



RiskMetrics Group

The Long and Short of It

Improving Short Selling Disclosure in Hong Kong SAR

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Caught Short? A Summary of Recent Short Selling Measures

We began work on this paper in June 2008, at a time when the markets were heading south, and short-selling looked like a side-show to the main event of the credit-crunch. We thought that the paper would stimulate debate on short selling. We had no idea that short selling would soon take centre-stage on the world's markets. In the space of just a few weeks, short selling was blamed for the decline of several banking institutions, and has been the subject of a number of 'emergency' measures aimed at curbing the practice for a limited time scale.

We have refrained from a complete re-edit of this paper, given that these measures are, by their nature, impermanent. Existing rules and regulations remain in place, albeit with new measures imposed on top of them. Instead, we document in this foreword some of the temporary measures that have been chosen by regulators to inhibit short-selling around the globe.

- **United Kingdom.** In June 2008 the FSA required short sellers to disclose net short positions of more than 0.25 percent in securities subject to a rights issue. The next action occurred in mid-September, with the FSA mandating disclosure of all net short positions in financial stocks greater than 0.25 percent. At the same time, the FSA prohibited any creation of or active increase in a net short position in a group of over thirty financial companies until January 16th 2009.
- **United States.** The SEC enacted a temporary restriction on naked short selling of nineteen financial stocks in July 2008, a ban that stayed in place until mid-August. Acting in concert with the FSA, the SEC banned short selling of 799 financial stocks (a ban that will expire Wednesday, October 8), and added to that list in subsequent days. The SEC also banned all naked short selling until the same date, and required institutional investment managers managing assets over \$100 million to make Form SH disclosures, which would include disclosures on the number and value of securities sold short for each equity security (except for short sales in options), as well as both the opening and closing of short positions.¹
- **Australia.** The Australian Securities and Investment Commission (ASIC) moved to first ban naked short selling and tighten disclosure rules on covered short selling in mid-September, and then within a matter of days widened the ban to all short selling. Several subsequent clarifications have exempted dual-listed stocks, market makers, index arbitragers and stock lending. The ban will remain in place for 30 days, at which point ASIC will reassess its efficacy. Legislation has been scheduled to improve the transparency of covered short selling.
- **Taiwan.** Taiwan moved to restrict short selling in mid-September. The Financial Supervisory Commission placed a ban on the short selling of the constituents of three key indices (the Taiwan 50, the Taiwan mid-cap 100 and the Taiwan Technology Index) if the share prices of those companies trade at below the previous day's close. The ban will be reviewed by the FSC in October.
- **Singapore.** The SGX has moved to disclose all failed trades subject to a buy-in. Specifically, the SGX will make public the list of securities subject to a buy-in - and the volume sought - at 11am every day (buy-ins occur at 11.30). The following day the exchange will publish the details of the previous day's buy-ins, including the dollar value attached. The SGX also increased the penalties for failed trades. The measures were introduced in late September, and will be reviewed after one month.
- **Hong Kong.** Hong Kong, with a ban on naked short selling already in place, has moved to double the penalty imposed by imposed by the Hong Kong Securities Clearing Co, Ltd on trades that fail to settle.

¹ Short positions of less than 0.25 percent *and* that have a fair market value of less than \$1 million do not have to be reported

- Germany. BaFin (the German market regulator) moved to ban all short selling of eleven financial stocks in mid-September, with the ban remaining in place until the end of the year.
- France. The Autorité des Marchés Financiers (AMF) in France placed a temporary prohibition on short selling of equity securities issued by credit institutions, investment companies, and insurance companies listed the Euronext, Matif, or Monep exchanges. The ban will stay in place until 19th December.
- Netherlands. Autoriteit Financiële Markten (AFM) in the Netherlands followed suit in mid-September, banning naked short selling of financial institutions for a three month period.
- China. The position of short selling in the PRC market remains unclear due to the lack of regulations or market rules specifically dealing with short selling (such as disclosure requirements) and consequently the lack of transparency about short selling. However, given the removal of restrictions on securities loans and intra-day trading by the 2005 securities law reforms and the view (within and outside China) that speculative trading is widespread on the Shenzhen and Shanghai stock markets, it is possible that there continues to be a very high level of undetected short selling in China.
- And the rest... Along with those countries discussed above, Greece, Spain, Norway, Russia, Luxembourg, the Republic of Ireland, Canada, Belgium, Portugal, and Switzerland have all enacted some form of temporary response to short selling.

Regulators have taken a wide range of action - some have banned all short selling, others have restricted bans to only naked short selling, and/or only naked short selling of a certain sector. What this snapshot doesn't capture is the ad hoc and piecemeal approach to these interim measures in many markets. Many regulators have moved to enact follow-on legislation, concerned that restrictions on short selling in other markets could impact their own.

However, these temporary measures ought not divert our attention away from the larger issues associated with the disclosure and regulation of short selling. Investors need to look carefully at how the regulation on short selling should be shaped in the future. Issues of regulation and disclosure should be at the forefront of their minds. This paper focuses on improvements to the short selling regime in Hong Kong - a market that has a well-established short selling framework. However, we would argue that these issues are pertinent to markets around the world.

We originally set out to stimulate debate on short selling. In the past month or so there has been nothing but. However, we would argue that the global fixation on restricting short selling has been the *wrong* debate. The debate we should focus on is how to optimize transparency and disclosure in short selling. We believe investors are better served by the creation of a transparent and fully functioning short selling framework that allows for market efficiency, but (rightfully) punishes market manipulation. We hope that this paper will serve to stimulate that debate globally.

Introduction

Short sellers have arguably replaced sovereign wealth funds, who in turn replaced private equity, as the cause célèbre amongst business commentators. Developments in the United Kingdom and United States this year have once again put short sellers in focus. Within Asia, short selling has long attracted attention, having leapt to prominence during the Asian Financial Crisis. The events of 1997 brought strong criticism of short-sellers from governments and regulators in the region, some of whom temporarily banned short selling and put in place stiff penalties.² Whilst the Asian tiger economies recovered from the 1997 crisis, the recent downturn in markets has led to more anxiety about short selling.

However, despite criticisms of short selling, the real issue is not the validity of short selling itself, but the level of disclosure that is required in each market. How much stock is being shorted at any one time? Who is shorting the stock? Could that shorting activity be having a detrimental impact on a corporate action, such as a rights issue or takeover offer? Answering these questions would give investors, stock lenders, and companies themselves a better insight into the dynamics of supply and demand for a particular stock. As such, it is timely to review the existing regulatory framework around short selling in Hong Kong.

This paper focuses on short selling in Hong Kong, and specifically on the levels of disclosure currently in place. It contrasts such disclosure with that of other markets, and suggests improvements for regulatory oversight in the territory. Several interlinking themes play into this research: *first*) the emergence of alternative assets in Hong Kong and Asia as mainstream asset classes; *second*) the rising awareness amongst global investors of the impact of short selling on equities markets, and *third*) the recent downturn in markets that has put short sellers into focus.

² The Economist, "Short selling: Nasty, brutish and short", Jun 19th 2008. Available at: http://www.economist.com/finance/displaystory.cfm?story_id=11591349

Key Findings

This paper looks at short selling disclosures in Hong Kong, and compares them to other markets. On the whole, Hong Kong compares positively. Specifically, we find that:

- Short selling rules and regulations in Hong Kong are robust... Hong Kong prohibits naked short selling, requires documented evidence of ownership (or of an agreement to transfer ownership) at the time of the sale, and also requires record keeping and information disclosure to the exchange.
- ...although requirements for short position disclosures are inconsistent. The SFO currently requires short positions of greater than 1 percent to be disclosed when the interested party also holds a disclosable long position in that stock (over 5 percent). However, where there is no disclosable long position the short position need not be disclosed. This creates a two-speed disclosure regime, and should be addressed by the SFC.
- Global disclosure requirements are widely divergent. Disclosure requirements in some regimes are far stricter and rigorous than others.
- Details of stock lending pool volumes, and aggregate stock on loan per security, should be disclosed to the market. Hong Kong lacks such disclosure - an overview of aggregate stock loan activity would provide more price signaling to the market.
- Stock lending needs to be closely monitored. Stock lending disclosure would act as a counterbalance to non-compliance with existing disclosures on short selling and to better understand any threats to settlement risk that the practice may involve.
- Hong Kong needs to work closely with China on short selling legislation. The unique relationship between the mainland and Hong Kong necessitates close cooperation with regard to the introduction of short selling into China. Disclosure requirements should be coherent and consistent, and there should be a well understood approach to legislation in the market. Allowing divergence of legislation and disclosure runs the risk of significant market manipulation and financial contagion.
- Short selling is an issue that cannot be neglected. Regulators in Hong Kong should seek to actively solicit market participants' views on current regulation and levels of short selling in the territory. The current market environment lends itself to short selling, and regulators should take heed of circumstances in the UK and US that have drawn attention to the potential for pernicious short selling tactics.

1. What is Short Selling?

"He who sells what isn't his'n, must buy it back or go to pris'n."

Daniel Drew, 19th-century speculator

Perhaps one of the most contentious strategies employed by a fund manager, short selling is both mistrusted and misunderstood in equal quantities around the world. This section provides an overview of the motivations for, and dynamics and mechanics of short selling, whilst also highlighting key areas where short selling affects those market participants who neither short, nor lend shares.

An Overview of Short Selling

Short selling involves the sale of an asset not currently owned by an investor (naked short selling), or temporarily owned by the investor (covered short selling), with the aim of repurchasing that asset at a future date for a lower price. In essence, short selling sees a fund manager profiting from a decrease in share prices.

The short selling of an asset short plays a critical role in aiding of price discovery and providing liquidity in the market place, and as such is central to a well functioning, efficient capital market. Edward Miller (1977), in a widely cited paper on short selling and price efficiency, noted that "...[i]n a market with little or no short selling the demand for a particular security will come from the minority who hold the most optimistic expectations about it".³ Similarly, Pedro Saffi and Kari Sigurdsson found "strong evidence to support the hypotheses...that short-sale constraints are associated with less price efficiency", and that "[r]elaxing shorting restrictions is associated with an increase in the speed by which information is incorporated into prices".⁴ In relation to Hong Kong, Chang and Yu of the University of Hong Kong found that "...short-sales constraints tend to prevent some negative information from being impounded into prices and that such constraints result in stock overvaluation".⁵ Long managers are able to better understand the prices that assets are valued at, and by allowing fund managers to capture gains on the downside, fund managers are able to generate returns in a declining market. Critics of short selling state that short sellers add to downward pressure leading to excessive negative momentum, resulting in prices that overshoot fair value. A counter to that argument often heard is that short sellers themselves create demand for a stock, given that short positions have to be closed out through an on market acquisition of the asset borrowed.

