



Investment &
Financial
Services
Association Limited
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14 October 2008

Senator the Hon. Nick Sherry
Minister for Superannuation and Corporate Law
Parliament House
CANBERRA ACT 2600

Dear Senator

Re: *Corporations Amendment (Short Selling) Bill* exposure draft

Thank you for the invitation to provide input on the draft exposure legislation entitled '*Corporations Amendment (Short Selling) Bill*' requiring the disclosure of covered short sale transactions on Australian financial markets. We welcome the Government's current review of disclosure practices and compliance with regulations in this area.

Short selling plays a crucial role in maintaining an efficient market by helping mitigate against price bubbles (where asset values are well in excess of intrinsic value) and fraud, stimulating liquidity and limiting market manipulation specifically designed to inflate stock prices.

There is academic evidence demonstrating that short selling has anticipated public revelations that firms have misrepresented their financial statements and further that short interest helps expose such misconduct. Uninformed investors who purchase stock in the misrepresentation period tend to suffer smaller losses when short sellers take aggressive positions.¹ There is also evidence that firms use a variety of methods to impede short selling, and that, on average, firms taking these actions have low abnormal returns (around -2% per month) in the subsequent year, consistent with the hypothesis that firms were overpriced.²

Given short selling's fundamental role in enhancing liquidity and boosting pricing efficiency, IFSA supports short selling with appropriate and prudent disclosure directly to the market supervisor or ASIC. As noted in our submission from May 2008 to the ASX short selling consultation paper, ensuring market price efficiency through active

¹ Jonathan M. Karpoff and Xiaoxia Lou, Do Short Sellers Detect Overpriced Firms? Evidence from SEC Enforcement Actions, Working Paper. September 6, 2008 Available at <http://ssrn.com/abstract=1102853>

² Owen A Lamont, Go Down Fighting: Short Sellers vs Firms, Yale ICF Working Paper No. 04-20. July 14, 2004. Available at <http://ssrn.com/abstract=566901>.

Two other useful references on this issue and the potential benefits of short selling are: House testimony of Owen Lamont: <http://financialservices.house.gov/media/pdf/052203ol.pdf> and SEC Testimony of Jim Chanos: <http://www.sec.gov/spotlight/hedgefunds/hedge-chanos.htm>

investment activities, such as short selling, produces positive externalities for the economy and particularly long-term diversified investors such as superannuation funds.

Short selling is often performed by investment managers as part of a 'long/short' strategy for superannuation funds and managed investment schemes for risk management or hedging purposes, and where they believe a particular stock is overvalued. These strategies are also frequently implemented as a medium to long term investment position to generate optimal returns.

Given the benefits associated with short selling, we are interested in ensuring that any changes to market rules and/or regulation are directed at maintaining the opportunity for these benefits without compromising the highest levels of market integrity, international competitiveness, investor confidence or inhibiting the adoption of new technologies.

Limiting or prohibiting the practice of short selling has the long term risk of adversely impacting market liquidity and trading volumes, investment mandates, efficient price discovery and stock lending activity. For example, there is strong evidence that the 15 July 2008 temporary restrictions on naked short sales of financial stocks in the US had a negative impact on various measures of liquidity and price informativeness (measures the impact of company specific information that is reflected in a stock price).³ These consequences may also reduce the underlying robustness and international competitiveness of the market, while ultimately failing to address concerns regarding market manipulation and fraud.

1. IFSA's preferred position: permanent disclosure and reporting obligations

The exposure draft Bill proposes a number of options to require the disclosure of covered short sale transactions on Australian financial markets. IFSA supports the implementation of option three, including the disclosure of all aggregate short sale positions by market participants (investors and fund managers) directly to the market supervisor, the ASX, on a timely basis. We consider that such action would promote market integrity, public policy decision making and assist surveillance of the market. We envisage that investors would disclose an aggregate of all their short positions on a company by company basis. This information would be aggregated, categorised according to the stock and released to the market on a bi-monthly basis.

This approach is consistent with the US method of requiring institutional investment managers to report short sales and keeping those reports confidential for two weeks after they are due to be electronically filed with the SEC. The delayed public release aims to prevent artificial volatility in trading and to avoid further downward selling pressure caused by short sales. The measure allows investment managers to keep their strategic and proprietary trading positions involving short sales confidential prior to public release.

IFSA also supports the incorporation of a de minimus exemption for reporting, consistent with requirements currently imposed by the SEC and FSA (i.e., aggregate short positions under a defined percentage of the outstanding shares in the company are not required to be reported). This will reduce data provision and capture costs for investors and the market supervisor. We submit that the level of the de minimus exemption may initially be defined at 0.25% to allow immediate reporting and disclosure. The de

³ Thomas J. Boulton and Marcus V. Braga-Alves, *The Skinny on the 2008 Naked Short Sale Restrictions*, Working Paper 2008, . Available at <http://ssrn.com/abstract=1267369>

minimum level may subsequently be lowered in order to enhance the information received by the ASX and ASIC while ensuring that trivial levels and noise that might come from delayed settlements continues to not be disclosed.

Additionally, we also recommend consistency of the proposed short selling disclosure regime with other existing individual reporting obligations, including the disclosure of substantial share holdings (positions exceeding 5% of the underlying stock).

Where the specific concern is market manipulation or speculation, the ASX and ASIC should have both the information and capability to investigate thoroughly and impose punitive penalties (including a trading halt where appropriate) where malpractice, settlement failure and/or illegal activity is identified. These punitive penalties should also be publicly disclosed.

