TOPIC:
“Short Selling in the United States and Hong Kong before the Global Financial Crisis: the Concept, the Regulation and its Comparison.”

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Topic:

Short Selling in the United States and Hong Kong before the Global Financial Crisis: the Concept, the Regulation and its Comparison.

INTRODUCTION

Market manipulating practices is a concern against which regulators frequently sought to battle. Although market activities are generally regulated, it is not possible to regulate against unforeseeable events that may rattle the markets and the economy. With the fall of the housing market in the United States (U.S.) and the collapse of the subprime market, the U.S. economy suffered a great hit whereby its negative effects had contagiously spread to the global financial sector. During the course of the downfall of financial markets, market manipulators perform practices like abusive short selling to take advantage of the panic to derive valuations on rapidly devalued securities in the pursuit of making large profits.

Historically, short selling has been blamed by politicians and business leaders for the chaos caused in times of financial turmoil. In essence, abusive short selling may bring about adverse effects on the economy by driving down stock prices. For that reason, short selling practices and procedures have been regulated accordingly with the aim to limit the chances of it being misused. Moreover, short selling regulations aim to prevent

market manipulation and exploitation, with an attempt to reduce market volatility in times of uncertainty. Nevertheless, this practice is generally allowed under limited circumstances as it is also recognized that short selling does in fact have some beneficial influence on the financial markets. In some circumstances, short selling can even be thought of as the grease to the market machine. In consideration of this, a regulatory balance on short selling laws is struck between legitimate risk-taking activities and abusive trading, rather than its outright ban as it was done temporarily in a number of countries around the world, including the U.S.

In the course of the collapse of the mortgage backed securities, the fall of the financial giant Lehman Brothers in September 2008 prompted the global financial crisis causing an emergency ban\(^2\) of short selling to be triggered around the world. The ban sparked a frenzy of controversy and attention to existing short selling regulations in the U.S., as it was believed that short selling was the major reason driving the decline in financial stock price causing market volatility. In recognition of this, regulators believed that short selling laws should be amended to be more stringent to stabilize the ailing financial market and to stop investors from benefiting in relation to the falling financial stocks.

The United States Securities and Exchange Commission (SEC) was amongst the first in the world to take a regulatory step to temporarily prohibit short selling of financial stocks. Other countries had followed the footsteps of the U.S. to prohibit short selling. The Hong Kong government and the Securities and Futures Commission (SFC), however, decided not to follow in the footsteps of the other nations.\(^3\) This is because the Hong Kong government and the SFC believed that abusive short selling behavior in Hong Kong is already strictly regulated and can only be carried out subject to restrictive conditions.

In light of the U.S. ban on short selling, this paper will discuss the concept of short selling in the context of its risks and benefits, as well as in the context of the current global financial crisis. Furthermore, this paper will briefly explain the short selling laws in Hong Kong and the U.S. with reference to their legislative intent. In addition, a

comparison of the two sets of laws, prior to the emergency ban, will be carried out and examined in terms of their regulatory approach. By analyzing the difference in law, it is argued that short selling law in Hong Kong is more restrictive than that of the U.S. law prior to the short selling ban, as the law in Hong Kong generally provides; 1.) greater coverage to a variety of short selling situations, 2.) more effective securities borrowing assurances, 3.) narrower exceptions to the law and 4.) harsher consequences for those who breach it. Given the restrictive nature of the law, short selling in Hong Kong is effectively monitored as it is the documentation requirements and the implementation of aggressive measures that allow the SFC to keep a „vigilant” eye on short selling activities.4

BACKGROUND

In the recent turn of events stemming from the collapse of the U.S. subprime market, to the failure in the market for mortgage backed securities, to the credit crunch that followed, the world is now suffering from the worst financial crisis since the Wall Street crash of 1929.5 Much of this economic turmoil is rooted in unsatisfactory regulatory regimes that allowed for the creation of asset backed securities with misrepresented risk profiles, and the irresponsible sales of these high risk repackaged mortgage securities to investors. When the subprime market fell, financial institutions and banks that invested in these high risk products suffered enormous losses. Two large financial institutions, Bear Stearns and Lehman Brothers were even forced into their sale and bankruptcy respectively, affecting millions of individuals around the world directly and indirectly. Amidst major dips in the financial stocks, the devaluation of financial assets caused investors to panic, creating more unwanted market volatility which spread globally. It is

believed by some regulators and economists that such market volatility could be attributable to practices such as abusive short selling. It is during the downward spiral of the financial markets where it was believed that short sellers aggressively short sold stocks of troubled financial institutions, further driving down price indexes and adding to the severity of volatility in stock markets.

As mentioned, regulators worldwide have taken steps to ban short selling either temporarily or permanently. The U.S. was amongst the first to implement the ban to prevent investors from profiting in relation to the falling financial stocks\(^6\) and to immediately cover all short positions\(^7\), signaling a weakness in the enforceability of U.S.’s short selling law. In the U.S., the SEC halted the short selling of more than 800 financial stocks from September 19\(^{th}\), 2008 to October 2\(^{nd}\), 2008.\(^8\) Later, the SEC further extended the list of financial stocks from 800 to 950\(^9\) and prolonged the duration of the ban until Oct 8\(^{th}\), 2008.\(^10\) Shortly after, the U.S. SEC adopted a final rule on October 17\(^{th}\), 2008 that ordered a permanent adoption of its September Emergency Order.\(^11\) However, this paper will not touch upon the SEC adoption of the final rule.

The objective of the ban on short selling is to prevent market volatility and to minimize the deepening downturn of financial stocks. Countries around the world, including the United Kingdom, Australia, Switzerland, and Austria,\(^12\) have also followed the footsteps of the US in the ban of short selling. Hong Kong, as mentioned, has decided not to implement a ban on short selling. Some critics have stated that as restrictions on short


\(^{9}\) Reuters in Boston. “SEC under pressure to extend short-selling ban.”

\(^{10}\) 3 days after the after the $700 bn government payout plan is enacted as law (Chung, Joanna. “SEC Extends its ban on Short Selling.” Financial Time 2 Oct. 2008. 28 Oct. 2008 <http://www.ft.com/cms/s/0/b661c5e2-901b-11dd-9890-0000779fd18c.html/>.)


