Comments on the draft Securities and Futures (Short Selling Exemption and Stock Lending) Rules (the "draft Rules")

1 Introduction

The financial institutions listed below (the "**Group**") appreciate the opportunity to provide comments on the draft Rules. As a general matter the Group welcomes the draft Rules as representing an important step towards relaxing the short selling regime in Hong Kong. However, the relaxation will be of limited use unless equivalent exemptions from the tick rule are also introduced at the same time. Also the Rules of the Stock Exchange (the "**SEHK Rules**") will need to be amended to permit exchange participants to conduct all the types of naked short selling permitted by the draft Rules. For example, the SFC gazetted a naked short selling exemption for SEHK Options Market Makers in July 2001 but the Eleventh Schedule to the SEHK Rules has not been amended accordingly.

The Group has several suggestions that are intended to make the draft Rules more practical in their application.

2 Rule 3 - Classes of transactions prescribed for the purposes of Section 170(3)(e)

According to paragraph 15 of the Consultation Paper the exemptions are meant to apply to hedging activities by issuers of structured products but the language of Rule 3(2) does not appear to cover the situation. Rule 3(2)(a) only applies where a position previously acquired in another security is hedged, and the security sold is a component of that other security or vice versa. If a product is structured with the economic features of a written put, to hedge that position it would be necessary to short the underlying stock. However, by issuing the product, is "a position acquired" in the underlying, especially if the product is cash-settled, as a bear Equity Linked Certificate or put warrant normally is? Under Part XV of the Securities and Futures Ordinance ("**SFO**"), a written cash settled put over Hong Kong stock does not give the writer a long position in that stock, thus the pre-requisite for a previously acquired position would not exist. The Group believes that "a component of that other security" should include an underlying of that other security. Also the language would not permit pre-hedging.

It appears that only Securities Market Makers and Futures Market Makers are able to rely on the exemptions. It is common, however, for exchange participants only to be used as execution agents. We assume that other parties, such as an offshore affiliate who hedges the position and uses the relevant market maker merely to execute the trade, would also be able to rely on the exemption.

In order to fall within the exemption in Rule 3(2)(a) and (b) the sale must be for "the purpose of hedging the risks of a position previously acquired". What evidence will be required by the SFC to show that the sale was for the purpose of hedging?

The Group would like confirmation that where a Securities Market Maker has submitted a redemption application on an exchange traded fund the Securities Market Maker acquires 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 Rule 3(2)(c) that the Securities

Market Maker acquires the right to vest the securities in the purchaser of them before the end of the trading day following the day of sale.

3 Rule 4 - Circumstances in which Section 171 does not have effect

We believe that Rule 4 is meant to provide 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 the routes set out in the Rule.

Rules 4(2)(b), 4(3)(b)(iii) and 4(4)(b)(iii) refer to “an arrangement”. What evidence will the SFC require to substantiate such arrangement?

To rely on the exemption in Rule 4(4)(b)(iii) an agent must have received an oral assurance (Rule 4(4)(a)) from his client; and must have entered into an arrangement whereby the client has agreed to provide a confirmation of the oral assurance in the form of a document to his agent by the end of the day on which the assurance was given.

As this exemption does not require the agent to keep anything during the day, what are the consequences if, for whatever reason, the client does not send any documentary assurance at the end of the day?

The Group would also like some guidance on what is required by "a confirmation of the oral assurance in the form of a document". Would an email message from the client be sufficient?

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 seems to go beyond what Section 171 requires in a documentary assurance (and also what would need to be provided by way of information if one of the other routes in Rule 4 is followed). In particular, the Group does not believe it should be necessary for the seller to provide details of the time the blanket assurance or hold has been given or a borrow has been entered into. It should be sufficient to know that the seller has the securities available. This information is not currently required under the Securities Ordinance and would make the obligations more onerous rather than providing a relaxation. The draft Rules should be designed to streamline procedures, not replace them with equally burdensome procedures.

The scope of Rule 4 is rather narrow as it only applies to short selling orders that are short selling orders by virtue of the seller having borrowed stock and not by virtue of it, for example, holding an option and borrowing to cover settlement obligations. Currently, when a client places a short selling order with a broker, the broker is required to confirm with the client whether or not it is a short sale, and if it is a short sale to then obtain the basic form of documentary assurance regardless of which category of short selling order the short sale falls into. It would be impractical to impose an additional obligation on sellers/brokers now, to ascertain what type of short selling order they are placing/receiving, where the intention of the draft Rules is to provide a relaxed regime. If the client tells the broker that it is a short selling order, the Group believes the relaxed regime should apply, regardless which category of short selling order the sale falls into.

If you would like to discuss any of the above issues with the Group collectively, please contact Alison J Fidler at Linklaters, 10th Floor, Alexandra House, Chater Road, Central, Hong Kong (direct line: 2842 4811/email: alison.fidler@linklaters.com).

List of Submitting Group Members

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

UBS Warburg