Australian Custodial Services Association

Level 24, 44 Market Street
Sydney NSW 2000
Tel: +61 2 8235 2530
Fax: +61 2 9299 3198
acsa@ifsa.com.au
www.custodial.org.au

21 October 2008

Corporations Amendment (Short Selling) Bill 2008
Corporations and Financial Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: shortsellingbill@treasury.gov.au

Dear Sir/Madam,

Re: ***Exposure draft of Corporations Amendment (Short Selling) Bill 2008***

The Australian Custodial Services Association (ACSA) represents the interests of the custodial services industry in Australia and appreciates the opportunity to comment on the Exposure Draft of the *Corporations Amendment (Short Selling) Bill 2008*.[1]

ACSA is a company limited by guarantee and currently represents members holding securities in excess of $1.3 trillion in custody and administration, and employing in excess of 3,000 people. All ACSA members either hold an Australian financial services licence under which they are authorised to provide custodial or depository services, or are authorised representatives of such licensees.

ACSA member clients comprise persons who fall within the definition of 'professional investor' under the Corporations Act. The entities for whom members of ACSA act largely comprise other financial services licensees, such as responsible entities of managed investment schemes, trustees of wholesale unit trusts, trustees of public offer, industry and corporate superannuation funds, life insurance companies and general insurers, together with listed companies, federal and state governments and government agencies, global custodians, international banks and other major financial institutions.

The traditional custody product comprises the core services of safekeeping and settlement, namely the receipt and delivery of securities and cash to settle client directed trades. However, most custodians will also provide portfolio administration services (which can include valuation, unit pricing, unit registry, regulatory and tax reporting, portfolio analysis and performance measurement) together with other services such as foreign exchange and securities lending.

One key characteristic of the provision of custodial or depository services is that the

[1] Whilst affiliates or other business divisions of some ACSA members may engage in short selling or securities lending, ACSA provides these comments from the perspective of a custodian only.

custodian is bound under the terms of its contract with the client to only act in accordance with the instructions of its clients or their authorised agents and representatives. The role of the custodian is thus akin to that of a bare trustee or directed agent.

Option four: Disclosure of stock lending transactions

ACSA supports the objectives of Treasury to increase transparency surrounding the activity of covered short sellers in Australian securities.

We note the Australian Securities Exchange (ASX) is advocating that *Option two: Disclosure of covered short sales to brokers* be supplemented with the reporting of securities lending data under *Option four: Disclosure of stock lending transactions*. In particular, ASX is proposing:

> Identification by custodians and other CHESS settlement system participants to the relevant ASX subsidiary of details of CHESS transactions facilitating stock borrowing and lending so as to enable publication by ASX of the aggregated data on a per security basis. [2]

ACSA sees several significant difficulties with this proposal, explained in further detail below, and does not support the adoption of *Option four: Disclosure of stock lending transactions* as a means of achieving Treasury's objectives.

However, if a securities lending disclosure regime is to be implemented as part of the covered short selling disclosure regime, custodians should only be required to provide the market operator with details of securities lending related transactions to the extent to which they are aware of such transactions through their role in conducting securities lending programs.

Securities lending data as proxy for short selling data

The disclosure of securities lending transactions cannot be used as a proxy for the level of short selling activity in Australian securities. Securities lending is of itself not a short selling activity. While loaned securities may be used by market participants to undertake short sales, securities lending is used by market participants for many other purposes including:

- arbitrage opportunities, including merger arbitrage, dividend arbitrage and convertible arbitrage;
- support of complex investment strategies (eg. equity swaps, hedges); and
- resolution of settlement failures.

Given the above, a requirement to disclose all lending related activity would result in the collection of a large quantity of information. As short selling is only one of the possible activities undertaken using loaned securities, much of the gathered information would not be useful and could in fact lead to a lack of transparency and inaccuracy or cause

[2] See ASX Position Paper *Transparency of Short Selling and Securities Lending* released on 2 October 2008, page 2.

investors to make an incorrect determination regarding the real level of short selling in the market.

