# EXPOSURE DRAFT OF THE CORPORATIONS AMENDMENT (SHORT SELLING) BILL 2008

## COMMENTARY

**23 SEPTEMBER 2008**

# TABLE OF CONTENTS



# NOTES TO PARTICIPANTS

It will be assumed that submissions are not confidential and may be made publicly available. If you would like your submission, or any part of it, to be treated as 'confidential', please indicate this clearly. A request made under the *Freedom of Information Act 1982* (Cth) for a submission marked confidential to be made available will be determined in accordance with the Act.

The BILL outlined in this paper has not received government approval and is obviously not yet law. As a consequence, this paper is merely a guide as to how the BILL might operate. The BILL may be amended following consultation.

# BACKGROUND

1. The *Corporations Act 2001* (the Corporations Act), at section 1020B, currently regulates short selling of securities, managed investment products and certain other financial products (section 1020B products).

2. Section 1020B generally prohibits the sale of a section 1020B product unless a person has a 'presently exercisable and unconditional right' to vest the product at the time of sale. The prohibition is subject to a number of exemptions under subsection 1020B(4) of the Corporations Act, which permits short selling in a defined range of circumstances. Under certain exemptions, a person who short sells must also disclose to a financial services licensee, when making the request, that the sale is a short sale.

3. Short sellers need to make arrangements to cover their delivery obligations before they fall due. This is normally done by:

   3.1. making a matching purchase at some point following the sale but before delivery falls due; or

   3.2. borrowing an equivalent amount of securities before delivery falls due, either before they enter into the sale or at some time between making the sale and when required to make delivery.

4. A naked short sale occurs where a seller does not own or has not borrowed or arranged to borrow securities at the time of sale but intends to purchase or borrow securities in order to meet the three business day settlement obligation.

5. There is some discussion about what constitutes a covered short sale. The broadest approach is to focus on whether borrowing takes place to meet delivery obligations. On this approach a covered short sale occurs where the seller has arranged to borrow stock in order to meet their delivery obligations.

6. A borrowing arrangement (or securities lending arrangement) occurs where the seller enters into an agreement or arrangement with a lender under which the section 1020B products will be delivered to the seller, and title transferred, on the condition that the seller will return, at a future date, the original or equivalent replacement section 1020B products to the lender. Loans in Australia are often made using a standard form of contract, the Australian Master Securities Lending Agreement.

7. While a borrowing agreement is economically a loan, there is a legal transfer of title between the lender and borrower, which allows the borrower to vest title to the section 1020B products in another person.

8. There is uncertainty around the use of stock lending agreements, the application of section 1020B(2), and therefore the requirement to disclose to a financial services licensee, in certain circumstances, that the transaction is a short sale (subsection 1020B(5)). It is understood that most market participants consider that a covered short sale falls within subsection 1020B(2) and so need not be disclosed.

9. Market practice has developed so that covered short sales are not usually reported to the market on the basis they are not truly 'short' because the seller, relying on the

borrowed stock, has a 'presently exercisable and unconditional right to vest the product' at the time of sale. Some limited reporting does occur.

10. While a person may borrow stock any time after the sale in order to meet delivery, subsection 1020B(2) requires that a person has a 'presently exercisable and unconditional right to vest the product' at the time of sale. If this is not the case, section 1020B applies to the sale.

    10.1. ASIC Regulatory Guide 196 sets out the circumstances in which a seller has a 'presently exercisable and unconditional right to vest the product' in relation to a borrowing agreement.

11. The Government has announced that it will clarify that covered short sales must be disclosed.

12. Recent action by ASIC has temporarily amended the operation of section 1020B. ASIC has:

    12.1. banned naked short selling;

    12.2. banned covered short selling (subject to certain exemptions); and

    12.3. introduced an interim disclosure requirement for covered short sales.

13. ASIC's response is a temporary measure which reflects the global crisis of confidence in financial markets and the need to maintain fair and orderly markets.

14. The Bill will replace ASIC's interim reporting requirements for covered short sales (see ASIC Class Order 08/751).[1] Unlike ASIC's interim arrangements, the disclosure regime under Bill is designed as a permanent addition to the law, in the interests of enhancing transparency, market confidence and market integrity.

