Box 4.1

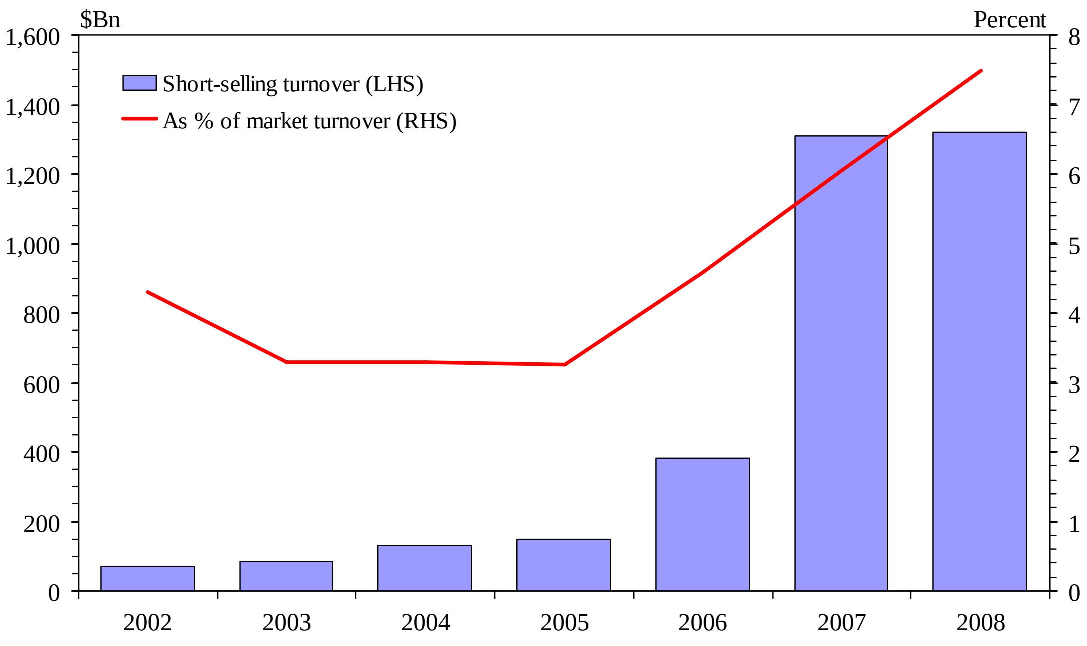
Equity short-selling[1] activity in Hong Kong

Short-selling helps price discovery, encourages trading and adds to market depth in the equity market. The more liquid the market, the narrower the bid-ask spreads can normally be found. In the past several years, short-selling has grown robustly in Hong Kong. But in the aftermath of the global financial turmoil, some overseas jurisdictions have introduced temporary measures to restrict or suspend such activity. The Securities and Futures Commission (SFC) has published two reports examining short-selling activity in the Hong Kong stock market, in October 2008 and April 2009 respectively, and this box article summarises some of the key findings in the reports and other recent developments.

Overview

Between 2002 and 2007, short-selling turnover jumped from $71 billion to $1,310 billion, boosting its share in total market turnover from 4.3% to 6.0%. Amongst other factors, the growth was underpinned by market making activity and the listing of Mainland enterprises in Hong Kong. Market makers' share of short-selling turnover for all stocks has surged from 4% in 2002 to 23% in 2007. Meanwhile, for the 57 newly listed H-shares in Hong Kong during 2004 to 2007, their aggregate share of the market's short-selling leaped from below 2% in 2004 to 24% in 2007. Despite the difficult environment in 2008, short-selling turnover still managed to edge up further to $1,319 billion, accounting for 7.5% of overall turnover for the whole year.

Short-selling has been distinctly on the increase in the past several years



[1] Short-selling refers to the selling of a security that the seller does not own.

Box 4.1 (Cont'd)

Unlike the other financial centres, Hong Kong has not introduced any temporary measures to restrict short-selling. There has been no strong evidence as yet indicating a flow of short-selling activity into Hong Kong after the imposition of relevant restrictions overseas. As a matter of fact, short-selling as a percentage of the total market turnover declined from 8.5% during 1 July to 18 September 2008 (before the short-selling ban was imposed on US financial stocks) to 6.7% during 19 September to 31 December 2008. In January and February 2009, the ratio was broadly similar at 7.4% and 8.0% respectively. It appears, therefore, that the ban on short-selling in the US and the UK has not given rise to any material impact on short-selling activity in Hong Kong.

Short-selling tightens bid-ask spreads, encourages trading and enhances market depth

SFC analysed the sell orders for 16 stocks[2] during the fourth quarter of 2008. It was found that market making short-selling orders have notable contribution to tighter bid-ask spreads as over 80% of them were placed at best-ask prices or lower. In particular, 34% of the market making short-selling orders were made at the bid price, thereby having a direct effect of boosting trading. Both ratios compared favourably to those for long sell orders (that is, selling of stocks that the seller owns), where 59% were placed at best-ask prices or lower and 29% at the bid price. Short-selling orders not relating to market making, of which 59% were placed at the best-ask prices, also helped adding to the market depth.

Comparison with overseas markets

While short-selling has been increasing as a share of Hong Kong's market turnover, the figure remained much lower than the ratios prevailing in New York and London, where reportedly the corresponding figures for 2007 were 25-30%. The lower ratio for Hong Kong could be attributable to more prudent short-selling regulations than those which were in place in many overseas markets prior to their implementation of the temporary measures. For instance, only "covered" short-selling in securities meeting certain eligibility requirements are permitted in Hong Kong. Moreover, short sales are required to have full audit trails and are subject to the tick rule (except market making related orders). The SFC will continue to keep a vigilant eye on global developments related to short-selling, but will also remain attuned to the specific needs of the Hong Kong market when considering any changes to short-selling regulations.

[2] These 16 stocks accounted for 55% of market capitalisation in Hong Kong at end-2008 and 51% of both overall and short-selling turnover during that year. Please see SFC's "Research Paper No. 44: How short-selling activity affects liquidity of the Hong Kong stock market" for more details.