It is useful to overview the two distinct forms of short selling employed by market participants - naked and covered short selling.

³ Miller, E.M. (1977), "Risk, Uncertainty, and Divergence of Opinion", *Journal of Finance*, vol. 32, issue 4, pages 1151-68

⁴ Saffi, Pedro A.C. and Sigurdsson, Kari, "Price Efficiency and Short-Selling" (December 10, 2007), *AFA 2008 New Orleans Meetings Paper*, Available at SSRN: <http://ssrn.com/abstract=949027>

⁵ Chang, Eric C. and Yu, Yinghui, "Short-Sales Constraints and Price Discovery: Evidence from the Hong Kong Market" (March 15, 2004), *EFA 2004 Maastricht Meetings Paper No. 3641*. Available at SSRN: <http://ssrn.com/abstract=565330>

Covered Short Selling

Covered short selling involves a fund manager borrowing stock in order to sell those shares.⁶

Covered and Naked Short Selling Explained

Two types of short selling exist

- Covered short selling sees investors borrow shares to sell short, with the hope of buying back the stock at a lower price in order to return to the lender
- Naked short selling, however, does not involve borrowing of shares - investors place sale orders and hope to purchase shares to settle at the settlement date

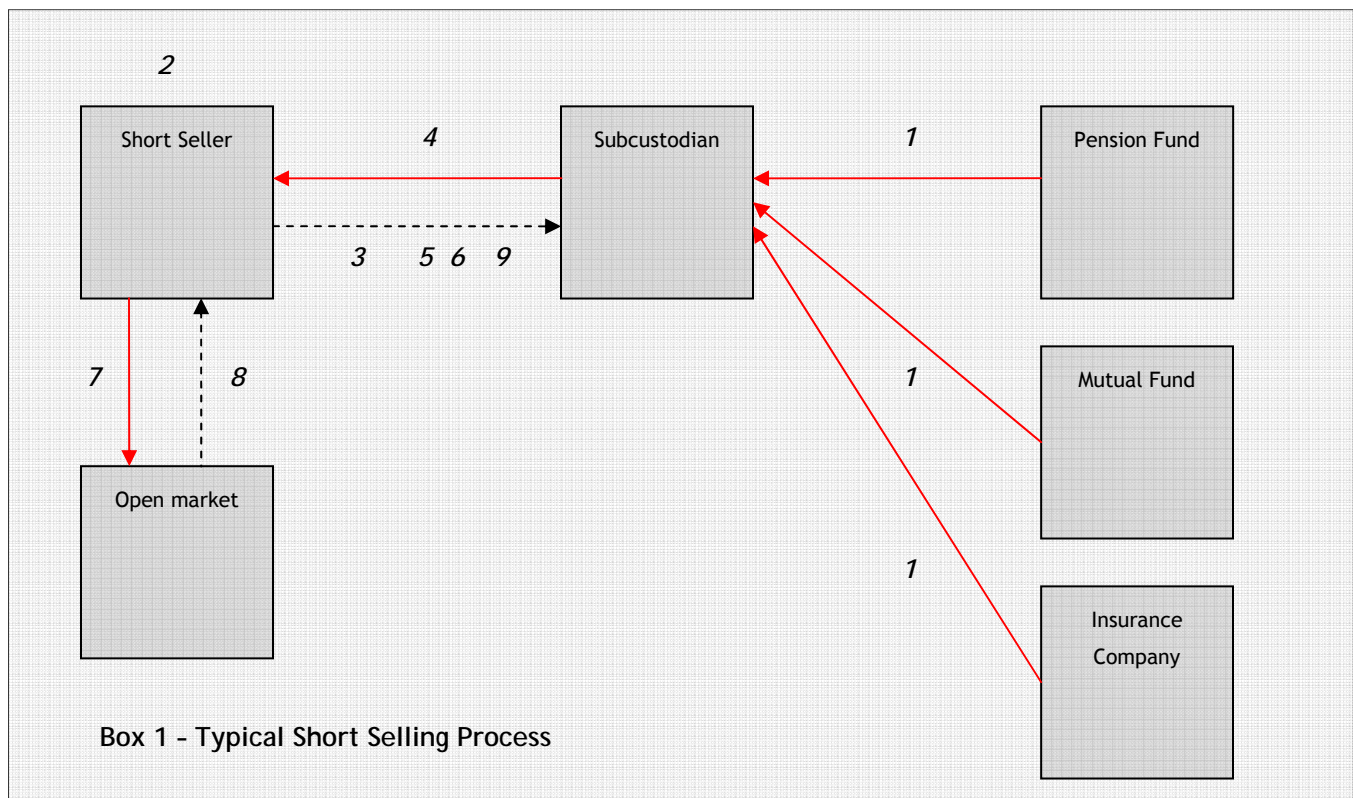
Why would a fund manager do this? In theory, a fund manager can sell shares that he/she has borrowed, wait for a period of time for the share price to go down, and then repurchase stock on the open market at the new, lower price and lock in the profit. For example (and setting aside any transaction and stock lending fees that might be incurred), a fund manager may have conducted fundamental analysis on a company and found it to be overvalued. The fund manager might then borrow 1,000 shares from a stock lending institution and sell them at HK\$10 per share, banking HK\$10,000. If the fund manager believes that

fair value for the stock is actually HK\$8, the fund manager could wait for the price to drop to that level, buy back 1,000 shares and return the shares to the lending institution, banking a HK\$2,000 profit. With no shorting facility, that fund manager might be missing out on returns to be derived from the downside that comes from an overvalued stock.⁷ This strategy would involve the transfer of shares from a stock lending entity to a fund manager wishing to short the shares, through the following (simplified) process (illustrated in Box 1):

1. Long term shareholders (in this example, a pension fund, a mutual fund, and an insurance company) deposit shares with an agent or principal lender (often a custodian bank) (1)
2. A borrower decides to short the shares of ListCo. Ltd., a company approved for shorting by the relevant exchange (where applicable)
3. The borrowing party approaches either a specific lender (e.g. a large institutional investor), or (in this example) a lending agent (i.e. a custodian bank that lends from a pool of shares] available to loan owned by its clients). A contract (including loan fee and term is agreed) (2)
4. The Subcustodian transfers the shares to the short seller (3)
5. Borrower pays the borrowing fee to lender, and deposits collateral (4)
6. Where a dividend is paid, the short seller manufactures synthetic dividends, and remits to the Lending agent (6)
7. Borrower sells borrowed shares on the open market for HK\$10.00 (5)
8. At T+x, borrower buys shares of ListCo. Ltd. on the open market for \$8.00 (7)
9. T+x, borrower returns share to lender (8)

⁶ Opinion differs on the technicality of whether the fund manager would take delivery of the shares before or after the sale order is placed, but the broad notion of selling a borrowed asset remains constant.

⁷ It is perhaps prudent to highlight the inverse gain/loss possibilities associated with short selling. When a fund manager goes long on a share the downside is limited, and upside unlimited; however, when a fund manager goes short on a share the upside is limited, and the downside is unlimited (share prices can increase infinitely before a fund manager closes out a position, whereas in a long position the hard stop is \$0, i.e. bankruptcy).



How is Stock Borrowed?

Stock lending is a global industry, involving almost all major institutional investors, generating annual gross revenues estimated to exceed USD20 billion.⁸ Stock lending involves temporarily transferring the ownership rights of a security to a third party with a contractual agreement ensuring that the borrower delivers the equivalent stock at a pre-determined date in the future.⁹ Indeed, stock lending is actually a misnomer; stock isn't actually borrowed - the ownership rights of those shares are transferred to the receiving party, with an agreement for the retransfer of those ownership rights at a specific date. The receiving party is then free to either vote, sell, or relend, those shares received.¹⁰ All economic benefits that would ordinarily be derived from the ownership of those shares (excluding price movements in the stock and voting entitlements) are manufactured by the borrowing party and accrue to the lender: for example, where a dividend of HK\$1.00 is paid, the borrowing party would receive that dividend, and would make a synthetic dividend payment to the lender to the equivalent value.

⁸ Putting Australian Securities Lending in Context - An independent perspective on recent developments in the Australian Securities Lending Market - a paper by Spitalfields Advisors, March 2008. Available at: http://www.spitalfieldsadvisors.com/SL_Yearbook.aspx

⁹ In many markets, stock lending is exempted from stamp duty that might arise as a result of the transfer of ownership - this is true of Hong Kong, where stock loans have been exempt from stamp duty since September 1994.

¹⁰ A further problem is that of 'phantom shares' in the context of voting. How would this happen? The short seller would sell shares to a counterparty, whose broker would record those shares acquired as a long position. In theory, the short seller would have also acquired full ownership rights as part of the stock lending arrangement. These rights would be transferred to whichever party acquires the shares sold by the short seller. However, the initial owner of the shares lent out might not know that those shares had been lent, and that as such their ownership claims were transferred (e.g. if the shares were lent by a sub-custodian). Therefore, and for as long as the short is open, (i.e. not closed out through the purchasing of shares on-market to settle the loan), if the acquiring party and the lending party were to both receive proxy forms relating to those shares and attempt to vote, they would potentially disrupt the proxy process by creating more proxy votes than are actually in existence.

A typical stock lending transaction would be structured as follows: upon making a borrow request, the receiving party will a) agree to return the borrowed securities, b) collateralize the loan with a deposit of acceptable securities (e.g. securities, security-linked instruments, or cash) either equal or greater value than the loaned securities, c) pay a fee for borrowing the stock, and d) remit to the lender of the securities any dividends that are received by the borrowing party during the term of the loan.¹¹ Whereas the fees for borrowing UK FTSE 100 equities (with the deposit of securities as collateral) are said to be in the range of 10 - 50 basis points¹², and the fees for borrowing widely held stocks in the US are said to be 25 basis points,¹³ the fees for borrowing HSI securities are said to be around 20 - 50 bps.