15. Your views and comments on the exposure draft are sought by 21 October 2008. They should be sent to:

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    Corporations and Financial Services Division
    The Treasury
    Langton Crescent
    PARKES ACT 2600

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[1] As at 23 October 2008, the interim reporting requirements for covered short sales have limited operation due to ASIC's current ban on covered short selling (bar certain exemptions).

# REGULATION IMPACT STATEMENT: DISCLOSURE OF COVERED SHORT SELLING

## BACKGROUND

16. There has been significant speculation in recent months regarding the activity of short sellers in Australian listed securities. Short selling is an activity where a person enters into an agreement to sell a security that the person does not currently own. Short sellers need to make arrangements to cover their delivery obligations to the buyer before they fall due (usually three trading days after the transaction is executed). This is normally done by:

16.1. making a matching purchase at some point following the sale but before delivery falls due; or

16.2. borrowing an equivalent amount of securities before delivery falls due, either before they enter into the sale or at some time between making the sale and when required to make delivery.

17. There are two types of short sale transactions: naked and covered. A naked short sale occurs when a seller does not own and has not borrowed or arranged to borrow securities at the time of sale but intends to purchase or borrow securities in order to meet the delivery obligation. A covered short sale occurs when the seller has arranged to borrow the security in order to meet their delivery obligations prior to entering into the arrangement to sell the security.

18. Currently, short selling of Australian securities is prohibited under the *Corporations Act 2001* unless a person has a 'presently exercisable and unconditional right' to vest the product at the time of sale. The prohibition is subject to a number of exemptions, which permit short selling in a defined range of circumstances. These exemptions currently allow a person to enter into naked short sale transactions subject to some conditions imposed by the Australian Securities Exchange (ASX) through its Market Rules. These conditions place a limitation on the range of securities that can be subject to naked short sales and requires disclosures surrounding these transactions. Reported end of day net-short positions reported to ASX are between 0 and 2 per cent of share trading volume.

19. In relation to covered short sale transactions, market practice has developed so that these transactions avoid the prohibition in the Corporations Act on the grounds that the seller is not truly 'short'. This is because the seller, relying on the agreement to borrow stock, has a 'presently exercisable and unconditional right to vest the product' at the time of sale. As a result of this, there is currently very little regulation relating to covered short sale transactions involving Australian securities. As a result of this, there is currently no disclosure applicable to these transactions. This makes it difficult to determine the amount of covered short sale activity taking place in Australian securities. However, it is believed that covered short sales are more common than naked short sales. An estimate of the amount of covered short selling activity can be derived from measures of the total value of securities available for lending. The Reserve Bank of Australia has reported that the value of equities loans outstanding was around $60 billion at the end of 2007.

20. It should be noted that some borrowed securities are used for purposes other than short selling (for example, parties may enter into a securities lending agreement to facilitate an arbitrage transaction relating to the security or to cover potential settlement failures), so this figure overstates the amount of covered short sale activity. It is impossible to determine

exactly the proportion of stock lending transactions that are used for covered short sales. For this reason, stakeholders, including the ASX, have questioned whether stock lending data can be used as a reliable proxy for the amount of covered short sales.

21. Based on the data above, it is estimated that the upper limit of short selling activity in Australian securities is approximately $60 billion. This equates to approximately 4 per cent of the total capitalisation of Australian listed securities (based on a total ASX market capitalisation of $1.5 trillion). The majority of this is expected to be in the form of covered short sales. The current uncertainty surrounding the actual level of short selling activity in Australian securities is compounding the direct impact of this activity as it is resulting in rumour and speculation in the market place.

*Issue*

22. The current degree of uncertainty surrounding the activity of covered short sellers in Australian securities is having a significant impact on Australian capital markets. Currently, when a security experiences a significant decline in price, it is unclear whether this is attributed to short selling activity or other factors, which is resulting in considerable rumour and speculation regarding short selling activity and potentially adding to price volatility. Speculation regarding the level of short selling activity in Australian securities is also having broader market implications. Confidence in the market, particularly among retail investors, is likely to be damaged as investors express concern about the perceived activity of short sellers in the market. A fall in market activity, and investor confidence about the integrity of Australian capital markets, will make it more difficult for companies to raise additional capital leading to an increase in the companies overall cost of capital and a fall in investment activity.

