22 October 2008

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

By email: shortselling@treasury.gov.au

Dear Sir/Madam

Corporations Amendment (Short Selling) Bill 2008

1 Introduction

The Australian Financial Markets Association (AFMA) represents the interests of participants in Australia's wholesale banking and financial markets. Our members include banks, stockbrokers, treasury corporations, fund managers, traders in specialised products and industry service providers. Their business places them at the centre of the equities market; brokering transactions, arranging and underwriting capital raisings, structuring products, trading and investing. They have a vital interest in the development of short selling regulation that promotes market transparency, market confidence and market integrity.

Share market volatility during the credit crisis has highlighted the need for government and the industry to work together to ensure that the conditions exist under which investors have confidence in the efficiency and fairness of the market. Australia's regulation of short selling is strict by international standards. Nonetheless, there is an evident desire amongst investors and many listed companies for greater transparency of short selling activity. Confidence in the integrity of the market is vital to support its economic functions; especially price discovery, investment facilitation, risk management and the provision of capital finance for Australian business companies. Therefore, this challenge to improve transparency must be met head-on and addressed in a comprehensive manner.

The success of new regulation to enhance transparency will depend on the identification and collection of market data that would best assist investors, traders, analysts and companies in undertaking their various (but related) activities. In other words, policy makers must be clear about the type of information that would be used by the various stakeholders to improve their decision making processes and then devise legislation and rules to implement the required information collection and dissemination process.

Sections 2 and 3 below address this issue directly and, thus, are the most important part of this submission. We also provide comments on technical aspects of the draft legislation that has been provided with the Commentary on the rationale for change. In formulating our recommendations, we have

considered the lessons learnt from the operation of ASX's current rules and overseas experience, especially in relation to the collection and use of information on short selling activity. This has been helpful in identifying proposals that are feasible and should in practice improve the regulation of short selling.

2 The Policy Objectives of Transparency

It is important to be clear about the purpose of short selling regulation before designing legislation to give effect to this objective. The Commentary proposes that 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

We agree that short selling transparency can enhance market efficiency through the price formation process and enable more effective supervision of market activity. This is because short selling intensifies market scrutiny and discipline on listed companies, while the risk of using short selling as an instrument for market abuse is reduced when there is appropriate transparency. For example:

- Transparency helps investors to avoid over-paying for a stock (eg short selling may sharpen the market's focus on a company whose disclosures are not timely or are incomplete). Short selling allows the price discovery process to occur more quickly as differing views on the value of a stock compete in the market place.
- Transparency assists management by focussing a company's attention on the issues in its business that might be the cause of short selling or by more quickly correcting inaccurate information on its business affairs.
- Transparency helps traders to assess the technical market conditions, having regard to positions that must be unwound or rolled-over in the future.
- Transparency discourages the use of short selling for illegitimate purposes, like market manipulation, by making the market aware of related transactions and by increasing the risk of detection by regulators.
- Given all of the above, transparency enhances investor confidence in the integrity and fairness of the market.

Short selling transparency can only achieve these outcomes if the data provided is comprehensive, consistent, reliable and can be readily interpreted by investors and other stakeholders. It is pointless producing data that is not valued by market participants and it is reckless to produce information that is complex or might easily be misunderstood by market participants. Our experience is that it is a significant challenge to obtain data within the framework of the current law and ASX rules that would create the sought after benefits without inadvertently generating regulatory risk or

unreasonable cost. However, having discussed these issues extensively with members, we believe there is a form of transparency that would meet the Government's stated objectives in a comprehensive and efficient manner.

3 Proposals for Effective Transparency

Short sales occur for a number of reasons including directional trading, price arbitrage, facilitating a client's trade and hedging of a derivative position, amongst other things. The existence of mixed purposes does not mean that information on short selling activity is not valuable; rather it means that care must be taken in interpreting such data.

It is information on positions (ie net economic short positions) taken by investors that is most relevant to price determinations in the market and, hence, drives price action. Consequently, data on short selling positions is the most useful piece of short selling information to an investor when they are evaluating market conditions. Moreover, it is valuable information to a regulator looking to detect an abnormal build-up in market pressure on a stock. Data on transactions do not provide a guide to actual positions in a stock and members advise their traders consider it is much less useful from a market transparency and efficiency perspective.