When the collateral constitutes cash, the lender might agree to pay the borrower a 'rebate rate' (the structuring of loan agreements vary from deal to deal, with tax issues a key consideration). This rebate rate is, essentially, the portion of interest that the lender pays the borrower for use of the funds whilst they are held as collateral. For example, the lender could deposit collateral cash received from the borrower in a cash deposit account, and accrue interest at a market rate. This interest is netted from the loan fee; for example, if the cash deposit fee on the open market was 5 percent, and the loan fee was 1.5 percent, then the rebate rate payable to the borrower would be 3.5 percent.¹⁴ Like the loan itself, securities or cash posted as deposit with the lender involve the transfer of ownership rights to the lender. In the case of cash, the borrower has no rights over the cash during the term of the loan (aside from the rebate rate); in the case of securities, the lender assumes ownership of those securities posted as collateral and as such assumes dividend and voting rights.

Most stock lending is conducted through market intermediaries, such as custodian banks or broker-dealers, specialist lending intermediaries, or prime-brokers, who are often able to pool together securities made available for loan by clients, and hence offer both scale and liquidity. This pooling also enables them to better judge demand and supply for a stock (and hence obtain a better price for the loan). The benefits accrued from stock lending (i.e. the lending fees) flow to fund managers through lower custody charges by sub custodian banks. For example, where a custodian might charge one fee for a custody agreement with a no-loan provision, a lendable custody portfolio might incur much lower (or zero) fees.

Stock on loan cannot be voted by the lender. Where a lender wishes to vote stock at a meeting, and is aware that the stock they wish to vote has been lent out, the stock lender must recall the stock on loan prior to the record date for the meeting concerned.¹⁵ This right to recall stock out on loan is ordinarily contained within the contract agreed between lenders and borrowers.¹⁶ Given the notice period required to stock recalls,

¹¹ Fees for stock lending are usually determined after considering a) demand and supply for the stock, b) the nature of the collateral to be deposited with the lending institution, c) the size of the dividend to be manufactured (and hence its impact on tax considerations for the lending party), and d) the length of the loan, and the degree of certainty over the length of the loan.

¹² Faulkner, M.C. (2007) *An Introduction to Securities Lending* (Fourth Edition), Spitalfields Advisors. Available at: http://www.spitalfieldsadvisors.com/pdfs/An_Introduction_to_Securities_Lending_4th_Ed.pdf

¹³ D'Avolio, Gene M., (2002), *The Market for Borrowing Stock* (February 11, 2002). Available at SSRN: <http://ssrn.com/abstract=305479>

¹⁴ In the US, the rebate rate varies in many markets depending on the supply of shares vis-à-vis demand. Where supply and demand are approximately similar, the rebate rate will approximate the overnight Fed funds rate. Where demand is greater than supply, lending fees rise and the rebate rate will fall to below the overnight Fed funds rate. Such stocks are said to be "on special". In some cases, this rebate rate can become a negative rate, where demand is sufficiently high.

¹⁵ The implication here is that with the intermediation of stock lending both within the outside of the firm, many front office participants (e.g. fund managers and corporate governance analysts) might not be aware that either the back office or a sub-custodian bank has lent stock out. In these instances, the fund manager might attempt to vote stock only to have such votes rejected by the custodian bank.

¹⁶ Recall notices usually give the borrow three days to return stock subject to a recall. Where a borrower does not return stock by a specified date (usually T+3, where T is the recall date), the lender can in many cases use the collateral posted to 'by-in' stocks to complete the recall.

lenders must ensure that they are able to actively manage their voting requirements in advance of meetings record dates (in the US, 60 days), or risk missing vote deadlines.

Naked Short Selling

Distinct from covered short selling, naked short selling involves the sale of an asset neither owned nor borrowed, and with no arrangement currently in place to acquire the asset. Essentially, naked short selling sees an investor place a sale order with a broker, and then making efforts to acquire those assets before settlement date (T+3 in many cases). The issue here is that whilst covered short selling sees an investor confident of settlement given the pre-arranged agreement on the asset, the naked short investor does not have confidence on delivering the asset at T+3, and hence runs of the risk of failing to settle.¹⁷ Where the short seller is unable to locate shares to deliver to the broker, the trade is said to have failed (termed 'failure to deliver').¹⁸

The implication is that whilst covered short sales might aid in price discovery and have little risk of non-settlement, naked short selling can serve to disrupt the orderly functioning of a market.

In circumstances where a short seller does fail to secure an asset for delivery, an exchange or clearing house will in some circumstances step in and buy the asset for delivery (buy-ins), imposing penalties on the party that has failed to deliver (including daily fees, dealing fees, and an interest charge). Failure to deliver rates could potentially be taken as a proxy for naked short selling activity in a market (although there are numerous alternative reasons for a failure to settle).

¹⁷ In particular, whilst large companies widely held by investment managers would potentially have a large pool of shares available for loan or for sale, the smaller, thinly traded shares (e.g. small- to mid-cap stocks) might not and as such there is a significant risk that the short seller might not be able to locate shares to settle the trade.

¹⁸ The US SEC publishes fails-to-deliver data on its website, two months after the last settlement date of each quarter, available at: <http://www.sec.gov/foia/docs/failsdata.htm>

2. What are the Issues?

For as long as short selling has been in existence there has been debate as to its ethics. From ‘bear pools’ operating in the Amsterdam Stock Exchange in the late seventeenth century to short-selling motivated stock manipulation in the early eighteenth century on the London Stock Exchange (which resulted in the criminalizing of short selling for almost 130 years in the UK), short sellers have been part and parcel of stock markets.¹⁹ More recently, short selling has been identified as being particularly prevalent during declining markets such as those seen after the Wall Street Crash, and the Asian Financial Crisis in 1997.

Maybe the overriding concern associated with short selling is the *asymmetry* of information disclosure between and within markets, and between types of trades. There is an observable divergence of rules and disclosure requirements globally. These variations mean that investors in some markets are information disadvantaged, compared to their peers in markets that require fuller disclosure in a position.

In many cases there is a significant lack of disclosure of trading volumes involved (either stock specific or market wide). By not knowing this information, market participants are unable to correctly gauge sentiment, and companies are not aware of the actions of market participants.²⁰ For market participants, short selling contains signals and information that are useful and material. Not having that information leads to information asymmetries, and places other investors at a disadvantage. Whereas long investors are required to disclose long positions over a certain threshold, investors who are short a stock are in many cases not required to disclose their position where it represents a certain threshold of a company’s stock (for example, a hedge fund short 3 percent net of a company’s stock may not be required to report that, despite that position being a) a significant economic interest in a listed company, and b) a significant statement of sentiment). Whilst covered short selling volumes could be estimated by the volume of shares on loan (where such information is available), naked short selling cannot ordinarily be detected.²¹ This has significant implications for the marketplace. For fund managers, selling pressures and demand for stocks could be misrepresented if a significant short selling campaign is underway. Companies themselves would not have knowledge of the pressures that their shares are under. Share lenders are unable to gauge what the correct market clearing price for a loanable stock is, given that they are unable to estimate the extent of demand for the asset.

For stock lenders, better understanding the volume of short sales would allow them to price stock loans accordingly. The lack of a central stock-lending entity (stock loan transactions are conducted between the borrower and the lender point-to-point) means that there is little by way of market wide price discovery. For example, Lender A might not be aware of the lending activities of Lender B; were Lender A to know that

Issues

Variations in disclosure requirements result in an unlevel playing field

Short selling volumes are important aspects of market data, yet disclosure requirements are inconsistent globally

Investors are not getting the whole picture - some market participants may have access to data (e.g. stock lenders), others do not

Stock lenders do not know market volumes and trends, and as such pricing may be inefficient

Companies do not know volumes of short selling in many cases

¹⁹ Finnerty, John D. (2005), "Short Selling, Death Spiral Convertibles, and the Profitability of Stock Manipulation" (March). Available at SSRN: <http://ssrn.com/abstract=687282>

²⁰ It is possible, although problematic, to estimate the amount of sales daily that were conducted with borrowed stock; specifically, market participants might be able to estimate those volumes by looking at the number of shares currently on loan in a market, and the number of shares in a company currently borrowed (any increase in stock borrowed for a specific company could indicate an increase in short behavior). However, this data is not readily available in many jurisdictions.

²¹ Not all stock lending is for the purposes of short selling; tax issues, for example, also drive stock lending activities.

Lender B had lent out all of its stock, and that a recall was in place by all of Lender B's clients, Lender A could negotiate materially higher lending fees (potentially leading to a negative rebate rate).²²

Short selling also impacts the companies involved. However, company directors in many regimes do not know how much of their stock is being sold short, and for what reason. It would be useful for companies to know how much of their stock is being sold short so that they can gauge market sentiment. It would alert the company to any negative campaign to 'short and distort', and take steps accordingly.²³

Short selling that ultimately depresses the market price of shares could have a significant negative impact on corporate actions. *First*, short selling that depresses the price of a company's shares might hinder fundraising activities, by artificially depressing the price of shares relative to offer prices in a right issue; this is an issue that has recently been discussed in the UK, and has led to action by the FSA that will be discussed in a later section.²⁴ *Second*, short selling that depresses the price of a company's shares could lead to a takeover offer failing if the offer is to be financed with shares and the bidder's shares are subject to a campaign to depress their share price.²⁵

A more concerning issue is related to the provision of equity finance, utilizing stock lending agreements as security. A number of market participants provide margin lending facilities to investors, taking as collateral securities pledged under a stock lending agreement. However, these market participants also provide stock lending facilities, and may lend the stock taken as collateral. Those investors who have taken a margin loan from the market participants may be unaware of the transfer of ownership as is the case with some collateralization agreements. The risk, therefore, is that the securities posted as collateral could be lent out, and potentially not returned if the market turns, and there is a squeeze on supply. Alternatively, any financial issues at the market participant might see debtors seizing assets (including securities posted as collateral now in the name of the market participant) in order to recoup losses. This would have implications for those investors who have posted securities as collateral, leading to the collapse of the market participant. This, in turn, spreads to all involved with the collapsed market participant. Indeed, this happened in Australia and Singapore where the collapse of Opes Prime Stockbroking Ltd led to the failure of an acquisition of Jade Technologies Holdings Ltd in Singapore. Dr Anthony Soh had posted securities with Opes Prime as collateral for a margin loan, allowing him to make an offer for Jade Technologies. However, those securities were said to be subject to a Global Masters Securities Lending Agreement (and hence ownership no longer lay with Soh), and

²² Currently, fees are charged for stock loans of around 20 - 50 bps in Hong Kong. However, by understanding supply and demand better (i.e. the level of stock on loan, the level of stock being short, and hence the potential demand for stock loans) would allow for a more efficient pricing of stock lending operations.