## Objectives

23. The objective of Government action in this area is to increase transparency surrounding the activity of covered short sellers in Australian securities. This would provide useful information to investors and regulators and also contribute to confidence and market integrity. In particular, disclosure of covered short selling activity:

- will provide an early signal that individual securities may be overvalued;
- will indicate that a proportion of the sales in an individual security will need to be reversed by new purchases (to cover the short seller's settlement obligations);
- will enhance investors' willingness to participate in the market by removing uncertainty surrounding the level of short selling; and
- may deter market abuse or reduce the opportunities for market abuse.

24. The Government is not seeking to prohibit or discourage covered short selling activity. It is recognised that covered short selling activity, appropriately regulated, is beneficial to the operation of capital markets by increasing market liquidity and pricing efficiency.

## OPTIONS

*Option one: Retain the status quo (no regulatory action)*

25. This involves retaining the current regulatory arrangements and seeking to encourage voluntary disclosure of covered short sales.

*Option two: Disclosure of covered short sales to brokers*

26. This involves placing an obligation on investors to disclose covered short sale transactions to their broker. The broker will then be responsible for reporting this information to the relevant entity, for example, the market operator.

27. Under this option, the general disclosure requirement and the penalties for failing to disclose information would be contained in the Corporations Act. However, supplementary regulations would be used to outline the technical aspects of the requirement including the timing of any disclosure and whether the investor is required to disclose transactions on a gross or net basis (gross disclosure would encompass any covered short sale transaction entered into by the investor whereas net disclosure would take into account any offsetting transactions entered into by the investor so only their net exposure was disclosed). Specifying the technical aspects of the disclosure requirement in regulations provides sufficient flexibility so the requirements can be amended to take account of any changes in market activity in the future. Given the ongoing and rapid development in the conduct and structure of financial markets, the regulations may also allow for the disclosure regime to be targeted to particular areas in the future.

*Option three: Direct disclosure of covered short sales to the market operator*

28. This involves placing a direct obligation on investors to disclose covered short sale transactions to the market operator. As discussed under option two, this requirement would be implemented through the Corporations Act supported by supplementary regulations covering the technical aspects of the disclosure requirement.

*Option four: Disclosure of stock lending transactions*

29. This involves requiring disclosure of all stock lending transactions on the grounds that it is a sufficient proxy for the level of covered short selling activity in a particular security. Similar to options two and three above, this option could be implemented through the Corporations Act supported by supplementary regulations.

*Option five: Review existing short selling regime*

30. This involves a wholesale review of the regulatory framework governing all short selling transactions (both naked and covered). This review would cover the existing rules relating to short sales in the Corporations Act.

## IMPACT ANALYSIS

*Option one: Retain the status quo (no regulatory action)*

31. This option has the benefit of imposing no additional regulatory costs on businesses. However, it will not address the current issues caused by the uncertainty in the market place regarding the level of covered short selling activity. There is no incentive for investors to disclose this information to the market. In addition, there is little capacity for the Government to encourage investors to voluntarily disclose this information particularly in circumstances

where short selling activity is being driven by foreign investors. This means that without some level of Government intervention in the market, this information is unlikely to be disclosed.

*Option two: Direct disclosure of covered short sales to brokers*

32. This option has the benefit of ensuring the market is fully informed regarding the actual level of covered short selling activity. As discussed above, the removal of the current level of uncertainty surrounding short selling activity will benefit the market by promoting greater market confidence, increasing the information available to investors and assisting regulators to identify potential market abuse.

