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30 June 2011

Supervision of Markets
Securities and Futures Commission
8/F, Chater House,
8 Connaught Road Central
Hong Kong

Dear Sir/Madam

Consultation on Securities and Futures (Short Position Reporting) Rules

Thank you for the opportunity to comment on the Commission's consultation paper dated May 2011.

Please refer to Attachment A for our submission and to Attachment B for comments we provided to the Commission on 20 March 2010. We are happy for you to disclose these documents to the public.

If have any questions or wish to discuss this further, please feel free to

Yours sincerely

Deacons

Attachment A

30 June 2011

SFC Consultation on Securities and Futures (Short Position Reporting) Rules:
Deacons' submission

Thank you for the opportunity to comment on the SFC consultation paper dated May 2011. Our comments focus on the proposals with regard to: (1) who must report; (2) reporting thresholds; and (3) offence provisions.

1. Who must report

With regard to who will be responsible for reporting their short positions, we broadly support the SFC's approach and note its genuine attempt to contain the burden of the new rules in this respect.

Nonetheless, we suggest that some refinements are required. As currently drafted, the rules impose a reporting requirement on every joint beneficial owner of jointly owned short positions (for example, on every partner of a general partnership, and each limited partner and the general partner of a limited partnership). This would lead to duplicate reports, which would complicate the analysis of the data.

We suggest an additional subsection in section 3 of the rules, to the effect that where a position in specified shares is jointly held, a joint owner is exempted from reporting obligations if proper reporting is done by one of the other joint owners. This approach would enable, for instance, disclosure by the general partner of the short positions of a limited partnership (each limited and general partner of which has an undivided share in the short positions). This would be consistent with the SFC's view as to how the interests of a limited partnership should be reported under Part XV of the Securities and Futures Ordinance (SFO).

Particularly because, unlike under Part XV, the new rules will involve anonymous public disclosure on an aggregate basis, it is important to ensure accuracy of the underlying data and to avoid duplication. We acknowledge that, even when a joint owner is exempted if proper reporting is done by one of the other joint owners, a risk of duplication would remain (as more than one of the joint owners might nonetheless report), but this may be preferable to endeavouring to devise and enforce a rule whereby: (a) one (and only one) of the joint owners is designated as having the reporting obligation; or (b) duplicative reports could be identified as such to avoid double counting. Any such rule would introduce significant complications.

With respect to reporting by a trustee, we refer to the following wording in draft rule 3(3)(b): "the position in specified shares attributable to each such trust is to be treated separately and not aggregated". We suggest this should be replaced with: "the position in specified shares attributable to each trust of which the person is a trustee is to be treated separately and not aggregated with other positions".

On another drafting point, for greater clarity we recommend the following addition to section 2 (interpretation): "'short selling order' has the meaning given by section 1 of Part 1 of Schedule 1 to the Ordinance".

2. Reporting thresholds

We note that the proposed reporting thresholds of 0.02% and HK$30 million were not canvassed in the consultation paper of 31 July 2009. Accordingly we trust that the SFC will take the opportunity to re-evaluate whether the proposed thresholds are appropriate, in light of any feedback the SFC may receive during the consultation process.

Our view is that the 0.02% threshold is too low and a dollar-value threshold is unnecessary. As submitted previously, we do not think there is anything exceptional about circumstances in Hong Kong to warrant thresholds that are radically lower than in most other major jurisdictions. We submit that a threshold should be set at a level that will enable the SFC and the market to track significant short position levels – it should not be set with an intention of receiving a certain volume of information.

The SFC refers to the need to obtain "meaningful" information, but actually appears to be going to set the thresholds at a certain level whether the information produced is significant in its import or not. This approach seems misconceived and is likely to tarnish the reputation of Hong Kong as a sensitively regulated place. We raise this issue again as we are aware of strong feelings in the investment community about it. It is important to set the threshold at a level that balances the needs of the authorities to have material information, with the need to avoid pointless compliance burdens. We suggest the SFC should be content if the threshold chosen does not, in normal times, necessarily produce a mass of information. This would not necessarily mean that the threshold is wrong, but that short selling in Hong Kong is, in normal times, less of an issue than in some overseas jurisdictions.

In the absence of any data in the consultation paper about the relative volume of physical versus derivative short positions, we do not think the exclusion of derivatives can warrant a radically lower threshold than in most other jurisdictions. Nonetheless, we support the exclusion of derivatives from this new regime, in order to control the compliance burden.