²³ Of course, as this paper has suggested, short selling constraints have been argued to maintain upwards momentum on share prices, and do not allow for downside pressures where the asset is overvalued. A market with efficient, legal, and relatively cost-effective short selling will allow an equilibrium price to be reached much faster than one which does not. Hence, it is here that one might see a reason for aversions to any short selling. Whilst 'short and distort' techniques are correctly vilified by corporate executives, legitimate short selling would have negative impacts on stock options (allowing a market price to move downwards and hence impact on options that might be 'in the money' held by the executive). Second, where executives have significant personal wealth tied up in a firm (e.g. a shareholder/manager owning 40 to 50 percent of a firm) the incentive would be to disallow significant downside movement - either as a general wealth preservation effect, or possibly because that position is used as collateral on other investments. Downside movement might lead to either a margin call, or a sale of assets held as collateral, thus weakening control.

²⁴ On a related issue, the Association of British Insurers have proposed that *underwriters* of rights issues refrain from short selling, and possibly lending, shares of companies whose shares they are underwriting during a rights issue. See: "Rights Issues and Capital Raising - An ABI Discussion Paper". Available at: http://www.abi.org.uk/Document_Vault/Rights_Issues.pdf

²⁵ Short selling of a takeover target itself is a legitimate investment strategy. However, short selling of a takeover target could lead to market disruption when, as discussed before, acceptance levels of the bid leads to a reduction in the availability of stock to buy in order to close out a position. Rules may be developed to trigger the suspension if short selling when acceptances cross a certain threshold, for example. Another issue is the short selling of a takeover bidder - the potential exists as discussed before for fund managers to drive down the stock price of an offeror during a takeover to be financed by equity, or by a significant portion of equity. This would, in essence, reduce the value of the equity portion and hence could scupper a takeover bid. As with other strategies, attempts to deliberately manipulate the market would, of course, be tempered by rules on prohibiting market manipulation and insider trading.

the shares were taken and sold by creditors of Opes Prime (ANZ Bank and Merrill Lynch) when it collapsed in 2008.²⁶ Consequentially, Soh was unable to complete the acquisition of Jade Technologies.

An associated issue concerns the interrelationship of securities lending with on-market settlement risk. Australia experienced CHES settlement delays on 29 January, 2008, with settlement delayed by several hours as a result of one market participant (Tricom Securities) being unable to fulfill its settlement obligations following an unspecified error with an associated securities lending programme. The Reserve Bank of Australia subsequently recommended improved disclosure of stock lending volumes as a means of better understanding the interrelationship between off-market transactions (such as securities lending) and on-market settlement risk.²⁷

This example draws attention to three issues surround short selling and stock lending: *first*, a lack of transparency (Soh is said to have not know that his shares were subject to a Global Masters Securities Lending Agreement, and it was not disclosed that the acquisition of Jade Technologies was to be financed via a margin loan involving collateralized securities); *second*, financial contagion is a serious risk - the fallout of the collapse of an Australian broker led to the collapse of a Singapore takeover, and; *third* off-market transactions such as securities lending may have a relationship with on-market settlement risk that poses concerns for financial system stability.²⁸ Disclosure is an obvious solution to these problems.

Naked short selling, i.e. the selling of shares not yet owned, borrowed, or located, has in particular attracted considerable attention and, it is argued, may potentially lead to greater price distortion. In theory, the naked short seller could place a relatively large sell order with a broker without any assets to settle, with market participants possibly interpreting the large open sale orders as significant negative sentiment, thus resulting in downwards pressure on the price of the asset. The naked short seller could then acquire the asset on the open market to settle the sale. Were this to be a covered sale, the seller would have incurred the cost of borrowing the stock, as well as the process of depositing collateral with a third party, and returning dividends accrued during the loan to the lender. By lowering the cost of short selling, and removing the necessity for depositing collateral and paying stock loan fees, larger volumes of stock can be sold short, and greater momentum can be achieved, and hence can have a potentially greater distortionary effect on prices.

Another concern is that short selling can destabilize the market, adding extra volatility. Indeed, an area that has attracted attention, the so-called ‘short and distort’ strategy, sees fund managers sell an asset short, and then seek to destabilize confidence in that asset by perpetuating negative rumours with the intent of undermining sentiment. The fund managers would move share prices downwards through this strategy, manipulating prices, and would profit from such movements. Whilst this is illegal (although hard to prove), many jurisdictions have experienced ‘short and distort’ tactics. More recently, Bear Stearns has been suggested as a target for ‘short and distort’ tactics, with one senior executive pointing at such short sellers for the downfall of the bank.²⁹ Those accusing short sellers have argued that self-interested fund managers have sought to deliberately undermine confidence in a company and thus capture downside gains.

²⁶ One interesting aspect of this is that if Opes Prime was retaining ownership rights of shares posted as collateral, they would be subject to similar disclosure requirements as other substantial shareholders where appropriate. However, Opes Prime did not make such disclosures. See “Does Opes spell unconscionable?”, Crikey, 10 April, 2008. Available at: <http://www.crikey.com.au/Business/20080410-Does-Opes-spell-unconscionable.html>.

²⁷ Reserve Bank of Australia, REVIEW OF SETTLEMENT PRACTICES FOR AUSTRALIAN EQUITIES - MAY 2008. Available at: http://www.rba.gov.au/PaymentsSystem/StdClearingSettlement/RevSetPracAusEquities/trans_disclosure_sec_lend.html

²⁸ In Australia, this ambiguity over ownership rights has now been resolved in favour of the transferee of the securities (see *Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Ltd* [2008] FCA 594).

²⁹ “Bringing Down Bear Stearns”, Vanity Fair, August 2008. Available at: http://www.vanityfair.com/politics/features/2008/08/bear_stearns200808

In markets where there is a very illiquid demand for a stock (e.g. small- to mid-cap stocks, and OTC stocks), those stocks are open to manipulation by short sellers. The predominantly illiquid demand for small- to midcap stocks in many Asian markets has led to a regulated approach in some markets, where short selling is only permitted for approved mid- to large-cap stocks (e.g. Hong Kong). Circumstances where demand for stocks outstrips supply as a result of short sales being covered is called a “short squeeze”. For example, if market sentiment on a stock changes, short sellers will compete with long buyers to buy stocks. An alternate situation could be where a large pool of stock lenders recall stocks at a time of illiquidity. Separately, one buyer may ‘corner’ the market and hold the vast majority of stocks, and as such restrict supply. Finally, speculators may deliberately force a short squeeze by buying in to a stock where they see a large number of open short positions. Those open shorts would need to be covered at some point, and an increase in buying activity might force those positions to be covered.

An added complication to issues of disclosure is the rise of 130/30 funds - funds that sell short a percentage of their portfolio in order to extend their long portfolio with the proceeds. Currently, such portfolios are constructed utilizing traditional short selling techniques. However, recent developments have sent the rise of in-house originated short selling, with the long portfolio lending to the short portfolio - this kind of ‘synthetic’ stock lending and short selling would impact on regulatory oversight.³⁰

On final issue of particular relevance to Hong Kong in particular is how short selling regulation is coordinated with the mainland. Whilst recent regulatory developments have seen short selling move towards acceptance and mainstream activity, there is not yet a vibrant and established short selling industry in China. The situation now is that H shares could legitimately be sold short, but what about A shares? As with much of the recent legislative developments in China, there is significant ambiguity. There is a paucity of guidance on this, and the situation now could feasibly be that short selling is being conducted in China, with little disclosure, either to domestic regulators, or the Hong Kong regulator. Moreover, the information is disclosed on HKEx websites, but questions remain as to disclosure thresholds. If an investor holds 2.5 percent of China Telecom H shares short, and 5 percent of China Telecom A shares long, where would that investor make a disclosure? To the HKEx? To the CSRC? To both? The HKEx and SFC would contest that the disclosure would have to be made to Hong Kong at the minimum, but there is little enforcement on the mainland to aid this disclosure.

Summary

Short selling is a highly emotive and contentious strategy and provokes strong reactions from many. Information disclosure requirements and regulatory frameworks differ from market to market, and the risks associated with short selling are material. Contagion from jurisdiction to jurisdiction is a real risk, given the integrated nature of markets, and the types of lending/shorting occurring. The following section will look more closely at short selling and Hong Kong, contrasting the regulatory regime in the territory with those of other markets.

³⁰ One issue that has not yet been discussed in financial literature in great depth is the potential for intra-firm stock-lending and shorting behavior, with the intention of making short term gains. Consider, for example, a large UK pension fund. That pension fund might have a sizeable (say, 2-3 percent of market cap) index-linked position in a major UK PLC. As an index tracker, that fund would be most likely to hold that UK PLC for the foreseeable future, diminishing the impact of short-term price movements. Consider, also, that this pension fund has an absolute return fund in-house as well. Assuming that the pension fund had all 2-3 percent of its holdings on loan, and recall would induce significant upwards price pressure, as short-sellers had to acquire stock on the market to close out positions. As much literature has suggested that short selling constraints (e.g. where demand for loanable stock is greater than supply of loanable stock) leads to such movement, the in-house absolute return fund could cooperate with the stock lending division of the in-house operations team to collude to take a long position in the stock, recall all stock on loan owned by the index tracker, and sell when the price rises. Furthermore, assuming the asset is fairly priced, the absolute return fund could sell short the asset at its peak, and capture downside gains as the pension fund relents its stock. Deliberate collusion might not even be necessary - the in-house absolute return fund could hear internal noise about an impending return, and take the position autonomously. This serves to highlight the importance of internal separations of information (Chinese walls) inside such firms. The former market manipulation would be illegal, yet theoretical possible.