33. Targeted consultation with stakeholders has indicated that the implementation of this option is likely to impose costs on market participants, particularly the market operator (ASX) and brokers. The ASX will need to amend its trading system for Australian securities to facilitate the reporting of covered short sales by brokers. This will also require the systems used by brokers to process sales transactions to change so that it is in line with the ASX trading system. In addition, they may be required to amend other trading systems they offer investors for example direct market access systems. This will be particularly relevant for those brokers that are not currently reporting naked short sales to the ASX. The extent of these costs and the proportion of brokers that will offer their clients the ability to execute covered short sales are currently unknown. The extent of any changes to systems is only likely to be known once the precise details of the disclosure regime are settled through any supplementary regulations.

34. For investors, the cost of reporting covered short sale transactions to their broker will depend on the size and complexity of their operations. For individual investors, the costs should be relatively minimal. However, for larger companies, particularly those with multiple trading desks, the costs could be significant. This is because different trading desks within the company may be taking different positions in the same security at the same point in time. The potential for simultaneous trading activity in the same security by different parts of the company makes it difficult for companies to know whether they are long or short a particular security on a real time basis. This situation can be further complicated when the company acts as both a broker and an investor (for example, an investment bank). Stakeholders have indicated that these costs become less significant in situations where reporting of covered short sale transactions is delayed. The timing of any disclosure requirement under this option would be determined through the supplementary regulations.

35. In addition, some investors have expressed concerns surrounding the potential loss of confidentiality regarding their trading activities. It is intended that the disclosure regime would only result in the reporting of aggregated data, so individual trades cannot be identified. However, there may be indirect information leakage when the investor reports the trade to their broker (for example, by the broker disclosing this information to other investors). The potential costs associated with any loss of confidentiality will be influenced by the timing of the disclosure. For example, if disclosure is required at settlement rather than when the order is executed, the costs associated with the loss of confidentiality is reduced. However, the information will be less useful to investors if only delayed disclosure is required. Decisions regarding the timeliness of reporting obligations will be settled through any supplementary regulations.

*Option three: Direct disclosure of covered short sales to the market operator*

36. As this option also results in the full disclosure of covered short sales, it will have the same benefits as option two outlined above. The primary difference between this option and option two relates to the incursion of regulatory costs.

37. Relative to option two, this option imposes less of a regulatory burden on brokers. This is because investors will no longer be required to report covered short sales to their broker. However, it is expected that it would impose a significantly greater regulatory burden on the market operator and investors. In relation to the market operator, it is expected that the implementation costs would be significantly greater if they receive the information directly from investors rather than through brokers as proposed under option two. This is because the market operator will need to establish processes and systems for this reporting of information directly from investors. In contrast, under option two, the market operator would be able to take advantage of processes and systems already in place for the reporting of information between brokers and the market operator.

38. Investors will also be required to make significant changes to their processes and systems to facilitate the reporting of this information directly to the market operator. These would be in addition to the costs for investors identified under option two in relation to determining their exposure on particular securities. However, a relative advantage of this option over option two for investors relates to confidentiality. In particular, by requiring this information to be reported directly to the market operator (rather than through a broker), there is a significantly reduced chance of information leakage regarding individual trades. As discussed under option two, the costs to investors associated with this loss of confidentiality will be largely influenced by the timing requirements placed on disclosure which will be determined through any supplementary regulations.

39. It is expected that the additional costs incurred by investors and the market operator under this option will be greater than the costs incurred by brokers under option two. This is because there are a smaller number of brokers (relative to investors) and the extent of change necessary to the systems will be less as brokers are already required to report information of a similar nature to market operators.

*Option four: Disclosure of stock lending transactions*

40. The benefit of requiring the disclosure of stock lending transactions is that it would provide information to the market that could act as a proxy for the level of short selling activity in Australian securities. However, as noted above, some stakeholders have questioned whether stock lending data will provide a sufficient indication of short selling activity given stock lending transactions are used for a range of other purposes in addition to short selling. Given this, disclosure of stock lending alone is unlikely to fully address the uncertainty in the market relating to the activities of short sellers.

41. The implementation of a stock lending regime will involve some regulatory costs for investors that would be required to report these transactions. In particular, the Government understands that IT infrastructure changes would almost certainly be needed to facilitate the reporting of this information to the securities settlement systems. Industry has informed the Government that the costs of making these changes will be influenced by the service agreements individual participants have with vendors. However, the total regulatory cost of implementing these changes is likely to be less than the regulatory costs associated with options two and three.

