Gray Market Dealings: Legality of Selling Placement Shares Before Completion of Placing

The SFC recently announced that persons selling shares placed to them before completion of the placement may commit illegal short selling. Whilst the announcement suggests a rule to that effect, closer examination suggests this is not the case.

The Securities and Futures Commission ("**SFC**") announced yesterday that "investors and intermediaries could face criminal prosecution for illegal short selling if they sell placing shares before completion of a placement". Whilst this is undoubtedly true, it does not follow, as a reader of the announcement may surmise, that the sale of placement shares before completion of a placement is invariably illegal.

Applicable Law

Under the Securities and Futures Ordinance ("**SFO**"), a person "shall not sell securities at or through a recognized stock market unless at the time he sells them:

- he has, or where he is selling as an agent, his principal has; or
- he believes and has reasonable grounds to believe that he has or, where he is selling as an agent, that this principal has

a presently exercisable and unconditional right to vest the securities in the purchaser of them." For this purpose, a "recognized stock market" is the Stock Exchange of Hong Kong ("**SEHK**").

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The SFC announcement does not address the language in the SFO which requires that an illegal short sale be made at or through the SEHK. A sale of shares of a company, none of whose shares have yet been listed on the SEHK, is unlikely to be made at or through the SEHK since the SEHK does not yet allow trading in those shares…

SFC Position

The SFC announcement stated that "In general, a placement before its completion is subject to various conditions which may or may not be fulfilled". As a result, the announcement posits that, before completion, it is illegal for a person to sell shares placed to him in a placement because the seller does not unconditionally own (*i.e.* have a presently exercisable and unconditional right to vest the securities in the purchaser) the shares placed to him. The announcement states: "It follows that anyone who sells these conditional placing shares before completion of a placement runs the risk of committing illegal short selling, contrary to the SFO, unless the person (or where the person is selling as an agent, his principal has) already held a sufficient number of shares to settle the trade.

Analysis

The SFC announcement does not address the language in the SFO which requires that an illegal short sale be made at or through the SEHK. A sale of shares of a company, none of whose shares have yet been listed on the SEHK, is unlikely to be made at or through the SEHK since the SEHK does not yet allow trading in those shares through its facilities. As a result, it is doubtful that the sale of such shares prior to the satisfaction of conditions of placing would fall afoul of the SFO provisions for naked short selling cited by the SFC. This should be the case even if such a sale were ultimately settled through a cross trade on the SEHK immediately following the listing.

In *Tullet & Tokyo International Securities Ltd. v. APC Securities Co. Ltd.* [2000] HKCFI 1519, the plaintiff sold 1 million China Telecom shares to the defendant and the defendant denied liability for the purchase. At the time of the transaction, China Telecom had applied for the listing of its shares on the SEHK but the shares had not yet been listed. The transaction took place through a telephone conversation and, in accordance with market practice, it was agreed that completion would take place 2 days after listing and if listing failed, the transaction would lapse. Amongst other things, the defendant argued that the transaction was unenforceable because it constituted a breach of the short selling provisions of the securities legislation then prevailing. Those provisions are materially identical to the SFO provisions cited by the SFC, stating:

A person shall not sell securities at or through the Unified Exchange unless, at the time he sells them:

- he has, or where he is selling as agent, his principal has, or
- he reasonably and honestly believes that he has or, where he is selling as agent, that his principal has,

a presently exercisable and unconditional right to vest the securities in the purchaser of them.

The court held that the transaction was not a breach of the short selling provisions because at the time when the parties agreed to the sale, there was no selling of China Telecom shares at or through the SEHK because such shares had not yet been listed and thus, the shares were incapable of being sold at or through the SEHK.