3. Short Selling in Hong Kong

Since its introduction in 1994, short selling in Hong Kong has attracted significant academic and industry attention. A list of securities eligible for short selling is updated regularly, providing market participants and academics with starting points for research on the impact of short selling on particular stocks. Volumes of short selling in Hong Kong appear lower when compared to other major markets - in 2007, Martin Wheatley, CEO of the SFC, stated that short selling accounts for only 5 percent of market turnover in Hong Kong, a significantly lower proportion than New York or London (where short selling is thought to account for 25 to 30 percent of market activity).³¹ Michael McKenzie and Olan Henry of the University of Melbourne suggest the figure to be marginally higher, at 7.7 percent of average daily volume in Hong Kong (over the period January, 2001 to April, 2006).³²

This section examines some of the characteristics of short selling in Hong Kong, and is structured as follows: *first*, the section will look at the system of short selling in Hong Kong; *second* the section will look at comparable regulations in the US, the UK, Australia, Singapore, and China; *finally*, the section will draw together some key differences.

The Eligibility List

Short selling was introduced in Hong Kong in 1994, with a pilot scheme selecting 17 securities that could be sold short. Whilst the initial scheme included the up-tick rule (i.e. sales orders were not to be made at below the best current ask price), this rule was abolished in 1996 when the scheme was revised.³³ The 1996 revisions also added to the number of securities eligible for short selling, increasing the number of eligible stocks to 113 (this 'eligible list' is updated quarterly, and the criteria discussed in Box 2 is taken from the SEHK Rules, Eleventh Schedule, Point 18).³⁴ As part of the governments plan to strengthen oversight of the securities markets in Hong Kong post-Crisis, regulators not only reintroduced the uptick rule, but also moved to strictly enforce the T+2 settlement period, increased penalties for naked short sellers, made it an offence to not report open short sales, and strengthened record keeping regulation for stock lenders. By July 16, 2008, there were a total of 544 securities eligible for short selling in Hong Kong, including Main Board and GEM stocks; in addition, market participants are able to sell short exchange traded funds (ETFs) (for example, Lyxor and iShares ETFs).

As with other markets (e.g. Australia), Hong Kong maintains a tick rule, whereby sale orders for short sales cannot be executed below the best current ask price (HKSE Eleventh Schedule, Point 15). All short sale transactions are identified to the broker at the time of the order, and exchange members each maintain ledger of daily short sale transactions (the exchange must have access to this ledger at all times). A daily report of all short sales transacted is also presented to the exchange. The report includes information on

³¹ Innovative Investor, Issue 1, February 2007. Available at: http://www.innovative-investor.com/pdf/news_market_moment.pdf

³² McKenzie, M. & Henry, OT (2007). "The Determinants of Short Selling in the Hong Kong Equities Market," Department of Economics - Working Papers Series 1001, The University of Melbourne. Available at: <http://ideas.repec.org/p/mlb/wpaper/1001.html>

³³ Essentially, the rule prevented 'bear raids' on a firms stock, whereby a group of short sellers can drive down a company's share price through consistently selling stock short on a declining share price. This 'death spiral' dissuades buyers from acting on what might be an attractive price, with the suspicion of a bear raid implying that there is more to come from the decline. How long does this spiral continued for? Essentially, for as long as short sellers want it to - the ceiling for short sellers is a stock price of \$0.

³⁴ The list of 'Designated Securities Eligible for Short Selling' maintained by HKEx is available at: <https://www.hkex.com.hk/tradinfo/secshortsell/secshortsell.htm>

aggregated daily short transactions, as well as details on each stock's short selling activity (with a 24 hour delay).³⁵

Box 2 - Eligibility for Short Selling in Hong Kong

The following stocks are designated as eligible for short selling in Hong Kong:

- all constituent stocks of indices which are the underlying indices of equity index products traded on the Exchange;
- all constituent stocks of indices which are the underlying indices of equity index products traded on HKFE;
- all underlying stocks of stock options traded on the Exchange;
- all underlying stocks of Stock Futures Contracts (as defined in the rules, regulations and procedures of HKFE) traded on HKFE;
- stocks which maintain a public float capitalisation (i.e. stocks in the hands of the public as in Chapter 8 of the Main Board Listing Rules) of not less than HK\$1 billion for either (i) a period of 60 consecutive trading days during which dealings in such stocks have not been suspended; or (ii) a period of no more than 70 consecutive trading days comprising 60 trading days during which dealings in such stocks have not been suspended;
- stocks with market capitalisation of not less than HK\$1 billion and an aggregate turnover during the preceding 12 months to market capitalisation ratio of not less than 40 percent;
- Tracker Fund of Hong Kong and other Exchange Traded Funds approved by the Board in consultation with the Commission;
- all securities traded under the Pilot Program;
- stocks that have been listed on the Exchange for not more than 60 trading days, with a public float capitalisation of not less than HK\$10 billion for a period of 20 consecutive trading days commencing from the date of their listing on the Exchange and an aggregate turnover of not less than HK\$200 million during such period; and
- all underlying stocks of Structured Product which is based on one single class of shares traded on the Exchange.

Hong Kong has moved to explicitly prohibit naked short selling by including a strict locate requirement in the Securities and Futures Ordinance. Exchange participants are required to ensure that short sellers have the ability to unconditionally vest the stock they are selling (SFO, §170(1), HKSE Eleventh Schedule, Point 1). Specifically, the short seller must have either borrowed the securities, or have obtained a documented confirmation that a counterparty is willing to lend the securities to the short seller.³⁶ Importantly, an open buy order does not count as an unconditional right to vest a security. Point 2 of the Eleventh Schedule prohibits market participants from executing sale orders if vesting rights are not secured in accordance with Point 1, and

³⁵ Available at: <http://www.hkex.com.hk/markdata/quot/qtn.asp>. Users must select a trading date, then click on "short selling turnover - daily report" which provides data on short selling turnover (volume and dollar-value) of individual stocks. The data is presented alongside total turnover data, allowing users to contextualize short selling behavior.

³⁶ The HKSE Eleventh Schedule, Point 1 also allows for possession of a derivative instrument (e.g. an option or warrant) that would confer a right to acquire stock as evidence of an unconditional right to vest the security.

SFO §171 makes clear that such evidence is required to be documented and provided to the agent as assurance. SFO §171(8) prescribes that such documentation should be retained for one year by the agent or exchange participant, and should make the document available to the SFC if demanded by the SFC.³⁷ SFO §172 mandates that any market participant who is aware that a sale order is a short sale should either inform the next person along the execution chain of the status of the sale as a short sale or, where the participant is the person inputting the order into any trading system, that person should indicate as such (in Hong Kong, that disclosure is required under SEHK Rules, Eleventh Schedule, Point 5).³⁸ Where a market participant is unable to deliver securities for settlement, CCASS Rule 35 allows the exchange to impose a fee on such a participant, and/or effect a borrowing of those shares to facilitate a settlement (with the fees to be determined by the exchange), and/or execute a compulsory buy-in in order to facilitate settlement.

With naked short selling prohibited, covered short selling is effected by borrowing stock on the market, or agreeing with a counterparty that they will lend the stock, in order to effect a sale. In Hong Kong, market participants lending stock are required to 1) maintain records of stock lending, 2) collect collateral of 105 percent of the value of the securities lent if the securities are to be used for short selling (SEHK Rules, Sixth Schedule, Point 9a), and 3) to mark securities to market daily (SEHK Rules, Sixth Schedule, Point 9b). Moreover, where there is a collateral shortfall, the borrower must post a collateral increase (SEHK Rules, Sixth Schedule, Point 10); similarly, where the value of the collateral posted becomes greater than 100 percent or 105 percent, the borrower may ask the lender to release excess collateral as appropriate (SEHK Rules, Sixth Schedule, Point 11)

One point of issue lies here - that of reporting of stock loans. Regulation in Hong Kong is such that any market participant can lend stock, yet there is little visibility over the activity. Some jurisdictions like Australia have observed that lending activity can impact settlement risk, and could be assuaged by improved transparency. But there is also an attendant benefit: stock lending disclosure, as an excellent proxy for short selling, would act as a counterbalance in the event that there is non-compliance with short selling disclosures. So what could be done? Our suggestion - all stock loans should be reported on a daily basis to the exchange (and then published to the market), not just held in ledger.

Disclosure Requirements

One area of contention around short selling and short positions in Hong Kong is the imbalance of disclosure requirements.

Disclosure of economic interests in certain circumstances is required pursuant to Part XV of the Securities and Futures Ordinance (Cap. 571). In Hong Kong, long positions of over 5 percent are to be disclosed to the exchange within three days. However, short positions of 1 percent or greater only have to be disclosed if the interested party concurrently has an open long position of 5 percent or greater. Specifically, if the fund manager does not have a disclosable long position, a short position need not be disclosed. Interests are not netted off (i.e. long minus short), so both disclosures must be made; a fund manager holding 6 percent of share capital long, with a 5.5 percent short interest must make two disclosures - the position cannot be netted off as only a 0.5 percent long position (this is distinct from the recently introduced UK FSA requirements, which allow for disclosure of net interests). Subsequent disclosures are required (for both long and short positions) each time that an interest increases over a percentage point, i.e. an interest increases from 6.8 percent to 7.1 percent.

³⁷ Contravention of SFO §170(1) brings with it a fine at level 6 and imprisonment of two years. Contravention of SFO §171(1-6, 8) brings with it a fine at level 5 and imprisonment of one year. The Criminal Procedure Ordinance (Cap 221) sets out the amount of fines for each 'levels'. A Level 5 fine equates to a penalty of HK\$50,000, whilst a Level 6 fine is HK\$100,000.

³⁸ Contravention of SFO §172 brings with it a fine at level 5 and imprisonment of one year.

Disclosure Issues in Hong Kong at a glance

Short positions need only be disclosed if above 1 percent, and accompanied by a long position of 5 percent or more

Short positions *without* a corresponding long position need not be disclosed

Open short positions are not disclosed

Daily short transaction volumes per stock are disclosed by HKEx

Stock loan data is not disclosed

Here, there, is an issue of obvious concern; in some cases short positions are to be disclosed, in others they need not be. For example, a shareholder who is 5.1 percent long, and 1.2 percent short needs to disclose both. However, a shareholder who is 1.2 percent long and 5.1 percent short need not. If short positions are deemed worthy of disclosure, then all short positions of 1 percent, for example, should be disclosed. If not, then none should be. Having one rule for long holders and one rule for short-only managers imbalances the market.