*Option five: Review existing short selling regime*

42. It has been a number of years since there was a comprehensive review of the short selling regime in the Corporations Act. A review of the existing regime would assist in ensuring the regulatory requirements reflect current market conditions and trading behaviour. While a review of the existing short sale review may be useful in the long term, it will not assist in resolving any of the uncertainty surrounding short sales in the near term. In addition, implementing a disclosure regime for covered short sales prior to the commencement of a

more general review of regulatory arrangements would allow the information resulting from the disclosure regime to inform the review and lead to a more effective regulatory outcome.

## CONSULTATION

43. To date, the Government has engaged in targeted consultation with stakeholder groups regarding the disclosure of short sales. Discussions at this meeting focused on identifying current market practice, the scope for additional disclosure of covered short sales and the likely impact on industry of any regulatory change. This includes meetings with ASIC, the Association of Superannuation Funds of Australia, Australiasian Investor Relations Associations, Securities and Derivatives Industry Association, Australian Shareholders' Association, Australian Securities Lending Association, Australian Financial Markets Association, Investment and Financial Services Association, the Alternative Investment Management Association and the ASX. These meetings were high level in nature and did not seek specific comments from stakeholders on each of the options identified above. However, the feedback from these meetings, in particular as it relates to possible implementation costs for investors and brokers, has been drawn on to develop the impact analysis section of this paper.

44. In addition, the ASX issued a consultation paper on short selling in April 2008. The Government considered the submissions received by the ASX on this paper as part of developing and considering its options for reform in this area. Submissions were received from a broad range of stakeholders including institutional investors, brokers, investment banks and investor associations. The ASX has not made these submissions publicly available.

45. The Government will also engage in public consultation by exposing draft legislation for public comment of any regulatory option adopted. This will ensure the views of the wider public are taken into account on this issue.

## CONCLUSION AND RECOMMENDED OPTION

46. This document outlines a range of possible policy options relating to the regulation of covered short sale transactions. Options considered include:

    46.1. no regulatory response;

    46.2. disclosure of covered short sales by investors to brokers;

    46.3. direct disclosure of covered short sales by investors to the market operator;

    46.4. disclosure of stock lending transactions; and

    46.5. review of the existing short sales regime.

47. Based on the impact analysis outlined above, option two has been selected as the recommended approach. Under this option, investors that enter into covered short sale agreements will be required to disclose this transaction to their broker. Technical aspects of the disclosure requirement, for example the timing of disclosure and whether disclosure of transactions is on a net or gross basis, will be specified through supplementary regulations (still to be issued).

48. Implementation of option two will result in the actual level of covered short selling in a particular security being disclosed to the market. This will provide confidence to investors

and also facilitate the identification of market abuse by regulators. However, it is recognised that this option will involve some regulatory costs, particularly by brokers and large investors that are required to update their existing systems to facilitate reporting of covered short sale transactions. While the precise amount of these costs cannot be determined until the technical aspects of the disclosure requirement is settled, it is expected that the regulatory costs associated with this option is less than what would result from the adoption of option three. The remaining options fail to sufficiently address the identified issue because they would still result in uncertainty surrounding the actual level of short selling activity in Australian securities.

## IMPLEMENTATION AND REVIEW

49. The Government is conscious of the need to effectively engage with industry to ensure the preferred approach is implemented in a way that minimises regulatory costs. The first stage in this process will be to consult with industry on the technical aspects of the disclosure requirement as part of developing the supplementary regulations. By specifying these issues by way of supplementary regulation, the regime will have sufficient flexibility to adjust to changes in trading behaviour of investors in the future and the conduct and structures of financial markets. Following this, a transitional period is likely to be offered to allow brokers sufficient time to make the necessary changes to their IT infrastructure in order to enable reporting of these transactions.

50. As the regime will be implemented through the Corporations Act, ASIC will be responsible for monitoring compliance behaviour of investors and brokers and taking enforcement action where appropriate. The Government will also continue to monitor the application of the regime to ensure that it is operating effectively. The Government intends to formally review the measures once they have been in operation for two years.