In this context, information that is relevant to the market and regulators on an ongoing basis includes:

- The amount of a stock that is shorted at a given time;
- The trend of short selling in short stock positions over time;
- The identity of entities that have substantial short positions.

This type of information is not currently available in the Australian market. However, two options are available to collect data in an efficient manner. AFMA believes that the direct reporting of short selling positions is the most effective form of disclosure. However, we do acknowledge the value of disclosure of stock lending positions, which is an alternative but indirect form of information on short selling.

Given the need to keep the regulatory burden on business within reasonable bounds, it is important for the Government to avoid imposing multiple layers of transparency regulation on the market; for example, by requiring real time tagging of orders and simultaneously requiring the reporting of stock lending transactions. The objective must be to provide a single, clear-cut source of data on short selling.

Proposal A: Direct Method - Disclosure of All Short Sale Positions

One of the greatest challenges in collecting functional data on short selling is the task of producing consistent data from all market participants on their short selling activity. We believe that the only way to overcome this is to collect information directly from entities that hold short sale positions. For example, fund managers may report though custodians and retail clients through their CHESS sponsors. Brokers currently report their own short sale positions to ASX on a daily basis but they do not have the information necessary to report their client positions (nor would many of their clients want to report this information to them). However, fund managers have signalled their willingness to disclose their aggregate short selling positions on a stock by stock basis to the market regulator on a bi-monthly basis – see IFSA's

submission in response to the Exposure Draft. This overcomes the main problem identified in the Commentary in relation to Option 3 that it presented.

AFMA supports the proposal developed by IFSA as it will produce the most meaningful and reliable aggregate data on short sale positions in individual stocks. It is data that the market would find valuable and would use. The data would be consistent and easy for a wide range of investors to interpret, relative to the other options. It would also provide listed companies with a clear insight into the build-up of short sale positions in their stock (this is not discernable from transaction data). Meanwhile, the market regulators would be on notice of significant and unusual changes in aggregate short sale positions in a given stock.

We agree the conditions proposed by IFSA in relation to the public release of information in a manner that reduces the risk of increased price pressure or volatility and preserve confidentiality of strategic trading positions and a de minimus exemption. We also agree that disclosure of substantial positions (5% of the underlying stock) is information that is relevant to the policy objectives. A rule requiring entities to register with ASX or ASIC as an entity eligible to short sell in the Australian market would promote effective compliance.

This proposal involves an appealing consistency of approach to that taken in key jurisdictions overseas. In particular, the Financial Services Authority in the UK now requires short sellers to disclose net short positions of more than 0.25% in financial stocks. The Securities and Exchange Commission in the US also moved recently to require disclosure by institutional investors of the number and value of each stock sold short, subject to a de minimus condition.

In our view, investors should focus primarily on the fundamentals of companies when making investment decisions, rather than level of shorts in the market. However, if this is relevant to the assessment of intrinsic value, information on the level of short sale positions (rather than transactions) is the easiest to interpret.

Alternative Proposal B Indirect Method - Disclosure by ASX of the number of shares that are subject to stock borrowing arrangements in the market.

Securities transfers for lending purposes could be coded in CHESS so that the quantity of each stock borrowed on any day is disaggregated from the total sales volume of the particular stock. This would easily capture all data, including that of offshore investors, as the offshore client must have their local custodian (or prime broker) obtain the stock borrowed in order to settle the trade. The data captures would be comprehensive, consistent, reliable and efficient to collect.

Stock lending can occur for a variety of purposes, so data on stock lending will not precisely identify stock borrowed for short selling. However, it would serve to identify an unusual build up in short selling activity, rather than the normal course of business activity.

