Law Council
OF AUSTRALIA

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The Manager
Market Integrity Unit
Corporations and Financial Services Division
The Treasury
Langton Crescent
Parkes ACT 2600

Dear Sir or Madam,

Exposure Draft of the Corporations Amendment (Short Selling) Bill 2008

I have pleasure in enclosing a submission on the Exposure Draft of the Corporations Amendment (Short Selling) Bill 2008 released by the Minister for Superannuation and Corporate Law, Senator the Hon Nick Sherry.

The submission has been prepared by the Corporations Committee of the Business Law Section of the Law Council of Australia. The submission has been endorsed by the Business Law Section. Owing to time constraints, the submission has not been reviewed by the Directors of the Law Council of Australia.

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Thank you for providing the Committee with an extension of time in which to lodge its submission.

Yours faithfully,

W Grant

Bill Grant
Secretary-General

24 October 2008

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Response regarding the Exposure Draft of the Corporations Amendment (Short Selling) Bill 2008

This is the submission of the Corporations Committee of the Business Law Section of the Law Council of Australia ("**Committee**") in response to Treasury's release of the *Exposure Draft of the Corporations Amendment (Short Selling) Bill* ("**Bill**") released on 23 September 2008.

The Committee welcomes the opportunity to comment on this paper and is grateful for the brief extension of time granted in which to respond.

Our submission

We support Option Two, as outlined in the Commentary to the Bill; supplemented with Option Four information
We support Option Five - review
We believe there is a pressing need for an immediate review of the market manipulation provisions.

Comments regarding regulations

It would have been preferable to release the proposed regulations that will sit with this Bill simultaneously. While we appreciate that this might mean that drafting resources which might not otherwise have been required would need to be applied to this task, it is difficult to comment meaningfully on some of the aspects of the Bill without seeing how this detail will be borne out in the regulations. We make this comment regarding this Bill and in relation to legislation more generally.

By way of example, the disclosure timing issue referred to in paragraph 35 of the Commentary accompanying the Bill is important (that is, the costs of information leakage to brokers of client positions - and the suggestion that this cost might be reduced if client disclosure was required at settlement, rather than on the trade date). The other consideration noted in paragraph 35 is the need to balance the fact that this information is less useful to investors if delayed. This disclosure timing issue is a very important aspect of the legislation which has been left to the regulations.

While the Commentary has acknowledged the issue, the Committee points out that in striking the balance between the two considerations noted in paragraph 35 of the Commentary, it would be unfortunate if the timing requirement included in the regulations meant that a law designed to enhance market integrity in fact created a new opportunity in the market for front-running, thereby undermining market integrity. Some of these concerns might be addressed in a range of ways, for instance, through appropriate information segregation procedures adopted by brokers.

Some drafting comments

The Bill deals with sales on Australian markets of shares in companies registered or quoted anywhere in the world. It does not deal with sales on overseas markets of

shares which are issued by Australian companies or quoted in Australia. Accordingly, where a company is quoted both in Australia and overseas, or where an Australian company is quoted on an overseas exchange, reporting under the Act may be avoided by executing short sales on the relevant overseas markets. This may not open up a regulatory gap, if comparable legislation is enacted in corresponding overseas jurisdictions e.g. if Canadian legislation requires comparable reporting of covered short sales of shares in Australian companies listed on exchanges in Canada. It would open up a regulatory gap, if overseas legislation was applied only to short sales of shares in locally registered companies, or of companies whose primary listing was in the overseas jurisdiction e.g. if Canadian legislation applied only to sales of shares in Canadian companies. The Committee is not suggesting however that as a result of this gap, the Australian legislation should have any extraterritorial application to trading of shares on overseas exchanges.

The Bill's reporting requirement relates only to covered short sales, not to naked short sales. The existing reporting requirements for naked short sales do not cover the same ground as that proposed by the Bill for covered short sales. We note that section 1020B as amended by the Bill would permit naked short sales included in an Authorised List, however ASX's recently published response to the Bill has indicated that it may not reinstate the Authorised List. No policy basis has emerged for a permanent ban on naked short sales. Should this decision be reversed, then the Bill will not address for naked short sales the issues addressed by the regime proposed for covered short sales, and we do not think that appropriate. At present, the regime under which naked short sales are reported and regulated is designed to manage settlement risk, not market manipulation. Where a short sale is covered within the day, it ceases to pose a settlement risk, so may be netted out for reporting purposes. The Bill is designed to enable regulations requiring gross reporting, no doubt because of a concern that covered short sales may have an effect on the market which should be disclosed, even though they are covered by purchases within the reporting period. If this is a justifiable concern as regards covered short sales, it is equally justified as regards naked short sales. It would be preferable that the Bill enabled regulations to be made requiring any short sales to be reported, whether naked or covered, and left any necessary differentiation between naked and covered sales to the regulations themselves. In that way, the definitions relevant to identifying covered short sales could be put into the regulations themselves, and more readily changed to accommodate changes in market practice.

Our submission on the 5 Options

The views expressed below relate to each of the Options of the Commentary to the Bill.