# DISCLOSURE OF COVERED SHORT SALES

### OVERVIEW OF THE BILL

51. The Corporations Amendment (Short Selling) Bill 2008 (the Bill) is designed to enhance the disclosure of covered short sales.

52. The Bill requires sellers of section 1020B products to advise their executing Australian Financial Services (AFS) licensee when the sale is a covered short sale. In turn, the AFS licensee must report the disclosed covered short sales to the relevant market operator. The Bill also requires AFS licensees to report principal covered short sales to the relevant market operator.

    52.1. It applies to sales made on a licensed market (such as the ASX) and sales that occur through on or off market crossings.

    52.2. The disclosure requirement applies whether the seller is inside or outside Australia.

53. It is an offence if sellers and AFS licensees do not provide particulars of the sale of section 1020B products, at the time and in the manner required by the regulations. Regulations will set the mechanics of disclosure from sellers to AFS licensees and AFS licensees to the market operator, including when and how disclosure occurs.

54. The Bill reflects a contained set of amendments directed at the disclosure of covered short sales. The Bill does not otherwise amend the terms of the short selling regime in section 1020B, and therefore the operation of section 1020B is unchanged.

## Commencement

55. Sections 1 to 3 are formal provisions and will commence on Royal Assent. Schedule 1 is to commence on a date to be fixed by proclamation. However if the provisions do not commence within 12 months of the Act receiving Royal Assent, they commence on the first day after the end of that period.

    55.1. This approach to commencement will provide sellers and AFS licensees with a transitional period before compliance with the law is required. It is understood that the new disclosure regime will require IT and other administrative changes. While the scope of the IT and other administrative changes will not be fully known until regulations are in place, some parts of industry have suggested the changes may take up to 12 months to complete in order to enable electronic reporting of these transactions.

## Schedule 1

56. Schedule 1 inserts new sections 1020BA and 1020BB to require the disclosure of client and principal covered short sales.

## DISCLOSURE OF SHORT SALE COVERED BY SECURITIES LENDING ARRANGEMENT– CLIENT DISCLOSURE

57. Section 1020BA requires clients to disclose short sales of section 1020B products covered by a ***securities lending arrangement.***

58. Key terminology for the purposes of this section:

 58.1. ***licensed market*** - the operation of the market is authorised by an Australian market licence (existing section 761A of the Corporations Act);

 58.2. ***securities lending arrangement*** – the lender agrees to deliver particular financial products to the borrower, and vest title, on the condition that the borrower will return, at a future date, the original or equivalent replacement financial products to the lender, and vest title. The definition of securities lending arrangement also encompasses the possibility that the lender will deliver, and vest title in, the particular financial products to a third party on the instruction of the borrower, and in return, the borrower may return the financial products to a third party nominated by the lender (subsection 1020BA(10)).

 58.3. ***sale*** – the entering into an agreement to sell section 1020B products is treated as the sale of the products (subsection 1020BA(7));

 58.4. ***crossing –*** an AFS licensee makes a sale of section 1020B products either on behalf of the buyer and seller of the products, or on behalf of a client on one side of the trade and as principal on the other side (subsection 1020BA(10));

 58.5. ***section 1020B products*** - securities, managed investment products, a debenture, stock or bond issued or proposed to be issued by a government or financial products prescribed by regulation (existing subsection 1020B(1)). Regulation 7.9.80B prescribes certain financial products for the purposes of subsection 1020B(1).

### Client and principal disclosure

59. Subsection 1020BA(1) governs client and principal disclosure of short sales of section 1020B products covered by a ***securities lending arrangement***.

60. The disclosure requirement applies:

 60.1. where an AFS licensee makes a sale of section 1020B products on a ***licensed market***, on its own behalf, or on behalf of a person, to a buyer (paragraph 1020BA(1)(a)); and

 60.2. before the time of ***sale***, the seller entered into, or gained the benefit of, a ***securities lending arrangement*** (paragraph 1020BA(1)(b); and

 60.3. at the time of ***sale***, the seller intends that the ***securities lending arrangement*** will ensure that some or all of the section 1020B products can be vested in the buyer (paragraph 1020BA(1)(c)); and

 60.4. the seller is not required under subsection 1020B(5) to provide information in relation to the sale (paragraph 1020BA(1)(e)).