Another area that has attracted attention globally is the issue of disclosure of outstanding interests in short

positions - very few markets actually require such disclosures, although as will be seen later the United Kingdom has introduced some disclosure requirements in certain circumstances. Hong Kong does not disclose aggregate open short positions in stocks; daily trading activity is disclosed, but the lack of disclosure requirements regarding the closing out of a short position prohibits aggregate open position disclosure. Specifically, whilst the exchange requires short *sales* to be disclosed during the transaction, there is no requirement to disclose if a *purchase* order is being made to close out a short position. Without an amendment of the regulation and legislation surrounding short selling, aggregate open positions cannot be disclosed. One other avenue that would facilitate such disclosures would be a daily disclosure by market participants of open short positions, an option discussed in later stages of this paper.

Stock loan data is similarly unavailable in Hong Kong. Investors might be able to estimate volumes of short selling and peaks in short selling on a company by company basis if stock loan data was available. Specifically, if a fund manager was able to see that on an average day, 20 percent of a company's stock was available for loan, and that on an average day only 2 percent of that company's stock was actually on loan, any day that saw stock on loan figures reaching 18 to 19 percent would represent a potential trading opportunity. Large volumes of stock on loan could indicate large open short positions - a buy signal to many. Whilst stock lenders would have that data in-house (and potentially available to proprietary traders of that institution), the general investing community does not. Neither stock available for loan nor stock on loan data are disclosed in Hong Kong. Such information is available in other markets (the United Kingdom, for example). This information asymmetry could well disproportionately benefit stock lenders over those who do not have such data in their possession. Provision of stock available for loan and stock on loan would enhance the efficiency of the market, and improve decision making, price setting, and stock loan pricing, and hence benefit all market participants.

Similarly, availability of stock on loan data would act as a balance to figures disclosed on volumes of short selling. The figures cited before of 5 percent and 7.7 percent for short selling as a portion of total activity appear low when compared to figures for other markets of 20 to 30 percent. There is, however, no way of estimating the actual levels of short selling if notifications originate at the seller himself. If the short seller does not disclose that a sale is a short sale, that sale is not included in official figures. Therefore, one way of providing a benchmark figure to estimate short sale volumes is to make stock loan volume available.

The HKEx also publishes daily turnover figures (including short sale transactions), and daily notifications of long/short disclosures on its website, which also includes useful general search functions of companies and substantial shareholders.³⁹

³⁹ Disclosure of interests: Search of daily summaries - Individual and corporate substantial shareholders. Available at: <http://sdinotice.hkex.com.hk/di/NSSrchMethod.aspx?src=MAIN&lang=EN&in=1>

How do Disclosure Requirements Compare?

This paper looks at the ways in which Hong Kong compares with other markets in terms of short selling regulation and disclosure. By benchmarking against a basket of comparable exchanges, it is possible to develop a broader perspective of where current Hong Kong legislation stands, and areas that might need to be addressed. This section will look at disclosure requirements in five key markets globally - the US, the UK, Australia, Singapore, and China.

Box 5 - Short selling requirements across selected markets

Issue	Hong Kong	United States	United Kingdom	Australia	Singapore
Covered short selling?	✓ ^α	✓	✓	✓	✓
Naked short selling?	×	×	✓	✓ ^β	✓
Eligibility list for short selling?	✓	× ^γ	×	×	×
Tick rule?	✓	×	×	✓	×
Disclosure of specific short positions per stock, per holder?	✓ ^δ	×	×	×	×
Disclosure of aggregate open short positions per stock?	×	×	×	✓ ^ε	×
Disclosure of stock on loan?	×	×	✓	×	×
Disclosure of stock available for loan?	×	×	×	×	✓ ^ζ

α - Covered short selling permissible in Hong Kong subject to stock eligibility rules.

β - Naked short selling permissible in Australia subject to stock eligibility rules.

γ - Eligibility list in US refers to locate requirements for certain stocks

δ - Over a disclosure threshold (currently 1 percent) where there is an open disclosable long position

ε - Net open positions aggregated and disclosed daily by the ASX

ζ - Only stock available for loan through CDP pool

US Requirements

Short selling in the United States has attracted significant attention in recent months. The market downturn that began to make itself felt in the early parts of 2008 and the subsequent demise of Bear Stearns have again put short sellers on the radar of legislators and regulators.

Despite extensive press coverage of short selling in recent months, the issue of *covered* short selling has never been widely noted as being problematic in the US. The area that has attached most attention in the US (as with

other jurisdictions) is that of naked short selling. The centerpiece of anti-naked shorting legislation in the US is Regulation SHO, adopted on July 28, 2004, with compliance required from January 3, 2005.⁴⁰ One of the key requirements of Regulation SHO is that it requires broker-dealers to ensure that they have documented evidence of “reasonable grounds to believe that the security can be borrowed” prior to settlement date in order to effect settlement, before they are able to accept a short sale order (Rule 203(a)1). Moreover, broker-dealers are required to ‘buy-in’ and close out failed deliveries for a ‘threshold security’ ((Rule 203(b)3).⁴¹ Broker-dealers that are members of a participating clearing house are also required to close out open short sales that have persistently failed to settle.⁴² But Regulation SHO does not require a firm borrowing of the stock - only a reasonable belief that such stock can be borrowed, and delivered.⁴³ Whilst the ‘locate’ must be documented (Rule 203(b)1), critics have argued that it is seldom enforced. Recent developments in US markets have opened Regulation SHO to further criticism, and have prompted the SEC to place nineteen financial stocks on a watch list that aimed to protect them from naked short selling, initially for the duration of a period from July 21, 2007, to July 29, 2008 (and subsequently extended to August 12, 2008).⁴⁴ As a result of the emergency order, any investors wishing to sell short the shares of the nineteen companies on the list must have borrowed the stock (or arranged to borrow the stock) prior to the trade. The key difference between Regulation SHO and the emergency order lies in the definition applied to the degree of confidence a short seller has in the ability to settle at settlement date. Whilst regulation SHO requires *reasonable grounds* to believe that the security can be borrowed so that it can be delivered on the delivery date (Rule 03(b)(1)), the emergency order requires that the investor have “...a bona fide agreement to borrow the security such that the security being borrowed is set aside at the time of the arrangement solely for the person requesting the security”⁴⁵ (congruent with current SFO requirements in Hong Kong). In essence, the emphasis is on brokers to ensure that the short seller has stocks available to settle - the previous requirement of ‘reasonable grounds’ left little to enforce.

Historically, one of the core tenets of US short-selling regulation was the up-tick rule. First introduced into the United States in 1938, the SEC abolished rule 10a-1 of the SEC 1934 Act in July 2007, thus removing the uptick rule for short selling legislation. Hence, short sales could be executed on ever-declining prices.

Unlike Hong Kong, however, the US currently has no requirement for disclosure of short positions. However, SEC Chairman Christopher Cox has recently discussed the potential introduction of short position disclosures,

⁴⁰ Securities And Exchange Commission, 17 CFR PARTS 240, 241 and 242 [Release No. 34-50103; File No. S7-23-03]. Available at: <http://www.sec.gov/rules/final/34-50103.htm>

⁴¹ A threshold security is defined as one that is publicly traded, and for which 10,000 shares have been subjected to ‘fail to deliver’ status, and for which such a volume accounts for 0.5 percent of the company’s outstanding share capital.

⁴² US Securities and Exchange Commission - Division of Market Regulation: Key Points About Regulation SHO. Available at: http://www.sec.gov/spotlight/keyregshoissues.htm#P48_5996. The SEC publishes monthly failure rates on its website (published quarterly, in arrears). Available at: <http://www.sec.gov/foia/docs/failsdata.htm>.

⁴³ The question remains under Regulation SHO as to overlapping of ‘reasonable beliefs’ - if a broker makes an enquiry and a custodian agrees to lend the same stock to 10 different people, knowing that the short will be covered on the market in 2 days before T+3, the problem still exists.

⁴⁴ The Securities Identified in the SEC Emergency Order of July 15 2008, include:

BNP Paribas Securities Corp.(BNPQF or BNPQY); Bank of America Corporation (BAC); Barclays PLC (BCS); Citigroup Inc. (C); Credit Suisse Group (CS); Daiwa Securities Group Inc.(DSECY); Deutsche Bank Group AG (DB); Allianz SE (AZ); Goldman, Sachs Group Inc (GS); Royal Bank ADS (RBS); HSBC Holdings PLC ADS (HBC, HIS); J. P. Morgan Chase & Co. (JPM); Lehman Brothers Holdings Inc. (LEH); Merrill Lynch & Co., Inc. (MER); Mizuho Financial Group, Inc. (MFG); Morgan Stanley (MS); UBS AG (UBS); Freddie Mac (FRE); Fannie Mae (FNM).

⁴⁵ US Securities and Exchange Commission, Division of Trading and Markets: Guidance Regarding the Commission's Emergency Order Concerning Short Selling. Available at: <http://www.sec.gov/divisions/marketreg/emordershortsalesfaq.htm>

along the lines of that in Hong Kong, i.e. where the threshold for short and long disclosures are the same (e.g. 5 percent).⁴⁶

UK Requirements

Like the US, short selling has attracted significant attention in the media in the UK over the past six to 12 months. Like the US, in the UK there is no disclosure requirement for short positions (other than those companies undertaking a rights issue - see below).⁴⁷ Unlike the US, UK regulations do not explicitly address naked-short selling - there is no Regulation SHO equivalent in the UK.

In terms of understanding the volumes of short selling, covered short selling volumes could be distilled from data on stock lending. Indeed, disclosure of stock on loan in the UK is readily available - Euroclear provides Monthly Stock Loan Data and Monthly Failure Rates on its website (although this information is voluntarily provided, and not required by regulation). However, there is no requirement for disclosure of aggregate short positions in a company; short sellers holding 3 percent, 5 percent or more of the company's shares in a short position are not required to disclose those positions. Unlike Hong Kong (but like the US), the UK FSA has not put in place any tick rule - short sellers are free to sell at any price.

