFC to justify its exercise of such power, for example by reporting to Government on a regular basis if it continues applying the tighter requirements.**

*Question 11:*

*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.*

**It appears that different parties have very different systems for complying with reporting requirements, and the SFC would need to consult widely if it is to obtain an accurate and comprehensive answer to this question.**

***Timing***

*Question 12:*

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

**IMPORTANT: The time within which reporting will be required will depend in part on how the points made elsewhere are addressed (and whether derivative interests are included within the regime): if aggregation up corporate chains, and the like, are necessary to prevent avoidance, then next day reporting is not realistic. The 3 day requirements in Part XV were only reached after lengthy discussion and consideration, as the shortest realistic disclosure period. If such a time period is not workable from the point of view of achieving the SFC's objectives, then this strongly militates toward a regime that:**

- is focussed on reporting on-market transactions only
- does not include derivatives

**The above goes to the heart of the proposals and needs to be very carefully factored to avoid embarrassment later.**

**We see reporting as at the end of each week as a sensible balance.**

### ***Who is required to report?***

#### *Question 13:*

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

**The obligations to report should be placed on holders of short positions, whether they are financial institutions or not. It may be unfair and difficult to enforce if the obligation is placed on a service provider to the holder of the short position e.g. a broker.**

#### *Question 14:*

*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.*

**Yes, subject to a similar nexus to Part XV e.g. that the holder remains ultimately responsible.**

#### *Question 15:*

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

**If a threshold approach is taken, having reporting on a per fund basis could result in reduced disclosure if individual funds fall under the threshold whilst the manager is managing a large overall short position.**

**A per manager approach would be consistent with the existing regime in Part XV as well.**

#### *Question 16:*

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

**We cannot see how the regime can work (avoidance would be too easy) if it does not provide for aggregation within groups, subject to exemptions of the sort that are in Part XV. For instance, a 4% shareholder could avoid disclosing having shorted its whole position if the shorts were written by a number of SPVs owned by it, just below the disclosure threshold; an investment bank's proprietary trading desk could do likewise. But this has huge implications for the timing requirements. See our comments above.**

### ***Information***

#### *Question 17:*

*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.*

**Before imposing such requirement the SFC should ensure that it would not impose a significant additional compliance burden.**

*Question 18:*

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

**We would expect that the utility of the information would be significantly compromised by passage of time without a system for quick submission and processing of the information; this suggests electronic reporting would be necessary. The SFC would need to ensure the process for electronic reporting is simple and reliable.**

***Private or public reporting?***

*Question 19:*

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

**We support public disclosure on a no-name, aggregated and delayed basis.**

*Question 20:*

*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)?*

**No strong views. If periodic reporting is adopted, report the aggregated periodic reports.**

***Exemptions***

*Question 21:*

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

**We do not see exemptions, other than those in Part XV, as being necessary.**

***Homing in on Part XV***

*Question 22:*

*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.*

**We strongly recommend that any new requirements should be as consistent with Part XV as possible, with variations where necessary to effect the new regime; we repeat the important general comments in Section A above.**

**Paragraph 43:**

(a) *The definition of "short position" in Part XV includes interests which we do not wish to include for the short position reporting regime, e.g., stock borrowings;*

**It may be necessary to have differing definitions of "short positions" for these purposes. If the inclusion of such interests is unsuitable for the SFC's**

**proposed short position reporting, what is the reason for their inclusion in the reporting of short positions under Part XV – could Part XV be amended (i.e. simplified)?**

- (b) *The disclosure obligations under Part XV for short positions apply only when a person is a substantial shareholder (i.e., one who has a long position of 5% of more);*

**Correct; the SFC will need to consider whether the existing regime in Part XV should be amended.**

- (c) *We consider the time period for disclosures under Part XV (i.e., 3 business days) to be too long for the purposes of short position reporting;*

**See “Timing” above; we can’t see how a wide-ranging new regime can be made to work within the short time periods the SFC has in mind.**

- (d) *Derivatives are calculated by notional amount for Part XV, we would like to include derivatives for short position reporting on a delta adjusted basis;*

**Noted.**

- (e) *There will be more flexibility to create a simpler and more effective set of rules to address the need for the short position reporting if Part XV is not used.*

**Correct: but this will be a case of variation within a consistent conceptual framework.**

**The Law Society does not see subsidiary legislation as being the right way forward, unless it is structured so as to achieve the above.**

**The Law Society of Hong Kong  
Securities Law Committee  
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