61. The disclosure requirement applies to both client and principal trading in ***section 1020B products*** on a ***licensed market.*** A ***crossing*** of a section 1020B product is treated as being made on a ***licensed market***. On the ASX, a crossing is conducted by an ASX participant

but may occur on or off-market. Under the Bill, crossings are treated as being made on a ***licensed market***, whether the crossing occurs on or off-market (subsection 1020B(9)).

62. Paragraph 1020BA(1)(b) covers the circumstances where a seller has entered a securities lending arrangement, or received the benefit of such an arrangement, before the time of sale. Such a benefit could arise if the borrower directed the lender to vest the section 1020B products in a third party, who subsequently short sells (see definition of ***securities lending arrangement).***

63. The Bill covers the possibility that sellers may be required to disclose short sales under the existing short selling disclosure regime and proposed section 1020BA. Here the disclosure requirement only applies if the seller is not already required to provide information under subsection 1020B(5) in relation to the sale (paragraph 1020BA(1)(d)).

64. Further, for the avoidance of doubt, the Bill clarifies that a sale in economic substance is treated as if the sale is made by an AFS licensee on behalf of a person. An example includes that a sale request is passed from the person to the financial services licensee through a chain of intermediaries (subsection 1020BA(8)).

### Mechanics of disclosure

65. It is an offence if client and principal sellers (AFS licensees) do not provide particulars of the sale of 1020B products, at the time and in the manner required by the regulations (subsection 1020BA(3)). The particulars include when the disclosure occurs and the manner of such disclosure (see further next steps). This will facilitate disclosure from client sellers to AFS licensees, and AFS licensees (as principal sellers) to the market operator (subsection 1020BA(4)).

    65.1. It is proposed to include details about the mechanics of disclosure in the regulations so that the regime is able to adapt more readily to the rapid and ever evolving changes in markets, and the mechanisms by which transactions occur.

66. The penalty for the offence is the same as the penalty under the existing short selling disclosure regime under subsection 1020B(5). The penalty is 25 penalty units or imprisonment for six months, or both (item 4, amendments to Schedule 3).

67. The requirement to provide particulars of the sale of section 1020B products, at the time and in the manner required by the regulations, applies whether the seller is inside or outside Australia (subsection 1020BA(2)).

68. The ability of the regulations to allow things to be specified differently for different kinds of persons, things or circumstances may be relevant in this context (subsection 1020BA(5)). For example further consultation may reveal that it is not possible for all kinds of sellers to comply with the same mechanics of disclosure under the regulations.

## Disclosure of short sale covered by securities lending arrangement– licensee disclosure

69. Section 1020BB requires AFS licensees to disclose client short sales of section 1020B products covered by a ***securities lending arrangement.***

70. Key terminology for the purposes of this section:

    70.1. ***sale*** – see paragraph 58.3;

70.2. ***crossing*** – see paragraph 58.4; and

70.3. ***section 1020B products*** – see paragraph 58.5.

### AFS licensee disclosure

71. Subsection 1020BB(1) governs AFS licensee disclosure of short sales covered by a securities lending arrangement.

71.1. The disclosure requirement applies if an AFS licensee receives information from clients on the particulars of the sale of section 1020B products on a ***licensed market***.

### Mechanics of disclosure

72. It is an offence if AFS licensees do not provide particulars of disclosed client sales of section 1020B products, at the time and in the manner required by the regulations (subsection 1020BB(2)). The particulars include when the disclosure occurs and the manner of such disclosure (see further next steps). This will facilitate disclosure from AFS licensees to the market operator (subsection 1020BB(3)).