\(^{12}\) See note 6.
selling have been implemented around the world, it was feared that the Hong Kong market may become a target for abusive short selling activities. Nonetheless, the SFC claimed that since short selling in Hong Kong is an important and beneficial component of the well-run market, it should be allowed to continue under restrictive conditions to ensure that the Hong Kong market will not become a „casino” for short selling activities.\(^\text{13}\)

Although the ban on shorting financial stock is helpful in the way of maintaining financial stock value, hedge funds specializing in the business of short selling have been suffering great financial losses as a result of the ban.\(^\text{14}\) It was said that hedge funds in the US have lost from approximately 5% to 9% since the temporary ban was implemented, making the month of September 2008 the worst performing month for hedge funds in a decade.\(^\text{15}\) With the revelation of unfavorable events as a result of the SEC ban on short selling, once can see that the prohibition may not be an effective solution to the market manipulation problem. A more helpful solution may be to legislate with the aim to achieve a medium between the ban on short selling and its restrictive allowance. As it will be discussed later, short selling can have some positive impact on markets as it may provide liquidity. Yet, when loosely regulated, its use can be problematic and can cause unwanted market volatility. In recognition of this, legislators in Hong Kong have been able to effectively regulate short selling through allowing its practice only under a number of exceptions and enforcing the law by the backing of severe consequences.


SHORT SELLING

The Concept

Short selling is a widely-criticized and controversial trading technique where profits are made when a company’s share price decreases.\(^\text{16}\) This is in contrast to long positions that most long term investors take, namely, profiting when a company’s share price increases. According to the U.S. SEC, short selling is defined as:

“…the sale of a security that the seller does not own or that the seller owns but does not deliver. In order to deliver the security to the purchaser, the short seller will borrow the security, typically from a broker-dealer or an institutional investor.”\(^\text{17}\)

According to this definition, short sellers make their profits by selling a borrowed security at a high price, where s/he subsequently buys an identical security to return to the lender. The short sale is deemed to be complete when the seller has discharged his obligation to the lender by delivering the identical security to him to cover the short sale.\(^\text{18}\) Where it is believed that there is an overvaluation of stock prices, short sellers will borrow these speculative assets from other institutional investors, mainly pension funds, and sell the asset at a high price.\(^\text{19}\) In essence, short sellers reap profit from their doubt on the accuracy of the price of a security.\(^\text{20}\)


\(^{19}\) See note 6.

\(^{20}\) See note 16.
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**Ethics of Short Selling**

It has been said that this practice has an “underworld” quality about it as it is not an entirely understood concept and more often, it is thought of negatively. This is due to the idea of short sellers making a profit from the selling of securities they did not own. Moreover, short selling has been frequently associated with market turmoil. For example, during World War I, it was feared that the German Kaiser Wilhelm II would „surreptitiously” short sell the U.S. markets causing great fear of market turmoil. 21 Another example is the investigations concerning whether Osama bin Laden had short sold insurance and airline stocks prior to the incident of 9/11. 22 Although there is generally scorned feeling towards this trading technique, it is said that not all short selling is done with the speculation of a market decline, but may be used by professionals to facilitate other transactions. 23 Instead, some argued that short selling could also, in some cases, be a positive contribution to the stability in financial markets. According to these arguments, short selling plays a role in fraud discovery which may have been overlooked. Moreover, it was noted that short selling could in fact help in providing liquidity to the financial markets and driving down overpriced and inaccurately priced securities. 24

**Risks in Short Selling**

Short selling is an incredibly risky form of investment. This trading practice generally provides only a limited amount of gain (as prices can only fall to zero) and unlimited losses (since prices can rise limitlessly). 25 In turn, where the borrowed security is re-bought at a significantly higher price than when it was first sold, short sellers will have to personally „cover”, or buy-back the identical security at a higher price than the selling

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21 Ibid p.v.
22 Ibid.
25 See note 21.
price forcing the short seller to compensate for the difference and leading to a considerable amount of losses. Since stock prices have an upward trend over the long run, short seller may therefore find it increasingly difficult to cover their short positions in the long run. In situations where masses of short sellers attempt to cover their position all at once, the result will cause the price of the stock to increase, known as a short squeeze. As a result, short sellers may find it very difficult to cover their short position during a short squeeze, leading again to substantial losses.\(^{26}\) Hence, to achieve success in short selling requires one to have intrinsic financial sense, and the highest quality of market research.

**General Short Selling Laws**

Short selling is generally allowed in many jurisdictions around the world. However, some jurisdictions do not allow short selling due to the risks that it bears. Despite its ill-effects in a dipping economy, it is undeniable that it can be a profitable investment technique in certain situations. At Common Law, it is not unlawful to short sell if the vendor has the security ready to be delivered at the time of contractual completion.\(^{27}\) In jurisdictions with a relatively free market, namely the United States and Hong Kong, short selling has been regulated and closely observed. Nonetheless, some critics have supported such constraints as studies have shown that a reduction in short selling constraints could reduce transaction costs, increase the efficiency of markets and lower mispricing situations in the market.\(^{28}\)

According to market regulations worldwide, there are a number of restrictions on how a security could be sold short, these restrictions include the size, price and types of stocks. Mostly, the law on short selling details the circumstances in which securities can be lent and borrowed. Generally, situations where a short seller sell a stock they have not

\(^{26}\) See note 24.

\(^{27}\) *Hibblewhite v. McMorrin* [1839] 5 M&W 462, 151 ER 195.

\(^{28}\) Fung, Joseph K.W and Draper Paul. Mispricing of Index Futures Contracts and Short Sales Constraints. Hong Kong : Business Research Centre, School of Business, Hong Kong Baptist University. 1999. p.9.
sufficiently borrowed, otherwise known as naked short selling, is largely prohibited in most jurisdictions around the world. Since naked short sellers do not borrow the security s/he sells, s/he will not be able to deliver the security to the purchasers causing the trade to be unsettled and incomplete. When there is a failure to deliver a security, this will become problematic for the general efficiency of the trade settlement process. Furthermore, as there is a failure of delivery, the general liquidity of the financial markets may be affected. Therefore, the law has been shaped to regulate all aspects of securities lending and delivery systems, as well as the procedure of how a security could be sold short.

**SHORT SELLING LAW IN HONG KONG**

*A Brief History*

In Hong Kong, experience with short selling has not been a positive one. It was during the Asian Financial Crisis, where the prominence of short selling activities on the Hong Kong dollar that led the government to tighten its market regulations on a number of trading practices. During the crisis, the Hong Kong dollar was recognized as the only freely convertible currency in East Asia that had not depreciated against the U.S. dollar. The strength of the Hong Kong currency lured many; mainly U.S. based hedge funds, to launch a speculative attack on it by selling it short. Realizing the potential profitability of this speculation, commercial and merchant banks around the world stepped in to join

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30 This because where there is a failure to deliver (FTD), an entitlement to the security is traded, such a status acts as a „counterfeit” currency which is used temporary to maintain the liquidity of the market. However since it is only a temporary replacement of the FTD, the counterfeit security may dilute and destroy the value of the security deflating its share price because of its false supply. (Welborn, John W. “The „Phantom Shares” Menace: Naked Short Selling Distorts Shareholder Control.” Regulation: Securities and Exchange (Spring 2008). 18 Oct. 2008 <http://www.cato.org/pubs/regulation/regv31n1/v31n1-7.pdf>.)

