

COMMENT ON DRAFT SECURITIES AND FUTURES (SHORT POSITION REPORTING) RULES

Thank you for giving us the opportunity to comment on the proposed draft Securities and Futures (Short Position Reporting) Rules (“**Rules**”).

1. WHAT TO REPORT

Section 3(1) of the Rules does not set out clearly what a person is obliged to notify to the Commission. Whilst s. 3(4) provides that the Commission may specify a form and the particulars to be contained in the form, in our view, the Commission's scope of discretion under s. 3(4) should be clearly delineated in s. 3(1). We suggest that s. 3(1) be amended as follows: “the person shall notify the Commission of the extent of the person's short position in each specified share in accordance...”.

2. WHO REPORTS

2.1. Section 3(1)

Section 3(1) of the Rules provides that the legal obligation to report resides with the person who “beneficially owns a reportable short position”. In our view, the phrase is unclear.

If the phrase is construed in the legal sense to refer to the person holding equitable title, the short position reporting regime will in essence amount to a voluntary regime. A person who does not wish to comply with the regime may simply split his short position across different legal entities, none of whom hold their short positions on trust for that person.

At the same time, it is not clear what is the subject matter to which such equitable title attaches. The shares have already been sold. Is it intended that the phrase refers to the person who has equitable title to the proceeds of the sale immediately resulting from the sale of the shares resulting the short position?

If the phrase is to intended to be construed other than in the legal sense (*e.g.* as a reference to the person who ultimately enjoys or bears the economic benefit or burden of the short position), we believe that the language should reflect this intention more clearly, particularly given that the phrase is essential to the definition of a criminal offence.

In our view, the focus of reporting should be on the person who controls the position. Thus, for example, in the case of a limited partnership, the general partner would, in the absence of other considerations, report. Equally, for example, in the case of a person who has allocated discretion to an external asset manager to make investment decisions, the external asset manager should report.

In this latter regard, bearing in mind the criminal nature of the Rules, we note that it would be manifestly unfair for a person to breach the Rules because an external asset manager exercising independent investment discretion on behalf of the person took a short position on behalf of the person and did not report that short position to the person in time to enable the person to comply with the Rules. It would seem also commercially undesirable for a person who has delegated investment discretion to multiple external asset managers for the purpose of administrative convenience to be required to collate short position information from each external asset manager (none of whom individually may have opened a reportable short position for the person) for the purpose of reporting.

2.2. Section 3(3)

As noted above, it is unclear how a person holds a short position on trust. In any event, a short position may be held through multiple levels of holding and any given level of holding may involve a person who is both a trustee and a beneficiary of a trust. For example, a client may short through a broker who in turn shorts through another broker. The client records the short position in his book; the 1st broker records the short position in its book as being held for the client; and the 2nd broker records the short position in its book as being held for the 1st broker. Assuming for the moment that a short position may be held on trust, it would appear that both the 1st broker and the 2nd broker are holding as trustees, the latter on behalf of the former and the former on behalf of the client. The result of s. 3(3) would appear to be that both the 1st broker and the 2nd broker would be obliged to report.

We note further that a short position may be partially held on trust and partially held otherwise than on trust and the Rules do not seem to clearly indicate what will happen in this event.

3. PENALTY

Whilst the Rules do not propose penalties, we note that the Commission proposes to amend the Securities and Futures (Offences and Penalties) Rules so that the maximum penalty on indictment will be a fine of \$500,000 and 2 years imprisonment and on summary conviction will be a fine at level 6 and 6 months imprisonment.

We note that these penalties are heavier than those prescribed under Part XV of the Securities and Futures Ordinance (“SFO”) dealing with disclosure of interests. There does not seem to be any basis for this discrepancy.

At the same time, in our view, the offence should be subject to reasonable excuse, which is consistent generally with offences under the SFO including those under Part XV of the SFO.

We note that there is no offence for a false or misleading notification which we believe is necessary to ensure the integrity of the reporting regime.