Finally, the new disclosure rules should capture all market participants. We therefore welcome the consideration of establishing an 'Approved List' of compliant funds/investors permitted to short sell and required to disclose their positions. We see as critical that Government and ASIC further develop similar mechanisms to ensure non-ASIC regulated participants/schemes are also required to disclose their short sale positions. In this regard, we note the steps taken by ASIC in relation to establishing a mutual recognition arrangement with the SEC and would like to see an extension of these arrangements to other foreign regulators where appropriate.

Disclosure of covered short sales to brokers

IFSA does not support the disclosure and identification of information trades (short sales) to other market participants as a permanent reporting solution. We submit that the disclosure of short positions to brokers (as proposed in option two) may result in commercially sensitive and active investment research related information being exposed to other investors and market participants. This has the potential to distort the market, encourage market manipulation and free rider behaviour (including front running strategies), and ultimately act as a disincentive for active investment research.

Securities lending clarification

Maintaining the confidence of securities lending programs/businesses is fundamental in preserving the liquidity and stability of Australia's capital market. We recognise that the Government has consulted widely on the current 30 day prohibition and has provided some relief, including a no action position for owners selling from stock lending portfolios (AD08 – 23). This position has clarified existing market/stock lending practices and we recommend that this no action position remains permanently in place.

Increased transparency of securities lending

In conjunction with option three, IFSA is also supportive of developing a system where aggregated lending data is disclosed by custodians directly to the ASX (option four). The disclosure of aggregated lending data, in addition to covered short sales, will provide transparency benefits for the market supervisor and enhance its capacity to monitor the efficient operation of the capital market.

Application of the uptick rule for covered short selling

We note that the uptick rule (where a short sale can only be made at or above the last transaction price) has been removed in many other developed countries with comparable markets. The current rule appears to artificially limit sell orders and distort prices without directly addressing transparency, market manipulation and fraud concerns.

Given the enhancements to the disclosure and reporting of short selling positions outlined above, we believe that the removal of the ASX's uptick rule as it currently applies to covered short sales is warranted.

Naked short selling

While investment managers and other investors may have little need for naked short selling, we note that this may be very useful for market makers and index arbitrageurs. The rationale for naked short selling is speed and when limited to designated market participants may involve very little settlement risk or risk of market manipulation.

2. Transitional reporting period

Certainty over future regulation/requirements is a critical matter for the market. Interim reporting and disclosure requirements should be in place as a matter of urgency to facilitate transition under the new regime and inform the development of permanent reporting obligations/data collection measures by Government and industry under the proposed *Corporations Amendment (Short Selling) Bill*.

We, therefore, support the introduction of an interim reporting requirement for covered short sales directly to the ASX until enactment of the legislation. Where the interim position data is not available and the ASX is not in a position to collect trade data, we concede that consideration of collecting the short selling trade data through brokers for a strictly defined interim period may be necessary. However, in our opinion the de minimus provision outlined above should allow direct reporting to the ASX. If collection is through brokers, we recommend that notification is at settlement date and the requirement is in place for a pre specified limited time (up to a maximum of 60 days).

3. IFSA's recommendations

In summary, IFSA is supportive of enhancing the transparency of short selling and securities lending practices where there is a principles based regulatory response promoting the integrity, efficiency and competitiveness of the Australian capital market. Aggregate short sale positions should be disclosed by market participants (investors and fund managers) directly to the market supervisor on a timely basis in order to assist surveillance of the market, public policy decision making process and promote market integrity.

We further note that there are three periods that must be considered, each of which may require different policy settings. These are:

1. Current period (September 22 to October 22) when a blanket ban of all short selling applies.

Market reaction by investors in long-short strategies and by stock lenders to the blanket ban has been muted because the message is that this is temporary (limited to 30 days) and short positions have not been required to be unwound. If the prohibition is extended, this may continue to directly impact market liquidity and trading volumes, investment mandates, and stock lending activity.

We encourage ASX/ASIC to immediately initiate the collection of information on short selling positions directly from investors. We suggest a reporting date already past (30 September) and that a de minimus exclusion (<0.25% of any company's stock) is allowed as this will dramatically reduce data provision and data capture costs.

2. Transition period – from October 22 until the new short selling regulations are fully operational.

If position data proves adequate, consider extending this to a regular fortnightly process (as in the US) or weekly/daily basis. The frequency of data collection might be expected to have a significant impact on costs. If direct position data from investors to the ASX requires more time to be fully implemented, consideration of covered short sale trade notification to brokers on settlement as described above may be implemented for a strictly defined maximum interim period.

3. Post the implementation of the Bill.

Our recommendations are covered above.

Australia continues to be well regarded for the strength of its regulatory regime and market integrity. Sound corporate governance practices increase confidence in the integrity and efficiency of the Australian capital market. The financial services industry and investors will benefit from a diverse market that is robust to shocks, provides liquidity and has an internationally competitive governance framework. We believe that the measures recommended above will promote certainty and confidence in the Australian capital market, while also upholding its robustness and efficiency.

We look forward to engaging in further consultation with you, The Treasury, ASIC and ASX on the permanent disclosure obligations foreshadowed in your exposure draft *Corporations Amendment (Short Selling) Bill* and supporting regulations.

If you have any questions with regards to IFSA's submission, please do not hesitate to contact myself or Joseph Sorby on (02) 9299 3022.

Yours sincerely



John O'Shaughnessy
Deputy Chief Executive Officer

Cc: Mr Tony D'Aloisio
Chairman
Australian Securities and Investments Commission