In attempts to bar the potential negative effects of such activity on the currency value, the Hong Kong Monetary Authority (HKMA) sold much of the U.S. dollars in its reserve in return for the Hong Kong currency, leaving banks in Hong Kong scrambling for liquidity as the banks were short of the Hong Kong currency. Under such tense liquidity situations, Hong Kong banks found themselves in a „credit crunch” situation, causing the Hang Seng Index to drop significantly on October 23rd, 1997. The drop in the Index caused significant market turmoil, dubbing the day of the decline “Black Thursday”.

Short selling activities carried out during this time of crisis with the Hong Kong dollar was infamously known as “double market play” where foreign investors have taken up much of the Hong Kong dollar causing a rise in price, while acquiring short positions in the currency to reap its profits. It was believed that not only were foreign speculators involved in “double market play”, but they were also formulating malicious rumors and lies against the Hong Kong dollar in attempts to deepen the financial turmoil which allowed short sellers to profit from the falling markets in Hong Kong. This market manipulating tactic causing the instability of the currency is fundamentally problematic. Not only does it expose the markets to potential volatility, but such manipulative activities may also cause the weakening of local and international confidence in Hong Kong’s ability to regulate towards market fair-play. With the vulnerability of the Hong Kong currency reflecting the weakening of the Hong Kong market regulatory system, the effect of short selling on the Hong Kong dollar, nevertheless, contagiously spread worldwide triggering plunges in global stock markets.

In an effort to avoid the reoccurrence of “Black Thursday” and other potential crisis, the Hong Kong government revealed their plans to tighten short selling regulations in the financial stock markets, including criminalizing unreported short selling and increasing

32 Ibid.
33 Hedge funds have been building up Hong Kong dollar funds through swap loans from multinational institutions. Whilst at the same time, these funds have built up short positions in the securities and futures markets. With much Hong Kong’s liquidity being take up, causing the rise in inter-bank interest rates, financial market indexes are force to drop substantially allowing these short sellers to reap enormous profits. (See note 31. p.64.)
34 See note 31. p.65.
the penalty for illegal short selling from a $10,000 maximum fine and six months imprisonment, to a $100,000 maximum fine and two years imprisonment. Furthermore, the Hong Kong government along with the SFC undertook tougher measures to crack down illegal naked short selling activities by making it a mandatory obligation for short sellers to first borrow the security in order to short sell it.

**The General Law**

Learning from the effects of the Asian Financial Crisis, short selling laws in Hong Kong have become relatively stricter than most of other jurisdictions. The law governing the short selling activities in Hong Kong is the Securities and Futures Ordinance Cap 571 (SFO). Under s. 170 of the SFO, the provision sets out the general requirements that must be satisfied in order to validate a sale in securities. Thus, short sellers must comply with this provision in order to effect a short sale. Where there is non-compliance of these requirements, the vendor will be subject to criminal liability. Under Hong Kong law, naked short selling is prohibited, whereas only covered short selling or the selling of borrowed shares is permitted subject to certain requirements. According to s.170(1) of the SFO, it is said that subject to certain exceptions, that a person shall not sell securities through a recognized stock market unless at the time he sells them, he has (or if he is selling as an agent, his principle has) a presently exercisable and unconditional right to vest the securities in the purchaser. However, if the person selling a security has a reasonable belief that he has or his principle has this exercisable right, he will fall within the section. On this ground, the vendor must prove his honest and reasonable belief beyond a reasonable doubt.

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35 See note 31. p.89.
36 S.170(2)(b) of the SFO.
37 Where a trade does not first own the asset in question or if he is not able to establish he is able to borrow the relevant asset before selling.
To legally short sell in Hong Kong, a short seller must hold an exercisable and unconditional right to vest the security in accordance to his discretion. The requirement is to ensure that in the event where a short seller wishes to sell a security they do not own, the security must be effectively borrowed\(^{40}\) by the short seller and that the person either has, or should have the reasonable and honest belief that s/he has a right to dispose of the shares. As a result, when a short seller disposes of the security without borrowing it, then the short seller will be criminally liable under s.170 of the SFO for naked short selling.\(^{42}\) Furthermore, the sale of the security must be done through a recognized stock market; hence, this prohibition will not be applicable to off-exchange short sales.\(^{43}\)

For the short transactions to be carried out in a recognized stock exchange, short sellers are to transact subject to the security market trading rules. Under the Hong Kong Stock Exchange regulations, short sellers are to trade subject to the „tick rule”. This rule could be best described such that no short sale could be made below the best current ask price. Adding to the existing provisions, short selling in Hong Kong can only be done on a number of exchange qualified securities listed in the “Designated Securities Eligible for Short Selling”.\(^{44}\) Moreover, to be an eligible participant of short selling activities within the stock exchange, Exchange Participants must comply with the requirements listed in the Rules of Exchange. However, these requirements will not be applicable to certain Exchange Participant listed under Schedule 14, 15 and 17 of the Rules of the Exchange.

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\(^{39}\) s.170(2)(c) of SFO.

\(^{40}\) The lending and borrowing of securities are governed by the Sixth Schedule of the Hong Kong Exchange and Clearing Rules and the Central Clearing and Settlement System Regulations.

\(^{41}\) R v. Lam Nai Sum Robin [1991] 2 HKC 582.

\(^{42}\) s.170(4) of the SFO.

\(^{43}\) s.170(1) of the SFO, Tullet & Tokyo International Securities Ltd v. APC Securities Co Ltd (Formerly known as Dharmala Securities Co Ltd) [2001] 2HKLRD 356, CA.

Exception to the General Law

Under s.170(3) of the SFO, a number of exceptions to the general short selling law are listed. Such exceptions include that if the short seller acts in good faith, believing or have reasonable grounds to believe that s/he (as a seller or where a representative of an intermediary with a Type 1 regulated activity) has the right, title or interest to sell the security short. Another exception is the security being sold by an exchange participant, who is acting as a principle and is acting in the course of his business of dealing in odd lots of securities (otherwise known as a parcel that is less than one marketable parcel) in accordance with recognized exchange company operating a stock market. Furthermore, where a security sale was done pursuant to an options contract, such transactions are also exempted. Lastly, and perhaps the most important exception to the general restriction on short selling is the class of transactions listed under Securities and Futures (Short Selling and Securities Borrowing and Lending (Miscellaneous)) Rules Cap 571R (SFR).

