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SFC's Short Position Reporting Requirements.

The SFC published its conclusions on its new short position reporting rules on 10 February 2012 and it is expected that the new requirements will come into effect on 18 June 2012 (subject to negative vetting by Legco). This bulletin summarises the key aspects of the new regime. Some of these remain unclear but the SFC has indicated that it will be publishing guidance and FAQs. These should hopefully resolve any remaining areas of uncertainty. The SFC will also be providing an e-mail alert service which will contain (among other things) the implementation timetable and the list of shares subject to the short position reporting regime (as amended from time to time). All affected market participants should subscribe to this service.

What needs to be reported?

A report needs to be filed by a person if he has a net short position as at the close of trading on the Stock Exchange of Hong Kong ("**SEHK**") on the last trading day of each week that is equal to or exceeds 0.02% of the issued share capital of the company or HK$30million which is the lower (calculated using the closing price of the shares on the reporting day and the total number of shares then in issue).

The reporting requirement only applies in relation to certain shares, namely, shares which are constituents of Hang Seng Index, the Hang Seng China Enterprises Index and certain other financial stocks (these must be both "designated securities" within the meaning of the SEHK rules and must be classified by the Hang Seng Indexes Company Limited as "financial stocks"). The SFC will publish a list of the shares which are caught which will be kept updated. The intention is only to catch large cap stocks and therefore the number of stocks caught will be significantly smaller than the number that are eligible for short selling on SEHK.

Currently, it appears that just under 90 shares would be caught.

How do you calculate whether you have reached the reporting threshold?

Only short positions established through trading in the shares themselves need to be included and then only if the short positions are established through trading on the SEHK or through an alternative trading platform which may be specified by SFC (none are as yet specified). Short positions established through off-exchange trading do not need to be included in determining whether you have reached the reporting threshold. However, the SFC has agreed that market participants may include such short positions on a voluntary basis if they wish to.

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Importantly, synthetic short positions established through derivatives do not need to be included.

As indicated above, you only have to report net short positions after deduction of any shares which you beneficially own.

Who needs to report?

The reporting obligation generally falls upon the beneficial owner of the short position rather than on any person who controls the position.

In relation to investment funds, therefore, the obligation would fall on the fund itself rather than the fund manager. In the case of a unit trust, the SFC has indicated that the trustee would be responsible for making the report. Where the fund is established as a partnership, one of the partners may report on behalf of the others. It would be permissible for someone to appoint an agent to report on its behalf such as a fund manager or prime broker. However, the principal would remain legally responsible for the report and must therefore ensure that the agent has the information it needs to make an accurate report.

Is aggregation permissible/required?

No. In contrast to the disclosure regime under Part XV of the SFO, aggregation across legal entities is not permitted or required. In relation to funds, as mentioned above, each fund must report separately even though they may be under common management. The SFC has also indicated that for corporate umbrella funds, each sub-fund must report separately.

Application to entities which use a trading unit/book methodology

As the new rules tie the concept of a short position to when there is a short sale on the SEHK, this raises the question as to how the regime should apply to firms which determine this by reference to trading books or trading units rather than at a legal entity level, an approach which is permitted under the SFC's short selling guidance.

This point was discussed with the SFC during the consultation process. The SFC agreed that such firms could adopt a different approach to calculating their overall short position which would involve looking at the net positions in respect of each trading book/unit (as at the close of business on the reporting day). Where trading books/units have a net short position these would be aggregated to produce an entity level figure. The firm would not be allowed in those circumstances to net off any long positions on trading books/units with a net long position.

Further guidance on this approach will be provided by the SFC. The SFC has recognised that this approach will yield data which is not readily comparable with that provided by firms which operate a legal entity approach. However, it has said that it is willing to live with that inconsistency and still thinks that the data provided would be useful.

Timing of report

The report has to be made within 2 business days of the day on which the reporting obligation arises. Note that Saturday is not a business day for these purposes so the reporting due date would generally be Tuesday if the reporting obligation arose on the previous Friday (which it would ordinarily unless the Friday was a public holiday).

Publication of data

Reports are made to the SFC on a private basis. However, the SFC will publish information on aggregate short positions in particular stocks on a delayed basis (this will not reveal any information about individual holders). The timing of the report has yet to be specified but it is expected to be around 1 week after each reporting obligation arises.

Emergency situations

Where the SFC believes that circumstances exist (in Hong Kong or elsewhere) which threaten or may threaten the financial stability of Hong Kong, the SFC may require short positions to be reported on a daily basis. In this case, short positions must be reported by the business day following the day on which the reporting obligation arises.

Penalties for breach

As with all requirements under the SFO and its subsidiary legislation, breach of the reporting requirements is a criminal offence punishable by a fine of up to HK$100,000 and a term of imprisonment of up to 2 years. A person only commits an offence if he fails to comply with the requirements without reasonable excuse (again, this is consistent with the approach under other SFO offences).

In practice, minor breaches are unlikely to be prosecuted, e.g. a report being filed a few days late. In accordance with its normal enforcement policy, SFC will take into account a number of factors in deciding whether or not to prosecute including whether the breach was innocent/accidental; whether it was a one-off incident (as compared to a systemic issue); and whether it was a first time offence. It is worth noting in this context that firms and individuals are routinely prosecuted for Part XV breaches, although the number of such prosecutions and the level of fines imposed appears to be relatively low (information published by the SFC indicates that between 1 April 2010 and 31 March 2011 there were 15 successful prosecutions with fines from HKD12,000 to HKD20,000. Fines of less than HKD10,000 are not disclosed).

Areas of uncertainty

There remain some areas of uncertainty in terms of how the reporting requirements should be applied which will hopefully be clarified by the SFC's guidance. In particular, it remains unclear how firms are to determine whether they have an open short position as at the end of the trading week. In other words, a firm may have opened a short position during the week but this position may have been closed out by the end of the week and it should not therefore count towards determination of whether the firm has crossed the reporting threshold. The SFC has not addressed this issue in any of its consultation papers, notwithstanding that it was raised by the industry on various occasions during the consultation process.

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