As mentioned above, there is no requirement for a pre-borrow, no requirement for pre-locate, and no regulation that deals directly with naked short selling explicitly. With no disclosure requirements for short positions, or pre-locate/pre-borrow requirements, very few market participants have insight into volumes of naked or covered short selling. Settlement failures are, as with other markets, dealt with via an exchange buy-in clause. Settlement of transactions on the London Stock Exchange is undertaken by Euroclear UK & Ireland, with the LSE imposing buy-in rules on trades that fail to settle. Specifically, if settlement has not occurred by the Intended Settlement Date, the LSE may (upon request from the buying member) serve a buy-in notice on the seller. The LSE will then impose a penalty on the counterparty for the buy-in, as well as a dealing fee (a percentage of the transaction, with a floor value) for the buy-ins. There is an additional charge for every day that the buy-in order is unmatched.

One indication of the perceived increase of short selling volumes, and the overall prevalence of short selling, is the recent move by the FSA to curb short selling of companies that are undertaking a rights issue. Specifically, the FSA introduced in June 2008 new rules (the Short Selling Instrument 2008) that would require disclosure of short positions in companies undergoing a rights issue.⁴⁸ Effective from June 20, 2008, short sellers are required to disclose 'significant' short positions (i.e. net positions of more than 0.25 percent) in securities trading on a UK-recognized investment exchange that are subject to a rights issue.⁴⁹

⁴⁶ MarketWatch, "SEC may force reports of large short holdings: Cox", 24 July 2008. Available at: http://www.marketwatch.com/news/story/sec-may-demand-reports-large/story.aspx?guid=percent7B5881207B-E88F-4C9D-B1F3-1E1E24F6D676_percent7D

⁴⁷ The FSA did float the possibility of disclosure of short positions as part of a Short selling, Discussion Paper (DP17), released October 2002. In a publication summarizing responses to DP17, the FSA stated that:

"As regards the targeted transparency measures, there were mixed views on the idea of requiring those holding large short positions in the securities of a company to disclose their positions. A significant minority felt this would be useful information for companies and would provide parity with the existing Companies Act regime, which requires disclosure of shareholdings above 3 percent. However, more respondents felt that the existing regime, which is intended to show where control of a company lays, would be inappropriate for disclosure of large short positions as short positions do not give voting rights. Many respondents also felt that publishing such information could be prejudicial to those holding large short positions by exposing their identity and increasing the risk of a "bear squeeze". We do not propose to pursue this option, not least because of doubts whether the reporting would be effective in practice."

⁴⁸ UK Financial Services Authority, Short Selling Instrument 2008'. Available at: http://www.fsa.gov.uk/pubs/press/PNO572008_instrument.pdf

⁴⁹ The 2008 Instrument names the London Stock Exchange's Main Market, Alternative Investment Market, OFEX/PLUS and the Specialist Fund Market as recognized exchanges.

However, the recent UK legislation in short selling during a rights issue does not include much by way of guidance vis-à-vis subsequent disclosures - do short sellers need to make a disclosure if the holding increases or decreases above or below the reporting threshold? Is disclosure required where the position is closed out? If short sellers do not have to disclose on closing out a position, that position could be seen to be open and hence guide market sentiment on a company.

Australia Requirements

Both naked and covered short selling are permitted in Australia. However, the regulatory framework that governs short sales is ambiguous. The Corporations Act (2001) states that shares can only be sold where the seller has, or the broker reasonably believes that the seller has, “a presently exercisable and unconditional right” to vest the securities in question (§1020B). Short sales, whether naked or covered, can only be effected if they fall within one of the exceptions to this requirement. The ASX Market Rules take a similar approach to short sales. Short sales are defined there as sales where at the time of sale the seller does not have “a presently exercisable and unconditional right to vest” the securities in the buyer (rule 2.10).

Many market participants have taken the view that, in a case of a covered short sale, the seller, having borrowed and consequently taken title to the securities, has the unconditional right - like that of a seller under a conventional sale - to vest the securities in the buyer. On this basis, the requirement in the Corporations Act is satisfied and there is no need to comply with any of the exceptions to that requirement. Equally, the short sale of borrowed securities can be treated as if it were not a short sale for the purposes of the ASX Market Rules. Hence, covered short selling is under-reported in the Australian market and the other regulatory conditions imposed on covered short sales are capable of being avoided.

Disclosure of short sales is two fold - both the Corporations Act and the ASX Market Rules enforce some form of disclosure along the execution chain. First, the seller of the securities must, pursuant to §1020B(5) of the Corporations Act, inform their broker that the sale is a short sale under §§1020B(4)(b), 1020B(4)(d) and 1020B(4)(e).⁵⁰ Second, ASX Market Rules prescribe that brokers must in turn report both short sales they transact to the ASX (19.3.9), and net short positions daily (19.6.1) (these net short positions as at 7:00pm on a trading day should be reported to ASX by no later than 9:00am on the next trading day). The ASX takes this information and aggregates it, and, distinct from many other markets (although not Hong Kong), publishes a daily list of securities sold short.⁵¹ This list includes not only the volume of shares sold short per stock, but also the percentage of shares sold short vis-à-vis the short sale limit (ASX limits the number of shares of a company that can be sold short to a percentage (currently 10 percent) of the total number of all approved securities of that company - ASX Market Rule 19.5.1).

As with the Hong Kong, the Australian short-selling regime maintains a tick test for sales - §1020B(4)(d) of the Corporations Act prohibits short sales where the executed price is lower than the immediately previous sale transaction. This is reinforced by ASX Market Rule 19.3.3, which also prohibits short sales in such circumstances.

Further regulation exists in the form of an approved list for naked short selling. Concern over settlement failure potentials has led to regulation stipulating that only certain securities are eligible for naked short selling in Australia - see Box 3 for more details on the eligibility criteria.

⁵⁰ ASX Market Rule 19.8.1 also mandates this disclosure, although the degree of oversight and enforcement that ASX might be able to bring about with regard to clients is not clear.

⁵¹ List of Approved Short Sale Products and Approved Short Sale ETFs (Including net Short Sale positions as at end of day). Available at: <http://www.asx.com.au/data/shortsell.txt>

Box 3 - Eligibility for Naked Short Selling in Australia

Under Market Rule 19.7.1, ASX may designate a share or security to be an approved short sale product if:

- (a) 50 million securities of the class have been issued (excluding securities of the class issued but held by any entity which ASX considers is related to the Issuer);
- (b) the market capitalisation of the securities of the class on issue is not less than \$100 million;
- (c) in the opinion of ASX there is sufficient liquidity in the market for the securities of the class; and
- (d) ASX considers that the securities should be designated as an 'Approved Short Sale Product' for the purposes of these rules.

Another regulatory development in Australia is a ban on naked short selling of securities of a bid target during the period of a takeover bid (covered short selling is still permitted during such a period) (ASX Market rules 19.5.3 & 20.7.1). By doing this, the ASX have moved to mitigate the potential for settlement failures in a time of diminishing supply for lendable stock - as acceptance of a takeover bid increases, supply decreases, and the potential for settlement failure increases.⁵²

Singapore Requirements

Singapore, unlike other more regulated short selling markets, has not enacted any short-selling related regulation, making estimations of volume challenging. Naked and covered short selling are both permitted (inasmuch as there is no restriction or prohibition on naked selling), and there is currently no disclosure requirement for short selling. The only caveat to short sellers is that in times of particular market volatility, the SGX can impose suspensions on short selling activity (although this is true of *all* trading activity, not just short selling). The sole rule in Singapore that is of interest to short sellers is that a seller must deliver a stock on settlement date (currently T+3) - financial penalties exist for those who fail to settle, with the exchange buying-in on behalf of the seller. Rule 6.7 of the CDP Clearing Rules prescribes mandatory buy-ins for failed trades (Rule 6.7.2 states that the CDP will buy in for all failed trades). Costs for buying in are borne by the party that failed to settle (Rule 6.7.2(4)), whilst the buy-in price as fixed by CDP is 2 minimum bids above the highest of the closing price of the previous day, to be increased by another 2 minimum bids if there is no buy-in at that price (Rule 6.7.4(5), 6.7.4(7)).

Stock lending is a developed and active part of the Singapore capital market. On the one hand, fund managers can borrow over the counter on a point to point basis, negotiating terms and conditions of the loan. Chapter 17 of the SGX-ST rules state that a borrower of securities must post collateral of 105 percent of the market value of the borrowed securities to the lender, and that variation payments must be made to the lender if the market value of the collateral is no longer sufficient for this 105 percent requirement (17.3).

An alternative to over the counter borrowings negotiated between a borrower and lender is the use of a borrowing facility set up the Central Depository (CDP) in Singapore. The CDP is the clearing and settlement subsidiary of the main exchange in Singapore, SGX. The CDP (a subsidiary of the exchange) facilitates stock lending by acting as a pool for securities to be lent. Securities that appear on an eligibility list (determined by volume) are eligible for lending. Lenders receive a mandated 4 percent fixed for lending securities, borrowers pay a mandated 6 percent.

⁵² However, this relates only to the target company, and not to the offeror. The potential here is for an offer made constituting shares and cash to be scuttled through a rival bidder shorting shares of the offeror. For example, Company A wishes to acquire Company B, and offers 50 percent of the consideration in cash, and 50 percent in shares, for a total consideration of \$100 million. However, Company C (Company A's biggest rival) wants not only to acquire Company B, but more importantly for Company A not to acquire Company B. Therefore, Company C shorts the shares of Company A, and decreases the value of the offer, therefore scuttling the bid. The 'Final Thoughts' section will discuss the implications of this for Hong Kong.