According to SFR, short selling done by HKMA appointed Market Makers, or its agents, of Exchange Fund Bills, Exchange Fund Notes and specific instruments under s.2 SFR, are exempted from the general short selling restriction. Also, the general restriction on short sales of securities would be inapplicable where the sale is conducted in the course of “jobbing business”. “Jobbing business”, in accordance to s.3(2) of the SFR, includes sale of securities by Securities Market Maker in performing market making or liquidity providing activities, on the exception that the Securities Market Maker acquires the right to vest the security to the purchaser before the end of the day of sale. Accordingly, “jobbing business” also includes where the short sales of security is done for the purpose

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45 s.170(3)(a) and s.170(3)(a) of the SFO.
47 s.170(3)(c) of the SFO.
48 s.170(3)(d) of the SFO.
49 S.397 of the SFO.
50 s.3(1)(c) of the SFR.
51 S.3(2)(c) of the SFR.
of hedging the risk of a position previously acquired in another listed company\textsuperscript{52}, or a futures contract\textsuperscript{53} whether in respect of another security\textsuperscript{54}. This provision is particularly important, as it allows investors of long positions to hedge their risk by short selling their stocks, while the stock will not be affected by price movements as a result of hedging.

\textit{Requirement to Confirm an ‘exercisable and unconditional right’ to Short Sell}

In s.171 of the SFO, this section sets out the requirements a short seller must comply with if s/he is authorized or has authorized his/her agent to short sell.\textsuperscript{55} Firstly a person selling as a principle or agent, shall not convey a short selling order (as defined in section 1 of Part 1 of Schedule 1 of the SFO) unless s/he has provided his/her agent or receive from his/her principal, an assurance, either orally subject to certain conditions\textsuperscript{56} or in the form of a document, that s/he has a presently exercisable and unconditional right to vest the property to the purchaser. Also, an assurance by the lending party must also be received, confirming that the lender has the security available to lend and deliver to him/her.\textsuperscript{57} An exchange participant who wishes to participate in short selling must receive a similar assurance of a security”s loan and delivery in order to short sell.\textsuperscript{58} Any breaches in this provision will cause a person to be liable on conviction to a fine at level 5\textsuperscript{59} and to imprisonment for 1 year.\textsuperscript{60} However, a defence to this charge would be available within this provision if the vendor placing the order did not know or had a reasonable belief that the order was not a short selling order.\textsuperscript{61}

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\textsuperscript{52} s.3(2)(a) of the SFR.
\textsuperscript{53} s.3(2)(b)(i) of the SFR.
\textsuperscript{54} s.3(2)(b)(ii) of the SFR.
\textsuperscript{56} S.4 of the SFR.
\textsuperscript{57} S.171(1) of the SFO and s.171(5) of the SFO.
\textsuperscript{58} s.171(2) of the SFO.
\textsuperscript{59} From $25,000 to $50,000. Schedule 8 of the Criminal Procedure Ordinance Cap 221.
\textsuperscript{60} s.171(12) of the SFO.
\textsuperscript{61} s.171(11) of the SFO.
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Requirement to disclose short sell

Short selling practices in Hong Kong are subject to disclosure obligations for exchange participants (or their representatives, who are aware of the short sale of securities). Under s.172 of the SFO, where an exchange participant or its representative knows or is informed of the short sell order, the exchange participant or its representative will have to inform the person who is to input the order into the trading system, that the order is a short sale order. Moreover, if the exchange participant or its representative is to input the order into the trading system themselves, s/he must also indicate that the order is a short sell order in accordance to the exchange rules. Failure to comply with such disclosure requirements will render the offender liable up to a level 5 fine and 1 year imprisonment.

SHORT SELLING LAW IN THE UNITED STATES

A Brief History

The U.S. congress previously granted SEC the authority to regulate short selling laws to prevent short sellers from causing and accelerating declines in the markets. Concerns of short selling techniques in the U.S. have traditionally been under scrutiny as they have elicited a long standing controversy amongst financial sectors in the world. Short selling in the U.S. stock market has been generally prohibited before 1930’s. The importance of regulating short selling lies within the general fear of its misuse specifically with insider trading, “dubious” takeover strategies, and bear raids. A bear raid is when...
there is a rising market in which speculators or short sellers see a market decline in the near future and therefore drive down prices to „cover” their position at a reduced price. Bear raids are recognized as a form of market manipulation and have appeared historically during financial turmoil, particularly during the crash of 1929.71

Another basis of the short selling law in the U.S. is the need to regulate against abusive short selling practices, such as “naked” short selling. Although a vast majority of short selling is legally allowed in the U.S., it is illegal for a vendor not to have the securities borrowed in time to make the delivery to the purchaser within the prescribed settlement period.72 Naked short selling in certain circumstances are not illegal under U.S. Federal Securities law as it is recognized that such a trading technique does in fact contribute to market liquidity. This positive contribution takes place when a particular security is thinly traded or illiquid, naked short selling can in fact stimulate market transactions to accommodate for such a security without arranging to borrow it.73 It is also recognized that naked short selling practices are performed with legitimate reasons. For instance, where there is a surge of interest in the particular security making it hard to borrow or where there are a limited number of market makers selling that particular security, for the sake of efficiency, the security may be forced to be traded first before the arrangement of borrowing that security.74 Nevertheless the primary goal of the U.S. law is to target those who do not deliver the securities sold short, rather than selling the security without first borrowing it.

In 1931, the U.S. stock market had only prohibited short selling where stocks were shorted at a downtick.75 Later, short sales are allowed subject to the uptick rule, also

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70 Ibid. P.9
71 Ibid.
73 Ibid.
74 Ibid.
known as the tick test\textsuperscript{76}, or the zero-plus tick\textsuperscript{77,78} The purpose of such standards set by law is that the U.S. SEC sought to avoid over-regulating short selling practices in an advancing market. Additionally, the tick rule aimed to prevent such short selling activities from being practiced during excessively low prices as they may potentially drive down the market and decelerate price levels.\textsuperscript{79}