Other Proposals

Both the above proposals are superior to the direct disclosure of covered short sales to brokers, as proposed in Option 2 of the Commentary. A key concern in this regard is the low value that traders attach to the information that

would be collected under Option 2. Transactional data is not as relevant as position data, as no observer of individual transactions can make a judgement as to the size of the open short positions in the market. There are also a variety of practical and operational problems encountered in complying with a real time tagging regime, which give rise to significant concern about the consistency and reliability of the data in terms of the objectives of transparency.

Option 2 data would not capture intra-day close outs, would be volatile over time and would not cover the purpose of short sales reported. Data quality would be reliant on clients reporting all of their short sales to their broker. Traders may not be able to advise if a particular sale is a covered short sale at the time of the order placement because they have incomplete knowledge of the entity's total position (eg because they are behind a Chinese wall) or how sales are intended to be settled. For instance, some traders rely on daily stock availability sheets provided by their equity finance desks to support their trading activities. The trader may not know whether the stock availability is sourced from existing inventory, borrowed stock, stock lent that can be recalled, etc; this may lead to over reporting in some instances. Further, when aggregating several orders together, some of which may be short, some of which may not, tagging the order will not give accurate information to the market on the level of short selling.

In addition, members have noted the need to balance transparency against possible market liquidity impacts, especially the willingness of traders and market makers to offer liquidity under these conditions, when assessing the benefit from the real time tagging of orders. There is a risk of greater market volatility.

Another key concern is that Option 2 would require significant systems changes and, therefore, would be expensive to implement eg Direct Market Access (DMA) systems would have to be reconfigured to capture covered short sale trades, as clients are prohibited from naked short selling but trading pursuant to a borrowing agreement may be permitted.

4 Specific Comments on Drafting of the Bill

As outlined above, we do not believe the approach adopted in the draft Bill is the best way to meet the stated policy objectives to increase the transparency surrounding the activity of covered short sellers. However, were this approach to be adopted, there are a number of matters that we believe should be dealt with during the finalisation of the legislation.

AFMA members are concerned that all the detail will be in the regulations that will be made pursuant to the Bill. Based on their experience with ASIC's temporary short selling ban and the range of practical reporting problems that still have not been resolved, particularly in connection with DMA client ordering systems and automated trading systems there is a strong desire for detailed reporting arrangements to be extensively consulted on before implementation so that they work effectively from an operational point of view and for there to be a smooth transitional process to a new regime.

The Bill as drafted is predicated on an approach to disclosure similar to that implemented by ASIC under its September 2008 Class Orders. As a result of the need to very quickly respond to the temporary regulatory requirements imposed by the regulator as a market circuit breaker resulted in a great deal of industry consultation taking place to produce workable outcomes. A

significant number of the practical issues encountered relate to disclosure requirements and adaptation of existing systems to meet new report systems.

As with any other law reform, where system changes are required there will be significant implementation costs and additional regulatory burdens to be borne by industry. Transitional arrangements need to allow for organisations to adapt to the new rules in a reasonable time frame that takes into account the time and effort required to change reporting systems. There is concern that changes being made to deal with the temporary ASIC reporting requirements will be different to the changes necessary for the permanent reporting requirements. This should be taken into account when settling on a final reporting regime.

The following specific comments relate to the drafting of the Bill and points where more clarity is required.

Alignment with the definition of "Section 1020B products"

Section 1020B(1) indicates the financial products to which section 1020B and 1020C is to apply. The proposed section 1020BA (10) introduces, inter alia, a definition of "security lending arrangement" (SLA). The scope of the definition of SLA effectively includes "securities, managed investment products or other financial products". It appears that the scope of the "financial products" referred to in subsection 1020BA (10) with respect to SLA is not aligned with the definition of section 1020B products for the purposes of section 1020B and 1020C.

Interaction of 1020BA(1)(d) and 1020B(5)

Paragraph 1020BA(1)(d) will apply where the person is not required to report under 1020B(5).

The interaction of these two provisions does not appear to be consistent and would benefit from clarification so that they do not overlap.

For example, if a short sale is made under 1020B(4)(d) (a short sale where stock is borrowed to cover), the short sale must be disclosed to the financial services licensee. However, the requirement for the licensee to report such a short sale to the exchange under the Bill's clause 1020BB only applies if the disclosure to the licensee is made under clause 1020BA, not section 1020B.