We note the contention that, unlike in Hong Kong, an objective of short position reporting regimes in some other jurisdictions is to discourage short selling, and that this would be achieved by public disclosure of a person's short positions in certain circumstances. For example, under European Union proposals, public disclosure of a person's short positions will be required at 0.5%. However, private disclosure will be required at 0.2%. Discouraging short selling by public disclosure cannot therefore be the intention of the 0.2% threshold. Rather, it must be the intention that data will be elicited at this level for the purpose of enhancing short position transparency.

As mentioned previously, we support the SFC being empowered to adjust the threshold level in contingency situations. As suggested in the SFC's July 2009 consultation paper (at paragraph 26(d)(ii)): "the law will need to set out the circumstances in which there is a contingency situation as well as the manner in which the Commission's determination[s] ... are communicated to the public".

Sufficient notice to enable market participants to comply with such adjustment would be required, and the power should be subject to a minimum possible threshold. A power to lower the thresholds would permit less onerous thresholds to be imposed in the first place, only to be lowered if they should prove inadequate in abnormal market circumstances.

3. Offence provisions

We wish to emphasise the potentially grave consequences of the proposed criminal offence provisions – including, for convicted individuals and institutions, regulatory consequences in jurisdictions worldwide and loss of reputation and business. From a market behaviour perspective, potential consequences include a shift in activity from physical shorting through stock borrowing, towards use of derivatives, which may raise market costs and inefficiencies.

Accordingly, we recommend that the SFC carefully consider whether the regime could be enforced through civil penalty provisions, including against persons who are not licensed or based in Hong Kong, and whether this would be more appropriate.

If it remains the SFC's view that criminal penalties are necessary, it should ensure that no absolute liability offence is created. The imposition of absolute liability may only be justifiable if it would serve some useful purpose (see *Hin Lin Yee v HKSAR* [2010] per Ribeiro PJ). It is not apparent what purpose will be achieved in convicting a person who breaches the new short position reporting rules despite exercising reasonable diligence in the monitoring and reporting of his short positions or in the selection and monitoring of a party to whom he delegates the duty.

Accordingly we strongly recommend that, as under Part XV, no offence should be committed if a person is not aware of his reportable short position (the exemption should be coupled with an anti-avoidance provision similar to SFO section 321 (notification by agents)), or otherwise has a "reasonable excuse" for failing to disclose it. This would be consistent with other offence provisions in the SFO, and in the Securities and Futures (Offences and Penalties) Regulation. Further, we recommend that the SFC should state its policy with respect to enforcement of the new rules, for example by adapting its existing enforcement policy guidelines for SFO Part XV offences. Although the new regime and Part XV will unfortunately be inconsistent in many respects, such an approach would at least show some endeavour, in terms of enforcement policy, to achieve a similar balance to that struck in Part XV.

Deacons

Attachment B

[19 March 2010]

DEACONS' SUBMISSION TO THE SFC ON ITS PROPOSALS FOR DISCLOSURE OF SHORT POSITIONS IN HONG KONG LISTED SHARES

This paper contains submissions in relation to the SFC's proposals for expanded disclosure requirements for short positions in Hong Kong listed shares, as contained in its Consultation Conclusions of 2 March 2010.

Generally, the Consultation Conclusions appear to have reached a sensible balance of conflicting requirements, and a lot of market comment has been taken on board, although the proposed thresholds are highly controversial, as discussed below. However, looking at the wider picture, it is worth noting that the US and Singapore have since abandoned such requirements, and France has suspended its regime pending the publication of proposals by the Committee of European Securities Regulators (**CESR**), of which more below.

1. Comments on the reporting threshold

The applicable threshold is the ***lower*** of:

- 0.02% of the relevant company's issued share capital, and
- a value of HK$30 million.

This double threshold:

- is much lower, in percentage of issued capital terms, than the thresholds applicable or mooted elsewhere (in those other significant jurisdictions which are continuing with this line of regulation), which range from 0.25% to 1%, and
- includes a second "value" element which was not referred to in the Consultation Paper and appears to be excessively low.