\textbf{The General Law}

Today, the U.S. law governing short selling of securities is called Regulation SHO. This regulation was adopted on June 23, 2004 by the SEC under the Securities Exchange Act of 1934 (“Exchange Act”) to update short sale regulations.\textsuperscript{80} The SEC had later amended the regulation a number of times with the aim to impose close-out requirements\textsuperscript{81} in attempts to address the failures in stock delivery on trade settlement date, and to target abusive “naked” short selling of certain securities.\textsuperscript{82} Within these regulations, the SEC promulgated two main rules that collectively regulate short selling practices.\textsuperscript{83}

\begin{itemize}
\item[76] Where the short sales are conducted where current prices is higher than the price of the previous trade.
\item[77] Where the current price remains unchanged but traded higher than the last trade at a difference price.
\item[78] See note 75.
\item[80] Regulation SHO was proposed and has effectively replaced Rule 3b-3, 10a-1 and 10a-2 of the Exchange Act.
\item[81] “close out” means returning the security to the rightful owner by either buying an equivalent stock from the open market or using the equivalent stock the borrower already owns.
\item[83] There were 5 rules proposed. 3 rules however, were not adopted was: rule 201 which specifies the inapplicability of any short sale price test and no other rule set by any self-regulatory organization should contravene this rule. The purpose of this rule is to implement a uniform price test for exchange listed and Nasdaq NMS securities. This test is to be based on the consolidated best bid rather than the uptick rule; Rule 202T was to provide a procedure for the SEC to suspend, on tentative bases, the trading restrictions of the short sale price test (“tick” test) of the SEC as well as any exchange or national association. For the short sales of certain designated securities, consideration must be given to the security’s liquidity, volatility, market depth and trading market. Moreover, it must be by order as necessary or appropriate in the public interest and consistent with investor protection. This test program however, only lasted from
\end{itemize}
RULE 200: Definition of “Short Sale” and Marking Requirements

Under this rule, the concept of ownership of a security is defined. Ownership, according to this rule is where a person or his agent has title to the security; where s/he purchased or has entered into an unconditional contract to purchase it but yet to have received it; where s/he owns and tendered a security convertible into or exchangeable for it; where the person has an option to it, where the person has rights or warrant to subscribe or to exercise it; or where the person hold a security futures contract to purchase it. Therefore, when the possession of securities does not fall within the definition of ownership under this rule, it will be considered to be a borrowed security. This definition was said to be in place to address the status of security future products and unconditional contracts to be purchased. The rule also defines the concept of ownership for a broker, dealer or a broker-dealer where their aggregate net position is not long. In addition to the definition of ownership, the rule requires the marking of sales (ie. “long”, “short”, “short exempt”) in all equity securities by broker-dealers. According to the SEC, the purpose of this marking scheme is to make it a requirement that only the sale of vendor-owned securities can be marked “long”, whereas the sale of borrowed securities would be marked as “short”. Moreover, the market requirement is in place to ensure that the borrowed securities to be delivered are or will be in physical possession or control of the broker-dealer’s possession prior to settlement.

84 17 C.F.R. § 242.200(b)
86 17 C.F.R. § 242.200(b) and 17 C.F.R. § 242.200(e).
87 See note 85. 17 C.F.R. § 242.200(g)(1).
RULE 203: Uniform Locate and Delivery Requirements

In sum, rule 203 requires the short sellers to borrow the securities before selling. This provision is said to incorporate provisions of existing self-regulatory organization’s “locate” rules into a uniform SEC rule to be applicable in all securities traded. The rule is divided into two subsections, one regarding long sales and one regarding short sales. According to the regulations regarding long sales, where a broker or dealer knows or reasonably knows that the security is, or to be, effected and the order is marked “long”, the broker or dealer shall not lend or arrange for its loan after the sale, nor shall s/he fail to deliver it upon its delivery due date.  

The long sale subsection also lists a number of exceptions to the rule against loaning a security order that is marked as a “long sale”. Such exception includes; 1.) a security loan by broker or dealer through the medium of a loan to another broker or dealer, 2.) if the vendor fails to deliver the security where the purchaser knows or has been reasonably informed by the vendor that the vendor owns the security, 3.) where the mistake transaction was discovered which would cause undue hardship from covering the transaction, 4.) or if the mistake was made permissible under a short sale price test. Another exception applies if prior to any loan or delivery related transaction, a national securities exchange or a securities association finds the sale was made as a result of a mistake made in good faith, or that due diligence was exercised to comply with the required marking procedures.

According to the regulation on short sales, it is stipulated that a short sale order shall not be accepted or effected by a broker or dealer unless 1.) the broker or dealer had borrowed the security or entered into a bona fide borrowing arrangement; unless the broker or dealer who has reasonable grounds to believe that security can be borrowed so it can be delivered on the due date; and 2.) the compliance of this section is documented. Like the regulation on long sales, a number of exceptions to this provision on short sales are

88 17 C.F.R. § 242.203(a)(1).
89 17 C.F.R. § 242.203(a)(2).
91 17 C.F.R. § 242.203(b)(1).
also listed.\footnote{17 C.F.R. § 242.203(b)(2).} The regulation on short sales will not apply to 1.) a broker or dealer that has accepted a short sale order from another registered broker or dealer and has undertaken the responsibility for compliance with the said provision; 2.) any sale is deemed to be owned pursuant to rule 200 provided that the broker or dealer has been reasonably informed that the person intends to deliver the security as soon as all restrictions on delivery has been removed; 3.) short sales effected by market maker in connection with bona fide market making activities, and transactions in securities futures. Rule 203 also stipulates that if a participant of a registered clearing agency has fail to deliver position at a registered clearing agency at a threshold security for thirteen consecutive days, the participant must immediately close out their position. However, this rule is subject to certain exceptions as well.\footnote{One exception is that if the said participant has failed to deliver the position in the threshold security\footnote{Also this exception will be applicable where the said participant security of the failed delivery was sold pursuant to Rule 230.144\textsuperscript{97} for thirty-five days and it will also be applicable where the failure to deliver in a threshold security has previously accepted from the close-out requirement of this section. Also this exception will apply where the said participant reasonably allocates a portion of a fail to deliver position to another registered broker or dealer for which it clears trades or for which it is responsible for settlement.} on the effective date of the amendment to this law and had been previously “grandfathered” from the close out requirement, meaning where the position was established prior to the security becoming a threshold security (such an exception was eliminated in 2007).\textsuperscript{97} Also this exception will be applicable where the said participant security of the failed delivery was sold pursuant to Rule 230.144\textsuperscript{97} for thirty-five days and it will also be applicable where the failure to deliver in a threshold security has previously accepted from the close-out requirement of this section. Also this exception will apply where the said participant reasonably allocates a portion of a fail to deliver position to another registered broker or dealer for which it clears trades or for which it is responsible for settlement.}  

\section*{A COMPARISON IN LAW}  

\textit{The Big Picture}  

Each set of laws is unique in their own right in terms of their general approach to regulating short selling activities. Nonetheless, the U.S. law regulates the legality of short selling by extensively defining its the parameters. This is done by firstly narrowing the allowed transactions with a clear definition of what ownership of securities is in order to distinguish it from borrowed securities in short sales. Where a transaction is defined as a short sale; the transaction is subject to certain requirements listed in Regulation SHO. In Hong Kong however, the approach to regulating short selling is quite different, as the
law aims to define the type of trading practice allowed by restricting what type of transaction is generally not allowed. Under the Hong Kong law, subject to certain exceptions, a vendor is prohibited from selling the security when he does not have a legal right to it. Since short selling is where the vendor acquires a legal right to sell the security by borrowing it, such a trading practice will fall outside the general restriction in Hong Kong.