### Other Regulation making powers

73. The Bill also permits other regulations to be made, which could amend the operation of the disclosure requirement to:

73.1. require the client (seller) to disclose to an entity other than the AFS licensee (subparagraph 1020BA(4)(a)(ii));

73.2. require the AFS licensee to disclose short sale information (from proprietary or client trading) to an entity other than the market operator (subparagraph 1020BA(4)(b)(ii) and paragraph 1020BB(3)(b));

73.3. specify the kind of section 1020B products the disclosure regime applies to (subparagraphs 1020BA(1)(e)(i)(ii) and subparagraphs 1020BB(1)(b)(i)(ii));

73.4. specify circumstances in which the sale is made (subparagraph 1020BA(1)(e)(iii) and subparagraph 1020BB(1)(b)(iii)); and

73.5. allow matters or things to be specified differently for different kinds of persons, things or circumstances (subsection 1020BA(5) and subsection 1020BB(4)).

74. This does allow, in future, an alternative approach to disclosure, which could change the vehicle for disclosure (for example requiring sellers to disclose direct to a regulator) and target disclosure of covered short sales to particular circumstances. This flexibility is included:

74.1. to allow the law to respond to an environment of rapid change, including technological innovation and ongoing developments in the conduct and structures of financial markets; and

74.2. because the new disclosure requirement will facilitate greater understanding of this area and may reveal a case for change to target the disclosure requirement to better serve the objectives of disclosure. One example could include targeting of reporting requirements to particular kinds of section 1020B products, such as securities of a particular sector.

## NEXT STEPS

75. Following exposure, it is intended that the Bill be introduced in the Spring 2008 sittings which run from September to December.

76. Concurrently Treasury will consult on the most appropriate mechanism for disclosure to be included in the regulations.

77. Under the terms of the Corporations Agreement 2002, the Ministerial Council will be consulted on the Bill.

## FEEDBACK

78. In addition to any comments on the draft Bill, specific comments are also sought on the following issues:

*Positive obligation on AFS licensees to inquire if the sale is a short sale*

79. It has been suggested that compliance with the disclosure regime will be enhanced if a positive obligation is placed on AFS licensees to inquire of the seller at the time of sale whether the sale is a short sale. In particular this may facilitate greater reporting by off-shore clients, as the inquiry will generate a greater understanding of the seller's obligation to disclose.

80. The obligation would require AFS licensees to put in place arrangements to ensure compliance with the measure.

81. The obligation would not extend to locating stock for settlement but could be likened to existing ASX rules that require a participant to inform its clients that the clients must tell a participant whenever they place an order for a short sale. If the obligation is included in the Bill, it would be an offence not to inquire and the responsibility of ASIC to enforce.

82. In particular, comments are sought on the benefits of such an obligation, the practical aspects of existing inquiry arrangements under the ASX rules and any compliance costs if an obligation is imposed under the Bill.

*On/Off market*

83. The draft Bill does not apply to off-market trades (other than off-market crossings undertaken by ASX participants). There is a view that short selling is more difficult in the absence of market infrastructure (for example because of the benefits the market offers in terms of liquidity, volume and speed and importantly the need to assume counterparty risk in off-market trades).

84. Comments are sought on the extent of off-market activity in section 1020B products and in particular short selling. Further, views are sought on how easy it is to short sell off-market and the risk of people transacting off-market to avoid the disclosure requirement.

*Ability of a lender or borrower to vest title from a securities lending arrangement in another entity*

85. We have received different views as to whether a third party is able to receive the benefit of a securities lending agreement on the instruction of the lender or borrower. If this occurs, the Bill is currently drafted to require a third party who receives such benefits and then short sells to disclose that short sale, even if they were not a party to the ***securities lending arrangement.***

85.1. The definition of securities lending encompasses circumstances where the lender will deliver, and vest title in, the particular financial products to another entity on the instruction of the borrower, and in return, the borrower may return the financial products to an entity nominated by the lender (subsection 1020BA(10)).

86. We seek comments on whether, in practice, third parties receive the benefit of a ***securities lending arrangement*** on the instruction of the lender or borrower, and if not, whether the possibility does exist that transactions may be structured this way.

87. Comments are due on 21 October 2008 and should be provided as set out in paragraph 15.