This threshold is controversial and was heavily criticised in a cogent article on www.webb-site.com (see www.webb-site.com/articles/soldshort). It is believed that many smaller investment managers, whose interests are not currently such as to make existing disclosure rules applicable to them, will be likely to fall within these requirements if these thresholds are adopted, with a consequent disproportionately heavy compliance burden.

SFC research has suggested that "based on turnover in 2007, the short selling/turnover ratio is much lower than in London and New York", and "the short exposure/market capitalisation ratio in Hong Kong in much lower than in New York". Further, based on 320 Hong Kong listed companies studied in February 2009, there would have been no disclosable short positions at the 0.5% of issued share capital ratio being proposed in the UK, and 36% of those 320 companies had a stock loan to market capitalisation ratio of less than the figure of 0.25% being widely mooted elsewhere.

However, although it appears that short selling may not be such a big issue, relatively, in Hong Kong as it is elsewhere, and although the fact that there may

be no disclosable short positions at all in some stocks at the 0.25% level is by no means necessarily a bad thing, the SFC has dropped the threshold dramatically, many observers believe irrespective of whether the extra information that may thereby be produced is meaningful or helpful, and ignoring the consequent increased compliance burden.

The SFC states that it wants to avoid "failing to capture substantial positions and therefore defeating the whole purpose of the exercise", but we believe that this misses the points that (a) a level of 0.25% is widely seen as an appropriate test of what is "substantial" in this context, and the fact of setting a lower threshold does not mean that that lower threshold has somehow become a valid measure of what is "substantial" in this context, and (b) if not much information is produced at that generally accepted 0.25% threshold, that is not proof of failure of the system, but that there is less of an issue in Hong Kong than had been thought (and the system would produce more information in future if short selling volumes rise). If anything, a threshold that produces some disclosures in respect of some stocks, but not a welter of it in respect of all stocks, appears to be at a suitable level.

We believe that it is important to have close regard to international comparisons in this context. We set out in the Appendix our understanding of the position in various relevant overseas jurisdictions. Note that the international position has, inevitably with the passing of time, developed significantly from that as described in the Consultation and Conclusion Papers. In summary:

- The US and Singapore have abandoned such requirements, and France has suspended its regime pending the publication of proposals by CESR, of which more below.
- The UK is proposing a threshold of 0.5% for disclosure of net positions, including under derivatives.
- Japan has a threshold of 0.25% for what appears to be single position (rather than aggregated position) disclosure.
- It is worth giving particular note in this context to the proposed pan-European regime for short position disclosure published by CESR in March 2010, as this represents a ***form of multi-national consensus***. It provides for a private disclosure threshold of 0.2% (and public disclosure at 0.5%). It differs from Hong Kong in including exposures through derivatives (which would militate toward a greater amount of information being produced at this threshold than would be in Hong Kong), ***but*** provides for disclosure of ***net positions,*** which would ***reduce*** the level of information produced. And, although things have perhaps moved on since then, the IOSCO final report of June 2009 into the regulation of short selling referred to a disclosure threshold of 0.25% adopted in various temporary measures: it contemplated that different jurisdictions could need to consider different factors in relation to the thresholds adopted, and that there were arguments for and against including derivative positions and reporting positions on a gross or net basis, *but referred to the need to avoid over-burdensome regulation.*

The SFC proposals are therefore on their face much more onerous than any overseas equivalent. Evidence is needed that Hong Kong's circumstances are so

exceptional as to justify a much lower threshold than is going to be applied internationally. We do not think that this evidence has been produced.

The SFC argues that, as derivatives are not being included in the Hong Kong regime, its reporting threshold should be lower than under other regimes, under which derivative positions are proposed to be included. This is a relevant point, but is balanced, we believe, by the fact that those regimes that include derivative positions will also require disclosure on a ***net*** basis, which would reduce the level of disclosable positions as compared to the gross reporting to be adopted in Hong Kong. In other words, the effect of including derivatives elsewhere will be offset at least in part by netting off, so it does not appear to be appropriate to use the "derivative difference" as a justification for a significantly lower Hong Kong threshold.