One major problem of the U.S. law on short selling is the frequency of changes in the law. From the replacement of the old short selling law with the Regulation SHO in 2004, the U.S. law on short selling has been already been amended twice within the last 4 years. In Hong Kong on the other hand, the short selling law was last amended in 2003. The frequency of the amendments in the U.S. law reveals that the underlying foundation of the short selling law is relatively weak with regards to its applicability and enforceability. Since the U.S. law on short selling initially offers too many exceptions to the general short selling rules, the law had created many unforeseen problems and loopholes. This can be reflected from the types of amendments made on the Regulation SHO. The said amendments involves the elimination of certain short selling exceptions and tightening the eligibility of available exceptions, such as the removal of the “grandfathering” clause and the imposition of a tighter close-out requirement for short sellers who are exempted from the general law. The constant need for amendments and the frequency of change in law incidentally creates a lack of legal certainty which may cause difficulties for law abiders to comply with the law. Therefore, the need to frequently amend the law signifies a general limitation on the effectiveness of the U.S. short selling law.


95 See note 94.
Legislative Intent

Both jurisdictions have promulgated their laws according to the general principle of short selling; where a person sells a security s/he does not have or own. In terms of the objective of short selling laws in Hong Kong, it is clear that these laws aim to prevent intended market manipulation and abusive short selling by emphasizing the importance of transparency through disclosure notices and audit trails. Within the Hong Kong laws on short selling, there is an obligation for short sellers to provide documentary confirmation to show that the sale to be shorted is properly arranged and is to be covered. Whereas the laws in the U.S., the law governing short selling tend to target more specific situations such as failure to deliver borrowed securities sold to the purchaser. By regulating against such situations, the SEC believes it can prevent unwanted hindrances on the efficiency of the trade settlement systems. In this regard, the specificity of the short selling law in the U.S. renders it to be narrowly applied to specific situations to prevent specific unwanted outcomes. With a shift in focus from their original objective of regulating against ongoing abusive short selling activities, to targeting specific short selling problems, the U.S. law may run into a difficulty with guarding against their initial fears of other possible market manipulating practices in regards to short selling. Thus, with the simplification its law, Hong Kong is more capable of successfully regulating short selling activities against any possible unwanted events as the law is more restrictive in the permissibility of short sales by ways of its broad application on a variety of circumstances.

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U.S.’s “Ownership” requirement vs. Hong Kong’s “Presently exercisable and unconditional right” requirement

While the style of regulating short selling is different between the two jurisdictions, the recognition on the importance of a short seller’s borrowed legal right to sell the security is ultimately the same. Although under both laws, a short seller must have a legal right to sell the security, the two jurisdictions however, have a very different take on the concept of the legal right. The difference in concept of the legal right can be reflected on the wording which the law makers chose to use in each jurisdiction.

Under the U.S. law, rule 200(b) of Regulation SHO states that a person will be in the conduct of short selling if s/he sells a security s/he does not own.\(^\text{97}\) Moreover, a person shall be deemed to own a security if s/he fits into the extensively listed criteria.\(^\text{98}\) In essence, where a person sufficiently “owns” the security as specified in the listed criteria and will be in possession of it, the sale will not be recognized as a short sale.\(^\text{99}\) Although this use of language offers a high degree of certainty, the extensive definition of ownership may allow some unforeseeable trading practices (which may have otherwise been considered as short selling in nature) to be conducted free from the appropriate short selling regulations.

Under Hong Kong law, it is stipulated that selling of securities is only allowed where the person has “a presently exercisable and unconditional right to vest the securities in a

\(^{97}\) 17 C.F.R. § 242.200(b).
\(^{98}\) 1.) The person or his agent has title to it;
2.) The person has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase it, but has not yet received it; or
3.) The person owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange; or
4.) The person has an option to purchase or acquire it and has exercised such option; or
5.) The person has rights or warrants to subscribe to it and has exercised such rights or warrants; or
6.) The person holds a security futures contract to purchase it and has received notice that the position will be physically settled and is irrevocably bound to receive the underlying security.

Such an exercisable and unconditional right is generally defined as the circumstance in which the person has the absolute right to have the security vested in him or in accordance to his discretion. According to the wording of the s.170 of the SFO, it is indicative that the Hong Kong government and the SFC recognize that there may be unforeseeable situations where a vendor may have the legal title or right to sell the security but does not in a sense "own" it. An example of this situation is when a vendor may have obtained a “hold notice” or a “blanket assurance” from the lender to borrow the amount but for some reason, the security was eventually not made available for its borrowing or its delivery to the purchaser. This is because at the time of the sale, the vendor had an honest and reasonable belief that the proper arrangements have been made to deliver the security to the purchaser and therefore, at that time, the vendor had acquired the necessary exercisable and unconditional right to vest the security in the purchaser.

The U.S. law is seemingly complicated on the coverage of its short selling regulations and can easily cause great confusion. As a whole, the U.S. law on short selling is relatively specific on its application as compared to the Hong Kong law. In the U.S., the short selling law is dependent on whether the seller owns the security or not, whereas in Hong Kong, the law focuses on whether the seller has acquired the legal right to sell the security. With the extensive nature of the definition of ownership in the U.S. short selling law, the law became overly complicated and technical, leaving room for potential loopholes. On the other hand, the Hong Kong law on short selling is relatively straightforward and seems to have full regard to the vast possibilities of rights that may be vested in a person to short sell a security regardless of its ownership.

Although it may be argued that a vague and imprecise nature of the Hong Kong legislation may cause difficulty for it to have any meaningful enforcement, the rigidity of

\[100\] S.170(1) of the SFO.
\[101\] s.170(2)(b) of the SFO.
\[103\] Ibid.
the U.S. provision leading to potential loopholes may bring about potentially more problems if traders can develop creatively new abusive short selling tactics through these loopholes. In consideration of investment creativity and the increasing variety in investment techniques, the simplification of the Hong Kong short selling law is capable of preserving its flexibility and applicability upon trading strategies that may be developed in the future, making the Hong Kong law is more resistant to future short selling techniques. Further, seeing as the premise for market regulation is to protect the capital markets as a whole, law makers should keep the short selling regulations relatively simple such that these regulations can be effectively used to serve in the interests of the financial markets and community.