This absence of specific regulation ranks Singapore as distinct from UK, US, Hong Kong, and Australia. There is no tick rule for short sellers, no disclosure required for short sellers, no approved list, and no stock/sector specific exclusions. It is therefore very difficult to estimate how much short selling behavior there actually is in Singapore. One way of estimating covered short selling behavior might be to look at stock lending volumes (it is important to note that not all securities are eligible for lending - the CDP maintains a list of around 200 securities that are eligible to be lent via the CDP, reviewing this list regularly). However, there is no disclosure of volumes of loans per se, although the CDP maintains and discloses its indicative stock loan pool data, available from its website.⁵³

China Requirements

One legacy of rampant speculation in mid-1990s China was the prohibition of short-selling, with caution the watchword on the part of regulators. One manifestation of this caution was the 1998 Securities Law which placed specific restrictions on short-selling mechanisms. In particular, Article 35 prohibited short selling by mandating spot, cash transactions, whilst Article 106 prohibited same day buying and selling (with the aim of preventing intraday short selling). Meanwhile, Article 150 prohibited securities houses from lending securities. This absence of margin-related trades - i.e. where a broker lends shares, the most common form of short selling - essentially deprived the market of the instruments of short selling.

However, with both the growing sophistication of the Chinese market and the speculative boom of the mid-2000s both driving the move, the 2005 Securities Law lifted the prohibition on stock lending mechanisms, and essentially the ban on margin-related trades (§§42, 142). Specifically, article 42 permitted both spot transactions and “any other form as prescribed by the State Council”, a departure from the 1998 Law. Restrictions on same day buying and selling, as well as the explicit prohibition of stock lending, were also removed.

Indeed, despite the relaxation of the 1998 Securities law restrictions, and the introduction of a futures exchange⁵⁴ (which would require short selling mechanisms in order to function), short selling in China has yet to be made explicitly legal, existing in a legal grey area currently, being neither prohibited nor legal. Short-selling could, however, be taking place in China currently. For sure, intraday short-selling is certainly possible. However, this would be undetectable under the current regime.

⁵³ CDP Lending Pool. Available at: <http://www1.cdp.com.sg/web33/scdcint/sbl/viewLendingPool.do>

⁵⁴ The China Financial Futures Exchange (CFFEX) was established in Shanghai in 2006, with the first future to be introduced at the CFFEX to be the CSI 300 index futures contract (a derivative of the CSI 300 index). However, and despite the relaxation of restrictions apparent in the 1998 Securities Law in 2005, and the establishment of the CFFEX in 2006, futures trading has still not commenced (the exchange is still in simulated trading mode).

Summary

There is a significant asymmetry globally with regard to disclosure requirements and regulation of short selling.⁵⁵ In some markets, short sales are required to be disclosed (US, Australia, Hong Kong), in others it is not (UK and Singapore). None of Hong Kong, Singapore, the UK and the US requires aggregate short position disclosures, although Australia publishes daily open (naked) short positions. Indeed, in many markets, there is no general holding disclosure requirement - short sellers holding 3 percent, 5 percent or more of a company's shares in a short position are not required to disclose those positions to the market (the exception being that Hong Kong requires disclosure of short positions over 1 percent where the shareholder has a disclosable long position only). The asymmetry of information is clearly an inefficient aspect of the market. The US and Hong Kong require stock to be pre-located/pre-borrowed prior to effecting a short sale - the UK, Australia, and Singapore do not. Some markets have effectively banned naked short selling, whilst others have no specific regulation. Furthermore, some markets disclose stock lending data, whilst others do not. Interestingly, opinion is divided over the tick test - the US, UK and Singapore have no tick-test; Australia and Hong Kong do. Box 5 draws together and highlights some of these key areas of regulation and disclosure, illustrating the disparities that exist.

Short selling is subject to a vast array of regulations and disclosure requirements globally. Information is available in some markets that can allow for an efficient operation of the market, whilst in others information on stock lending is either opaque or not disclosed at all. In an age of financial integration, concerns over contagion through market failures, this level of asymmetry is a cause for concern. The next section will look in more detail at some of the specific issues that Hong Kong may need to look at going forward in order to facilitate a transparent and efficient market for short selling, with potential actions proposed.

⁵⁵ This section does not include an in-depth comparative discussion of short selling disclosure requirements in China, given the lack of regulation and legislation designed for such activities.

4. What are the Solutions?

Information asymmetries associated with short selling represent a serious regulatory gap in a connected financial system. Asymmetries that impact on dual-listed stocks, for example, have the potential to lead to short-selling strategies that could yield profits on one exchange, at the expense of fund managers on another.

However, we should be cautious when discussing the merits and demerits of short selling. The issue is one of disclosure and regulation, not of whether or not short selling is good or bad for the market. An outright ban on *all* short selling could lead to overvaluation and lack of downwards momentum. Fund managers would be unable to make bi-directional bets, and as such alpha would be consequentially constrained.

Proposals for Change to the Hong Kong Regime

The paper has identified several areas of concern surrounding the short-selling regulatory regime in Hong Kong. Here, proposals are made on how short-selling regulations might be developed and enhanced going forward.

- Harmonize short selling disclosure requirements. Currently, only short positions over 1 percent coupled with disclosable long positions (i.e. greater than 5 percent) need be disclosed. This is untenable. Where an entity has a material *economic* interest in the performance of the company (separate from voting rights) this should be disclosed.⁵⁶ Hong Kong already requires partial disclosure (i.e. contingent on long positions). This should be extended across the market, i.e. all short positions of greater than 1 percent should be disclosed, regardless of long interest.
- Require daily notifications of open short positions. Notification is currently required for a short sale, yet the market has no signal that an open short has been closed off. The volume of open shorts on an aggregate level for an individual stock is of interest to the market, and as such open short information should be collected by the exchange at the end of each day (and published to the market), as is done in Australia.
- Trip circuit removal from eligibility list. Hong Kong should consider making explicit a trip circuit to temporarily remove stocks from the eligible list of stocks that are available for short selling in circumstances. This might occur where failure rates, or maybe stock price declines, are above a certain threshold. Whilst regulators currently have powers to suspend short selling of stocks on an ad hoc basis (settlement failure concerns led to the suspension of short selling of HSBC Holdings Plc, Hong Kong Telecommunications Ltd. and China Telecom (Hong Kong) Ltd. on 2nd September 1998), triggers that would lead to a suspension (and the period of suspension) should be made explicit, and communicated to the market. Removal from the list may be temporary, but inclusion on the suspended list would be an indication that questionable short selling is occurring, and that a significant volume of short sellers are potentially impacting on the price.
- Disclosure of stock loans. Hong Kong should disclose data on aggregated stock on loan per company. By making this data available to all market participants, the exchange would enable greater transparency of supply and demand, better pricing of stock lending, and would allow investors to better understand market sentiment and price securities accordingly.

⁵⁶ The importance here of the clause 'separate from voting rights' is that, historically, justification for long disclosure came from the influence an investor might have through crossing a threshold of voting rights, e.g. 5 percent of voting rights and greater might trigger a disclosure. This paper argues that economic interest should be seen as of interest to regulators and the market, and as such short positions (where a fund manager might have tens of millions of dollars exposure) should be made public. This paper does not, however, propose a specific disclosure threshold for these positions.

- Active cooperation with CSRC on short-selling regulation and disclosure requirements. Whilst this is not a specific action, it is imperative that the HKEx and SFC strengthen ties with the CSRC and both the SHSE and SZSE on issues such as short selling, to ensure that cross-market manipulation is not occurring. When China does introduce and encourage an active short selling market in China, the HKEx and SFC should be involved in assisting CSRC in crafting regulation, and in facilitating cross-border investigation. Whilst there are only certain types of market manipulation that are possible now, when A shares and H shares are fully fungible there will be serious potential for market abuse.
- Consult the market on the current short selling regime. Whilst not strictly a proposal for change, we believe that it would be useful for the SFC to consult the market on these and other areas of short selling within the Hong Kong short selling regime. Specific issues could involve the degree to which short selling of a takeover target is tolerated, and whether or not the tick test is to be retained going forward, for example. It may be that the market as a whole is content with the current regulatory regime - however, seeking views and establishing a short selling dialogue is a useful exercise, and can only be beneficial to regulators.

5. Final Thoughts

For as long as short selling lacks transparency short sellers will continue to be pariahs of markets participants during market declines, taking the blame for excessive swings and market crashes. There are three questions that need to be considered when discussing short selling. *First*, is it an acceptable form of investing? *Second*, is naked short selling acceptable? And *third*, what level of disclosure/regulation is required?

Many would agree on the first issue, i.e. that short selling is legitimate when done within the constraints of the law. Short and distort tactics are, rightfully, not part of this legitimate strategy. On the second issue, opinions are divided. The US and Hong Kong, are clear on their view of short selling as not including naked short selling. The UK and Singapore, on the other hand, do not explicitly address naked short selling. It is difficult to reach consensus. However, the third question links to this - what degree of disclosure should there be? The key issue here is that the asymmetry of disclosure globally represents a significant threat to sustainable market conduct globally. Volumes of short selling have increased dramatically - London Business School has estimated that short selling activity increased to \$5,000 billion in the three years up to 2006, increasing by a factor of four over that same period.⁵⁷ Disclosure requirements have not, on the whole, increased proportionately.

There are significant information asymmetries and disclosure disparities that threaten the efficient functioning of the market. This paper has identified some areas that we believe can be looked at in Hong Kong as a means to eradicating information asymmetries. How Hong Kong deals with these issues remains a major test for the territory. In the meantime, market participants must be aware of the information asymmetry outlined in this paper, and must seek to manage it as one of the many investment risks they encounter.

⁵⁷ Saffi, Pedro A.C. and Sigurdsson, Kari, "Price Efficiency and Short-Selling" (December 10, 2007), AFA 2008 New Orleans Meetings Paper, Available at: <http://ssrn.com/abstract=949027>

Glossary and Acronyms

Acronym	Full Term
ASX	Australian Securities Exchange
CCASS	Central Clearing and Settlement System (Hong Kong)
CDP	Central Depository Pte Ltd (Singapore)
CO	Companies Ordinance
FSA	Financial Services Authority (UK)
HK\$	Hong Kong Dollar
HKEx	Hong Kong Stock Exchange
HSCI	Hang Seng Composite Index
LR	Listing Rules
LSE	London Stock Exchange
OTC	Over The Counter
SEC	Securities Exchange Commission (US)
SEHK	Stock Exchange of Hong Kong
SFC	Securities and Futures Commission (Hong Kong)
SFO	Securities and Futures Ordinance (Hong Kong)
SGX	Singapore Exchange Ltd.
UK	United Kingdom
US	United States
SZSE	Shenzhen Stock Exchange
SHSE	Shanghai Stock Exchange