The second, HK$30 million, element of the threshold seems to be arbitrary and inappropriate, and much too low. It does not appear to have international equivalents (other than under temporary US emergency requirements). See again the Webb-site article for cogent criticism. As Webb-site says, it will only apply as the applicable leg of the threshold to the very biggest stocks, and, for the biggest of those, is far too low. For example, HK$30m is 0.002% of China Mobile's market capitalisation. Such a small percentage cannot be relevant for disclosure. We recommend that the second leg should be removed, or set much higher. We favour the former, as that will reduce the compliance burden significantly. If a "value" threshold is to be retained, it should be the ***higher*** of the percentage test and the value test (which should be set at more than HK$30 million), so that smaller-value percentages of smaller-cap companies do not require disclosure until they reach the value threshold.

In any event, the SFC will have power to change the requirements, including lowering the thresholds, so it can afford to start with higher thresholds, and lower them if it deems necessary in particular circumstances.

2. <u>Complexity: other possible approaches</u>

The proposals are to be implemented in new subsidiary legislation.

Having two parallel, inconsistent regimes for the disclosure of short positions is messy and obviously undesirable in principle. We urge the SFC to minimise duplication and inconsistency by using the same concepts and definitions as are already in Part XV, to the extent practicable. This will help market users, most of whom are already familiar with how Part XV works, and will already have monitoring and disclosure systems and procedures that are based on its framework and definitions.

A simple alternative way forward could be to amend Part XV so that ***all*** short positions are disclosable once they are at or over the 1% threshold already in Part XV, irrespective of the size of the "long" position held. This would require minimal changes to the existing regime, which participants already know and have systems to comply with, so could be implemented relatively quickly (except for any Legco logjam issues). As Part XV includes derivative interests, this would give wider and more complete disclosures once over the 1% threshold - and would help bridge the gap between the level of the "new" regime's proposed threshold and the 1% level in an amended Part XV.

If the 1% threshold in Part XV is seen as too high, that could be reduced to (say) 0.5% (or even 0.25%, although this should not be necessary, given that derivatives would be included in this regime), with equivalent incremental thresholds. This would be more complicated drafting-wise, but would still result in a much simpler overall regime than having two separate, parallel and inconsistent disclosure structures for short positions.

Appendix - summary of current international position

ANALYSIS OF SHORT POSITION DISCLOSURE IN CERTAIN JURISDICTIONS

Note: stated in the order mentioned in SFC Consultation Conclusions

Country/ Jurisdiction	Status of Requirements	Threshold	Derivatives included?	Gross or net?	Notes
UK	"Short Selling: Feedback on DP09/1" (FSA Feedback Statement 09/4; October 2009) at 3.14.	0.5%	Yes	Net	"Net basis" means long positions can be offset against short positions (and it appears that long positions in shares themselves as well as through derivatives should be offset). (see "Short Selling"; FSA Discussion Paper 09/1; February 2009 at 5.36)
Singapore	Abandoned. "Response to feedback received from proposed transparency measures in relation to short selling" (Singapore Exchange; undated). At page 5-6, it is stated that:- *"After consideration of responses from the public consultation, SGX has decided that it will not, at present, adopt the requirement to report substantial short positions for the following reasons:* *(i) the costs of implementing such a measure is not commensurate with the benefits that*	---	---	---	

	would be derived; and *(ii) and the aim of increasing transparency is already served by implementation of marking of short selling orders.* *SGX will continue to monitor the effectiveness and relevance of measures to increase transparency of short selling."*				
France	Expired end of January 2010. Awaiting outcome of CESR.	---	---	---	
USA	Abandoned "SEC Takes Steps to Curtail Abusive Short Sales and Increase Market Transparency" (SEC Press Release 2009-172; 27 July 2009). At page 3, it is stated that instead of renewing the rule, the Commission and its staff, together with SROs, are working to substantially increase the public availability of short sale-related information through a series of other actions including (1) daily publication of short sale volume information; (2) disclosure of short sale transaction information and (3) twice monthly disclosure of fails data.	---	---	---	
Japan	"FSA extends temporary measures regarding restrictions on short selling and purchase of own stocks by listed	0.25%	---	"A short position over 0.25%"	On the face of the announcement, have to report single positions of over 0.25%. The regulations are in Japanese and we have not

	companies" (FSA announcement; 22 January 2010).				ascertained whether derivatives are included and whether reporting is in single position or aggregated, or gross or net.
CESR	"Model for a Pan-European Short Selling Disclosure Regime" (CESR Report; March 2010).	0.2% private 0.5% public	Yes	Net	"Net" means "long positions could be offset against short positions". Unclear whether "long position" includes actual holding of shares, but probably does.