**U.S.’s “Easy/Hard to Borrow” Lists vs. Hong Kong’s Assurance Rule**

The effectiveness of short selling is generally dependent on the consensus of the lender and borrower that the security would be lent out or borrowed at a certain instance. A failure to successfully organize a “borrow and delivery” arrangement for a security, it can potentially impede the liquidity of the market particularly the trade settlement system. Having understood the workings of a fast paced market system, regulators from both Hong Kong and the U.S. recognize that an effective lending-borrowing arrangement may be overlooked from time to time. This is because it is ultimately inefficient for market participants to ensure that every little step is followed through in situations where time is of the essence. To deal with these situations, Hong Kong and the U.S. have developed very different systems to accommodate to them.

Under the U.S. short selling law Regulation SHO rule 203(b)(1), it stipulates that prior to accepting any order for short selling or prior to giving effect to the short sale, the short seller must “locate” the securities available for borrowing and document it.\(^{104}\) This is done by either borrowing or entering into a bona-fide arrangement to borrow a

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\(^{104}\) See note 99.
security.105 This rule is to be complied with and performed by the person on whose account the short sale is to be executed. However, the requirement to “locate” may also be satisfied where the borrower has reasonable grounds to believe that the security can be borrowed and delivered at a certain time.106 The determination of “reasonable grounds” can be said to be satisfied if the security to be borrowed is listed in the “Easy to borrow” list.107 According to the SEC, designated lists of securities such as the “Easy to Borrow” list will provide an accurate assessment of the current lending market to establish what types of securities are available for loans. Therefore, when a security is listed on the “Easy to borrow” list, this may be a ground for a short seller to reasonably believe that the security intending to be sold short would be available for borrowing.108 As a result, not only can a market participant rely on these lists to establish the availability for a security for shorting, but this mechanism can also be used to guard against potential delivery failures and trade settlement problems.

Alternatively, under Hong Kong law, the problem with settlement failures are resolved by making it a legal obligation for short sellers, their agents who receive and execute short selling orders, and exchange participants (selling as a principal or an agent) to report short sales. Under s.171 of the SFO, the provision stipulates the necessity of the said parties to either provide or receive documented assurances that the security has been sufficiently borrowed at the time of the short selling order is placed. For instance, where the short seller is selling the security as a principal, s/he must not convey the short selling order unless s/he provides to his/her agent an assurance that s/he has a presently exercisable and unconditional right to vest the security on the purchaser.109 Similarly, a short seller selling as an agent must receive a similar documented assurance from his principal before accepting or conveying the short sales order.110 Also, an exchange participant must also receive this assurance prior to executing a short sale order.111
However, as provided by the provision, where a person fails to comply with the said obligations will be held liable, unless s/he pleads a successful defence of either believing or reasonably believing that the order was not a short sale order or s/he did not know it was a short sales order.

The main difference between the Hong Kong and U.S. requirements on securities borrowing in regards to short selling transactions is that the Hong Kong law creates legal obligation for parties of a short sale to provide and receive actual assurance that the security has been effectively borrowed, rather than having a mere reasonable ground to believe that the security has been borrowed. Whereas in the U.S., the fact that the short selling law has a „reasonable belief” standard to regulate the assurance of a security is to be effectively borrowed prior to its sales, may not provide enough certainty to ensure that the securities borrowed can in fact be delivered. In Hong Kong, the standard for ensuring that the security is borrowed before its sale is much greater than that of the U.S. The basis for the effectiveness of the Hong Kong obligation of assurance is the recognition that it may not be practically possible whilst it is burdensome to leave the obligation to a short seller to investigate and identify whether the security is available to be sold short. Therefore, it is more practical to have the short seller and lender work together to attain assurance that the security is available for borrowing. Setting a reasonable belief standard that the security is borrowed would likely give rise to unwanted leniency and a potential for loopholes, as this reasonableness standard makes the rule easy to achieve by wrongdoers and hard to build a prima facie case against wrongdoers’ reasonable belief by the prosecution.\(^{112}\)

**Market Making Exception**

As mentioned, short sales are generally allowed in the U.S. and Hong Kong, subject to the general prohibition on the sales of securities of pre-borrowed. Naked short selling of this sort is illegal, as this trading technique is potentially harmful to a smooth running of

\(^{112}\) See note 29.
a financial market. Yet, in light of the possible need to facilitate transactions, market makers as an exception have been granted a permission to conduct naked short selling, or the selling of securities to which they do not have sufficient title. By means of this exception, liquidity providing market makers are able to save processing time and expenses that may be involved with the pre-borrowing requirement in a short sale. With this acknowledgment, both Hong Kong and the U.S. have excused market makers from the necessary compliance to the pre-borrowing rule. Although market makers who short sell are generally exempt, the laws in each jurisdiction regarding the exemption are slightly different from each other.

In the U.S., as previously pointed out, the general rule for short sales is that a broker or dealer may not accept a short sale order unless they have borrowed, entered into a bona-fide arrangement to borrow or reasonable grounds to believe that the security is borrowed. This rule, however, is subject to a number of exceptions, where one of which includes short sales that are carried out by a market maker in connection with bona-fide market making. Although a market maker under this provision is eligible to short sale without first borrowing the security, the market maker nevertheless will be subject to a close-out requirement. This close out requirement is that where a market maker fails to deliver the security for thirteen consecutive settlement days, then s/he shall immediately thereafter close out the fail-to-deliver position.

In Hong Kong, a short seller must generally attain a presently exercisable and unconditional right to vest a security to the purchaser. As mentioned previously, this general rule is subject to a number of exceptions. Like the law in the U.S., there is a general exception to this rule where the sale of securities is carried out in the course of

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113 17 C.F.R. § 242.203(b)(2)(iii) and s.3(1) of the SFR Cap 571R.
114 17 C.F.R. § 242.203(b)(1).
115 A market maker is a specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis. 15 U.S.C. § 78c(a)(38).
117 17 C.F.R. § 242.203(b)(3).
118 s.170 of the SFO.
conducting jobbing business. As mentioned, “jobbing business” includes sale of securities by stock exchange registered market maker in performing market making or liquidity providing activities. Under the Hong Kong law, market makers registered at the stock exchange, like those in the U.S., are exempted from the general rule which imposes the obligation of first borrowing the security before its sale. However, under the Hong Kong law, the close-out requirement for these securities trader is far more stringent. Under the SFR, market makers are to acquire the right to the borrowed security by the end of the next trading day of the sale, whereby the short selling order is to be settled subsequently by buying back the securities.

