

RE: Consultation on Securities and Futures (Short Position Reporting) Rules

In response to the consultation paper published in May 2011, we take this opportunity to express our comments on the draft subsidiary legislation.

The administration workload of reporting the short positions faced by both investors and the SFC outweighs the benefits of information extracted from it. Investors would consider twice before taking short positions. The requirements are thus discouraging short-selling. Market turnover will shrink and bid/ask spread will widen. Market liquidity as a whole will also deteriorate. The Hong Kong stock market and economy are the ultimate entities bearing the consequences.

The current draft does not take into account the rationales of market participants taking the short positions. There are various reasons of taking short positions, apart from having the conviction of lower share price in the future. To name a few, these reasons include:

1. Portfolio hedging: market participants are holding long shares of securities and may want to hedge certain risks. Current draft does not allow netting of long and short positions in identical securities.
2. Structured product market making: market makers of structured products, e.g. warrants and CBBC, often do hedging on the structured products sold. Reporting on short positions arising from these activities certainly hinder further development of exchange-traded derivatives and structured products.
3. Share arbitraging and convertible bond arbitraging: arbitraging between assets is widely recognized by both academics and practitioners as a driving force of market efficiency. Arbitrageurs are deterred by the Rules and thus the market becomes less efficient.

Aggregating the short positions of individual investors and reporting to the public oversimplifies the various rationales behind taking such short positions. Such aggregated report will very likely create misleading information for the public and lead them to make misinformed decisions. It is not likely to be the SFC's goal of misleading the public, in our view.

The reporting threshold proposed in the draft is too low. It is understood the relative threshold of 0.02% of issued share capital is based on the average daily short selling turnover of a mid-cap or small-cap index constituent stock. However, holding long positions and buying and long selling activities of the same stocks does not have similar reporting requirements. It is thus logical to induce that short positions are stereotyped and not receiving fair regulatory treatments as long positions currently do. We thus propose short positions should receive similar disclosure requirements as long positions currently do. We suggest public disclosure is required for short positions amounting to 2% of issued share capital or more, and any subsequent changes in those short positions are disclosed as well, until the positions are less than 2% of the issued share capital.

In relation to the absolute threshold of HK\$30 million, reporting short positions of this size on large-cap companies would not yield more useful information than a higher absolute threshold, given the market capitalization and turnover of these large-cap companies. We thus propose the absolute threshold to be raised to HK\$100 million.

The reporting threshold is based on average daily short selling turnover while reporting of short positions is done weekly. In our opinion, investors building short positions over the week may cover part of their short positions on the last trading day of the week to avoid the obligation of reporting. As such, market behavior will be distorted by the legislation. The requirement itself exerts impacts on the market and does not truly capture short positions as would otherwise have been the case in the absence of the requirement. The price discovery process emphasized as an aim of establishing such reporting requirement is also disrupted by the requirement itself, due to reduced turnover and market liquidity, wider bid/ask spread and less market efficiency.

The Singapore Exchange, a market deemed as a major competitor to the Hong Kong stock market, has proposed a reporting threshold level of 1%. If the threshold set by the subsidiary legislation is too low, trading activities will very likely be diverted to other areas in the region, hindering further development of Hong Kong as the global financial hub.

Instead of reporting short positions, providing more education to the public about short selling is considered more constructive to market development. In mature markets, short selling activities are one of the fundamental activities carried out by investors. Absence of such activities in Hong Kong certainly positions Hong Kong not in the same rank as other mature markets.

It is not our wish nor in our interest to witness the development of the Hong Kong stock market moving backwards and away from becoming a global financial hub.