

ASA Submission: Exposure Draft Corporations Amendment (Short Selling) Bill 2008

The ASA makes this submission in response to the Government's exposure draft of the Corporations Amendment (Short Selling) Bill 2008 (hereafter referred to as the Bill) and the associated commentary dated 23 September 2008.

The ASA has had the benefit of considering submissions made by the Australian Securities Exchange (ASX) and Chartered Secretaries Australia (CSA) prior to finalising this submission and where appropriate has included comment on those submissions.

The ASA

The Australian Shareholders' Association (ASA) is a not-for-profit organisation formed to represent, protect and promote the interests of investors in shares, managed investments, superannuation and other financial investments.

Background

The ASA took part in a consultation process carried out by Treasury in April 2008, with regard to deficiencies in section 1020B of the Corporations Act 2001. The ASA position was then and is now that the definition of a short sale in the Corporations Act needed to be changed to include those short sales covered by acquiring shares through a stock lending agreement (i.e. a contract for the sale and re-purchase of securities).

The Government in its Regulation Impact Statement accepts that this is the case. The ASA is pleased to see that the Bill addresses this deficiency on section 1020B.

Subsequent to the consultation, the Australian Securities and Investments Commission (ASIC) in conjunction with the Australian Securities Exchange, moved to prohibit both naked and covered short sales (including those sales covered by securities lending agreements) in September 2008, in response to similar prohibitions in overseas markets. On 23 October 2008, this ban was extended.

Response to the exposure draft of the Corporations Amendment (Short Selling) Bill 2008 and Regulatory Impact Statement

The Regulation Impact statement outlines five options, and concludes that Option two, Disclosure of Covered Short Sales to Brokers, is the appropriate option.

The ASA supports option two on the basis that transparency of covered short sales should provide:

- for a fairer market;
- the regulators with information to assist in identifying market manipulation;
- confidence to investors.

Retail shareholders are particularly concerned about short selling when done in concert with market manipulation. These so called 'distort and short' strategies have been widespread in Australia prior to the short selling ban being imposed. Retail shareholders have no confidence that the market supervisor and regulator are identifying and penalising the perpetrators under the current regime.

Whilst supporting option two, the ASA also makes submissions on the following matters:

- **Disclosure of stock lending**

Option 4 proposes the disclosure of stock lending transactions, on the basis that these transactions provide a proxy for short selling activity, not currently reported as it is covered by a lending agreement.

Whilst the ASA does not support this option as the solution, there is potential benefit to be gained from requiring the disclosure of stock lending, as a means of checking the level of disclosure of covered short selling. Whilst stock lending is used for other purposes and therefore is not a direct proxy for short selling, it could provide a useful indicator to regulators as to whether clients and market participants are complying with the new disclosure requirements.

Accordingly the ASA would like to see the Government regulate the disclosure of stock lending activity.

- **Government Review**

The Government has indicated an intention to formally review these measures once they have been in operation for two years. A formal review is supported by

the ASA and should include an assessment of the claimed benefits of short selling, that it increases market liquidity and pricing efficiency.

Whilst these benefits are frequently quoted by market operators, participants and institutional traders, research in carried out in other jurisdictions provides arguments both for and against these benefits.

The lack of disclosure and therefore data about the short sales in Australia prohibits research into these benefits being carried out at this time, however the ASA would like to see this research carried out prior to or as part of any Government review of short selling.

The ASA supports the CSA's proposal that stock lending arrangements form part of the review.

- **The 'uptick' rule**

The Corporations Act imposes an 'uptick' rule on covered short sales. This rule provides that short sales can only be affected in a rising market for the security. A similar rule is imposed on naked short sales by the ASX Market rules.

In effect, the rule has not applied to those short sales covered by stock lending agreements. It is understood that most covered sales have avoided the provisions of the Corporations Act, including the 'uptick' rule by lending the stock.

Accordingly it is only naked sales where the 'uptick' rule should have been applied with any regularity in the past.

The Bill whilst bringing short sales covered by lending agreements into the definition of a short sale does not impose an 'uptick' rule on these transactions. However it does not seek to remove the 'uptick' rule on short sales covered by borrowing arrangements. There is no reason for treating the two types of covered sales differently.

The ASA position is that the 'uptick' rule should be applied to all covered short sales. The ASX states that as it has effectively not applied in the past it is not necessary now. However given that the rule in effect has not applied to covered short sales in Australia it is impossible to know whether there has been a detrimental effect. It is appropriate that the test be imposed on all covered short sales. Whether the test should remain in place should be considered as part of the Government review in two years.

- **Naked short selling**

The ASX in its submission proposes either that it continue the ban on naked short selling indefinitely, or that the Corporations Act be amended to remove the capacity of the market operator to permit naked short selling.

The ASA supports the decision-making about both naked and covered short selling being centralised in the one organisation and accordingly supports the removal of this capacity from the market operator.

- **Interim arrangements**

On 21 October 2008 ASIC announced that it would extend the ban on short selling of non-financial stock until 18 November 2008 and of financial stocks until 29 January 2008 and that it would be putting in place disclosure and reporting arrangements that will apply from the time the ban is lifted.

Provided the arrangements proposed, details of which were not known when this submission was written, address the issue of non-disclosure of short sales covered by stock lending agreements, the ASA would support this interim measure.

- **Compliance with the proposed disclosure requirements**

The changes proposed by the Bill and the regulations are of course only the first step in achieving transparency. It is important that ASIC be adequately resourced to investigate and enforce compliance.

- **Other important considerations**

The capital gains tax (CGT) exemption for securities lending agreements:

Treasury and the Australian Taxation Office should review the securities lending CGT exemption to assess its consistency with the exemption's initial intent.

Financial penalties for failure of a seller to advise a market participant that a sale is short:

The financial penalties for breach of section 1020B (5) of the Act are insufficient and should be increased to provide an effective deterrent.