In comparison to the Hong Kong market maker exception, it is evident that the exception to the general rule is quite restrictive. With respect to the U.S. market maker exception, market makers being given a thirteen day close-out leeway are potentially dangerous since it may leave room for market participants to abuse this exception. It has been widely criticized by commentators, that this U.S. market making exception is a well known tool for manipulators and that this window of time would allow market participants to utilize their creativity to roll the failed position from one to the next. For this reason, the drafted restrictions in the Hong Kong market maker exception, as compared to the U.S., are relatively successful in terms of regulating towards timely short sale execution.

119 r.3(1)(c) of the SFR.
120 s.2 of SFR states: “Securities Market Maker… means a person who is registered with the Stock Exchange for the Company for the purpose of performing, in accordance with rules made by the Stock Exchange Company, market making or liquidity providing activities in respect of securities listed or admitted to trading on the recognized stock market it operates or an issuer of any structured product listed on the recognized stock market operated by the Stock Exchange Company under Chapter 15A of the listing rules.”
121 Securities and Futures (Short Selling and Securities Borrowing and Lending (Miscellaneous)) Rules Cap 571R.
122 r.3(2)(c) of the SFR.
Consequences of Breach

Perhaps the most notable difference between the Hong Kong law on short selling and the U.S. law is the disciplinary action taken in case of a breach. In the U.S., the short selling laws stipulated under Regulation SHO are silent as to the penalties to be imposed on violators of the rules. Rather, the enforcement of these rules and the disciplinary actions taken in its breach seem to be conducted by the stock exchanges themselves. In some cases, those who have been prosecuted by the stock exchanges (New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX)) for violating the SEC rules have been hit with a penalties and fines of over millions of dollars. For instance, in July 2007, AMEX had imposed penalties with a total of US$8 million on two options market makers for violating Regulation SHO. However, not all violations of the short selling law result in a costly fine. In 2006, the NYSE had brought disciplinary action against four investment institutions where the penalty only totaled at US$1.25 million. With the cases of violation only resulting in fines, the disciplinary effect for these short sellers may only amount to a small slap on the wrist. As the profits from abusive short selling can be astronomical, it may be a profitable risk for short sellers to violate the current rules. For this reason, the success of the enforcement of short selling rules in the U.S. remains doubtful.

Although breaching a short selling regulation in the U.S. results in millions of dollars in fines, the Hong Kong regulations on the other hand, stipulates that those who contravene the short selling rules are liable upon conviction with a fine and imprisonment. For instance, according to s.170 of the SFO, those who do not borrow securities prior to selling them may be liable upon conviction to a fine at level 6 and to imprisonment for 2 years. Although the level 6 fine (as the highest penalty) is substantially lower than that of the reported fines in the U.S., Hong Kong courts are however able to impose

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124 See note 29.
125 Ibid.
126 The four institutions were; Daiwa Securities America, Goldman Sachs Execution and and Clearing, Citigroup Global Markets, and Credit Suisse Securities (USA). (See note 29.)
127 Ranges anywhere from HK$50,001 to HK$100,000. Schedule 8 of the Criminal Procedure Ordinance Cap 221.
128 s.170(4) of the SFO.
criminal liability upon the contravention of law. Moreover, the penalties stipulated within these short selling provisions can possibly be interpreted as offences with strict liability. Therefore, as compared to the U.S. law, Hong Kong enforcement of the short selling laws is more vigorous in regards to its noncompliance, and therefore those who contravene the short selling law will be subject to not only a fine but imprisonment.

The force behind the enforceability of every law is vitally important to ensure the compliance with the law. Therefore, to guarantee compliance, regulators must enforce and impose meaningful penalties to punish law violators and discourage those from abusing the system. In the U.S., the penalty for violation is a substantial fine. When compared to the maximum fines stipulated in Hong Kong’s legislations, the penalty was still not authoritative enough since breaches such as settlement failures still continued to rise indicating that the market participants were fearless with of the consequences. Hong Kong has been successful in deterring short sellers from breaching the law by imposing criminal liability. While on the other hand, the U.S. may want to take action towards reforming their laws by defining what types of liability may be imposed and possibly introducing criminal liability as an additional form of punishment.

CONCLUSION

Today’s ever evolving investment strategies are growing in numbers. The developing techniques used are not only budding from the wisdom of early investors, but these techniques are also gradually more complex making it difficult to regulate against. As market participants are becoming increasingly familiar with the legal parameters of the market activities, market participants are beginning to expand their investment strategies in search for loopholes around the law. With this in mind, regulators have attempted to carefully craft the laws in hopes that they will satisfy the needs of market integrity. Laws, like the laws on short selling, are enacted for the purpose of protecting the market and other affected parties from potentially abusive market manipulation. Unfortunately, the truth about regulating highly intricate trading practices, like short sales, is that where
there is high level of complexity in the practice regulators aim to control; it usually calls for legal sophistication. Consequently, overly complex and technical regulations sometimes may not work in the best interest of society.

In the context of short selling laws, Hong Kong and the U.S. have had a relatively long history with regulating short selling activity. However, the U.S. comparatively has had more experience regulating against short selling than Hong Kong. Since short selling activities have appeared relatively earlier in the U.S. than in Hong Kong, the laws that govern these activities in the U.S. are naturally more elaborated as they have been amended continuously to adopt to market needs and ongoing short selling-related problems. Because the short selling law in the U.S. is highly developed with its restrictions and exceptions, the law itself is full of loopholes leading to its inadequate enforcement. As an eventual outcome to this general weakness, major institutions around the world had been closed down along with the fall of the global financial market. The U.S. government, however, had recognized this potential setback with their short selling law and had attempted to rectify the situation by implementing a temporary ban on short selling.

Ultimately, the short selling laws in the U.S. are not entirely the underlying problem to the deepening fall of the financial markets, but the practice of reckless capitalism. Although the U.S. financial markets are one of the most notorious playing grounds for investors, their free-market status will inevitably lead to more manipulative trading tactics other than short selling. While Hong Kong also has a relatively free market that attracts prospective investors, the laws in place will cause market manipulators like short sellers to find themselves, more or less, in a great deal of difficulty in trying to make a quick buck from a falling market. Therefore, whether or not short selling activities are in fact a major contributor to the intensifying the worst global financial crisis in decades, regulators around the world should reflect on their regulatory regimes in place to ensure that the laws against short selling or market manipulating activities alike, are enforced strictly to preserve the integrity of the markets and the confidence in the financial system as a whole.
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