Custodian as lending agent vs third party lending programs

Lending programs can be structured in several ways, including:

(a) the custodian acting as lending agent on behalf of its clients, in which case the custodian would have records of all loans and may identify loan related transfers; and

(b) the lender appointing a third party to arrange the loans, in which case the custodian would not see or necessarily be aware of the lending transaction.

In each case the custodian would not ordinarily know the purpose for which the securities in any individual loan transaction will be applied and would not know whether the securities are to be shorted.

With respect to third party lending programs, the custodian does not have access to loan records and would not have any direct knowledge of the lending transaction. The custodian acts in accordance with delivery instructions from the lending agent, transferring securities from the custody account of the lender to another account. Conversely the custodian could be instructed to expect a transfer of securities into the lender's custody account. The custodian is only able to determine at a general level that a loan has occurred through recognition that the transfer instructions originate from the lending agent and, as noted above, it would not know the purpose of the loan.

Though the custodian receives delivery or receipt instructions, which may number in the hundreds or thousands per day, it will not always be provided with details of the underlying transactions from which these transactions originate. Securities lending is only one of many activities to which these settlements may be attributable. In the absence of specific information from the lender, the custodian will not be able to determine which transactions are lending related and provide accurate reporting. This may lead to a custodian having to consider taking a conservative approach and over reporting to ensure that it is not exposed to any additional regulatory risk.

Offshore custody clients

It is not clear whether any requirement for a custodian to disclose stock lending transactions is to have any extraterritorial application. As custody clients may be located offshore, it may be difficult for a custodian to compel a client to provide lending information. If custodians are to be required to disclose stock lending transactions, they should not be held accountable if a client does not provide the required information to the custodian.

Practical issues

There are several practical issues that need to be considered further in the event a stock lending disclosure regime is implemented, namely:

- It would need to encompass the substantial lending activities of all parties who undertake lending directly between counterparties offshore, as any failure to capture offshore lending of Australian securities would lead to significant under

reporting of transactions. It would also need to capture lending activities undertaken directly between counterparties without the involvement of custodians.

- Custodians would need to either undertake time-consuming and labour intensive manual reporting or develop and implement potentially costly system enhancements to enable them to comply with any new automated reporting requirements. In the event stock lending transactions are to be flagged, assuming such information is known by or disclosed to the custodian, further system enhancements may be required. The format and content of any reporting will need to be prescribed before any system development can occur.

- In most instances, due to contractual arrangements, a custodian cannot provide additional information to the market unless it has a legal obligation to do so. Accordingly, any requirement to disclose must be a market mandate to ensure custodians do not breach client agreements.

- We note the ASX "would be prepared to introduce rules that required reporting of securities lending information by custodians through the CHESS infrastructure, with such data to be aggregated and made available to market users".[3] However, as the CHESS participant is often the subcustodian or its nominee, rather than the custodian, and such parties would not normally have any knowledge of securities lending transactions, the ASX proposal would necessitate flagging by the custodian of relevant transactions through the instruction/settlement process.

- It is not clear when the reporting needs to occur – with respect to the first loan only or with respect to all subsequent loans, eg. B borrows from A to on lend to C. If subsequent loans are also to be reported, assuming the custodian has knowledge of these, this could inflate the loan figures and contribute to the inaccuracy of the data.

- It is also not clear whether custodians will be able to share any stock lending disclosure with their affected clients and/or their clients' brokers.

- The commencement arrangements will need to specify whether existing loan positions give rise to retrospective reporting obligations or whether only new loan activity needs to be reported.

Conclusion

For the reasons stated above, ACSA does not support the implementation of a stock lending disclosure regime in its current form as it does not believe it would assist in achieving the objectives of the proposed legislation. Imposing a requirement on custodians to disclose all lending related activity is not only impractical, but would result in the collection of a large quantity of information which would be of questionable use. This could lead to a lack of transparency surrounding the activity of covered short sellers in Australian securities and cause investors to make an incorrect determination regarding the real level of securities lending and short selling in the Australian market.

[3] Page 10, ASX Position Paper.

If you have any questions regarding this letter or custody matters generally, please contact either myself on (02) 9250 4660 or Natalie Thomsett of State Street Australia Limited on (02) 9323 7004.

Yours faithfully,

Bryan Gray
Chairman