Clarification of entering into 'agreement to sell'

In paragraph 1020BA(7), it the expression 'an agreement to sell' is used. This terminology will need to be more precisely defined. For example problems arise in the case of off market crossings (such as special crossings) where it is not always clear when the agreement to sell is made.

The timing of what constitutes entering in to an agreement to sell should be clarified with reference to the wording of 1020BA(8) and in the context of a transaction chain where multiple parties/intermediaries are involved.

Economic substance

In paragraph 1020BA(8), the reference to 'in economic substance' is likely to prove very confusing to market participants and will need to be given greater precision.

The assumption is that the term is intended to cover a chain of lending through a number of intermediaries. If this is the intention this should be expressly stated. If a wider range of circumstances is intended to be covered these should be specified to avoid regulatory uncertainty. Accordingly, defining what constitutes the making of a sale in 'economic substance', including the factors to be taken into account and any de-minimus threshold, should be specified.

In addition the status of other 'covered' short sales under genuine purchase arrangements that do not involve securities lending will also need to be clarified

Meaning of 'crossing'

Paragraph 1020BA(9) refers to a 'crossing'. This provision is directed at what are referred to 'special crossings', which are large transactions executed off market due to their large size.

The Commentary on the Bill explains that the sale by an AFS licensee 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)) constitutes a 'crossing'.

Subsection 1020BA (9) deems a crossing to be made on a licensed market – The definition of 'crossing' is critical to the potential scope and application of the Bill, if enacted in its current form, to unlicensed markets.

Clarification of the meaning of the phrase 'on behalf of' is required and whether, for example, this connotes, as applicable an 'agency, sub-agency' or other arrangement where, for example, there is no express or implied authority to act for the relevant principal as agent.

Paragraph 1020BB

The above comments relating to 'agreement to sell' and 'crossing' apply equally here.

5 Responses to Commentary Questions

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

The Commentary notes the suggestion 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, it suggests this may facilitate greater reporting by off-shore clients, as the inquiry will generate a greater understanding of the seller's obligation to disclose.

The temporary inquiry rules imposed by ASIC through its class order putting in place section 1020BC of the law have resulted in a number of practical problems with the obligation placed on brokers to make inquiries of their clients.

The inquiry requirement is a significant burden as it cannot be automated in all cases, and therefore leaves room for human error. Additionally, it slows time to market, particularly where the order is not received orally. Such a

circumstance is where the order from a client is a system's based one. If the client omits to state explicitly, it must be referred back to the client before execution. This imposes considerable execution and timing risk on the client.

Other mechanisms exist to effectively communicate to off-shore investors in respect of their obligation to report orders that are short sales. For example, this reporting is in essence a legal compliance exercise, so the matter should be addressed at that level as it pertains to the operating practices of the organisation. This approach is adopted in respect of other obligations an investor is expected to meet under the Corporations Act (for example, substantial shareholder notices).

Therefore, the reporting obligation should be communicated through regular compliance networks, which may include well articulated client briefing materials. This is more likely to promote the internal policies and procedures that will assist compliance on an ongoing basis. Given the scale and scope of the recent international initiatives to regulate short selling, there is a high level of awareness of associated compliance obligations, which will also promote compliance.

On/Off market

The draft Bill does not apply to off-market trades. Comment was sought on the extent of off-market activity in section 1020B products and in particular short selling. The factors identified in the Commentary, especially the existence counterparty risk and difficulty in transacting in an efficient manner are highly relevant and a significant disincentive to off-market trading.

As preliminary point regarding of drafting, the above drafting comment on the need to provide an effective definition of 'special crossing' is also worth reiterating in this context. Subsection 1020BA (9) deems a crossing to be made on a licensed market. The definition of 'crossing' is critical to the potential scope and application of the Bill. Care needs to be taken to ensure that it does not inadvertently cover OTC market transactions.

It has been noted by the Reserve Bank of Australia in its review of equities settlement practices in Australia that the extent of off-market trading is difficult to accurately gauge. Regardless of the value of securities lent, it remains the case that the great bulk of short selling activity relates to necessary hedging for risk management purposes.

The stock market has shown very wide amplitudes of volatility in recent weeks after the ban was imposed and the inability to short sell has meant that a market driven by economic fundamentals has not had the cushioning effect of short sellers stepping when share prices are falling quickly. The economic effect of the current ban on short selling amply demonstrates that not allowing the activity significantly diminishes market efficiency and severely curtailed the ability of market participants to effectively manage their market risks during a period of high volatility.

Further views were sought on how easy it is to short sell off-market and the risk of people transacting off-market to avoid the disclosure requirement.

The current ASIC based ban on short selling and disclosure requirements, where short selling is carried out by market makers who are still subject to ASIC current disclosure rules, which applies to off market transactions for securities that are able to be traded on a licensed market, has demonstrated that people cannot avoid disclosure requirements.

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

Comment was sought 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.

The question about the ability of a lender or borrower to vest title from a securities lending arrangement in another entity arises in cases of third party arrangements where intermediaries are involved in transacting the stock lending arrangement. The motivation for borrowing is the borrower of the securities wants to obtain temporary access to the specific securities. These types of transactions typically are highly intermediated, as the securities lenders usually must rely only on the intermediary to source the demand for the securities. The leading intermediaries for institutional investors, in terms of market share, traditionally have been the custodian banks.

A beneficial owner might often be a life insurance common fund or superannuation fund, while the ultimate borrower could be an investment fund manger seeking to hedge their position. The fund manager for a life insurer or superannuation fund would normally be reluctant to take on credit exposures to borrowers that do not have a sufficiently high credit rating. Most institutions use an intermediary to avoid the expense, administrative and operational difficulties and the credit and other risks of running their own programs. In these circumstances, the principal intermediary performs a credit intermediation service in taking a principal position between the lending institution and the investor wanting to hedge.

The leading intermediaries for institutional investors, in terms of market share, traditionally have been the custodian banks. There are two types of securities lending programs offered by custodians through either principal programs or agency programs. With principal programs, securities are lent to an intermediary principal (such as a custodian bank), who then on lends to many more counterparties. This saves administration and limits credit risks to the principal. If the principal is a custodian bank, that risk usually is uncollateralised.

In the case of an agency program, the lender deals with an intermediary (usually a custodian), who then deals directly with a large but limited number of end borrowers. This involves extra administration and wider credit and other risks. These risks are laid off through collateralisation arrangements.

A custodian that operates an agency program will do so primarily for its own reasons, such as because of the potentially adverse balance sheet and capital adequacy implications for the custodian of operating a principal program. The choice by the custodian bank to offer an agency program is not primarily driven by client needs. Because of the risk management need, all loans in an agency program are required to be adequately collateralised.

6 Other Matters

Members believe the tick test should be removed, as it is outdated and acts as a disincentive for investors to disclose short sale orders. We note that before the SEC removed the tick test rule in the USA, it pilot tested the proposition and concluded that the test does not have a large impact on

market quality. It found that the price test is not a good fit for modern financial markets and may impose trading and compliance costs that exceed the rule's benefits

Another other area of the short selling law that the Government should review is the concept of "presently exercisable and unconditional right to vest" with respect to stock lending arrangements. Consideration should be given to adopting the US position (based on a "reasonable grounds basis"), as it is not practical given typical market volumes for every stock loan transaction to be confirmed to each of the ultimate lender and the ultimate buyer prior to each sale (given that most stock loans are intermediated). This is a matter that should be subject to further consultation with industry.

More generally, we note that policy changes that might be contemplated but which are not considered in the Commentary should be opened to industry consultation.

7 Further Consultation

As an industry body which has worked closed with ASIC in its implementation of the current temporary short selling arrangements and a vital interest in effective regulation, AFMA would be pleased to closely work with you in settling the Government's policy on short selling disclosure. We would be happy to meet with Treasury representatives, at their convenience to discuss the proposed legislation in more detail. Please contact David Love on 02 9776 7995 to pursue this consultation process.

Yours sincerely

Duncan Fairweather
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