1 Option One - maintain the status quo

If the Committee's submission about review and updating of market manipulation provisions of the Corporations Act (outlined at 5.1 of this paper) is accepted, then it may be possible to maintain the status quo with respect to the laws relating to short selling.

2 Option Two - disclosure of covered short sales to brokers

We note that this Option has been adopted as the recommended approach for the Government. The Committee agrees with this preference.

The Committee's view is that placing an obligation on investors to disclose covered short sale transactions to their brokers and in turn requiring brokers to report those short sales to the market operator is the preferable option.

We prefer Option Two to Option Three because a requirement for investors to make direct disclosure to the market operator raises practical issues of investors' knowledge of the regime, method of disclosure, direct market access and sanctions for non-compliance.

Section 1020B(5) of the Corporations Act currently requires a client disclose to its broker when it conducts a short sale. Such under-reporting as currently occurs may in part derive from the legal question of whether a covered short sale is currently a "short sale" which requires disclosure under current law. That difficulty should be overcome by the Bill.,

The Committee does not support a requirement for the broker to be obliged to request its client to advise it whether a sale is a short sale each time it accepts an instruction to trade. There are significant practical difficulties in applying such a requirement, which may lead to a less efficient trading process. Many orders occur by verbal instruction from a client to a broker. Where there is a frequent course of trading, the formalism of a request for this information is likely to inhibit its practical application Orders are also received in writing, electronically and can be placed direct into the market. For written and electronic orders, such as by sending a file by e-mail, the broker would in such instance not be able to execute without calling the client to confirm the purpose of the trade. This would delay the speed of execution (particularly where the client is in a different time zone) which would impact on the efficiency of the market. It is also the case that the majority of trades are not short sales and to place a requirement on a broker to ask this question for each order would be excessive and potentially confusing to the investors.

The Committee instead supports current industry practice - that the broker fulfil its obligations by pointing to the laws relating to the disclosure of short selling activity in the terms of appointment between it and its clients.

3 Option Three - direct disclosure of covered short sales to the market operator

Option Two is preferable, for the reasons highlighted above. The Committee believes that there are significant difficulties in relation to enforcement if a disclosure obligation is placed on investors to disclose covered short sale transactions direct to the market operator (for example, in relation to offshore investors).

We also suggest that greater changes would be required to market operators' systems under this Option.

4 Option Four - disclosure of stock lending transactions

There appears to be popular demand for this information to be made transparent. We note that other jurisdictions such as the UK require this disclosure.

The Bill deals only with covered short sales, and not at all with the overall short position in the market, or with the level of securities lending from time to time (except as revealed by disclosures that shares have been borrowed and sold). While the volume of covered short sales from day to day may be useful information, it needs to be placed in the context of the overall short position in the market, or at least the rate at which short positions are being closed by buying in and returning borrowed securities. A certain level of short sales, or of securities borrowing, may support very different inferences, depending on the concurrent level of short-cover buying or returns of securities previously borrowed. The draft Bill makes no provision for regulations to require the disclosure of short-cover buying, or of returns of securities previously borrowed.

The Committee agrees with the Government's comment that the disclosure of stock lending is not a perfect proxy for short selling. We support the ASX's position paper "Transparency of Short Selling and Securities Lending" released on 2 October 2008 in response to the Bill insofar as it outlines that if the Government is to achieve the provision of "greater transparency on the extent of directional short selling in a cost effective and efficient manner, short selling data supplied under Option 2 should be supplemented with the reporting of securities lending data". (See page 7 of the paper).

5 Option Five - review existing short selling regimes

It will be necessary to carry out a review of the regulatory framework in this space if the Bill comes into effect and we would suggest this be done within two years.

As outlined below, it is our primary concern that a review of the laws relating to market manipulation is required now.

5.1 A pressing need to review the market manipulation provisions

It is the Committee's primary concern that a wholesale review of the laws relating to market manipulation should be carried out, and that is more important to market integrity, as opposed to a review of the regulatory framework relating to short selling. The regulatory responses, via the Bill, the ASX position paper and the various ASIC releases and class orders dealing with short sales are, at their core, aimed at preventing market manipulation. The Corporations Committee has previously submitted the market manipulation provisions should be re-examined.

We are of the view that sections 1041A - 1041H (and related provisions) each require a specific review as these sections derive from 1970s market activity. In that regard, we note:

- it is clear the sections reflect the market circumstances which they were designed to meet: state based stock exchanges with open outcry trading. The sections do not meet the challenges of computerised stock markets, multiple local and international markets for stocks, simplified electronic communications around the world, and the advent of programmed trading strategies;

- there is a notable lack of successful prosecutions under these sections to date. The difficulties of enforcement of existing laws is made worse by the impact of globalisation, where trading decisions or conspiracies may be made offshore, which complicates enforcement of existing laws, for instance, to deal with "rumourtrage". Different enforcement strategies and enforcement powers will be needed to address this.

5.2 Naked short sales

We are of also of the view that a general review of the laws relating to naked short sales is required, particularly in light of intra-day activities and the blanket ban that is currently imposed.

Thank you for the opportunity of making these comments on the Bill. If you wish to discuss any aspect of our response, please contact the Chair of the Corporations Committee, Greg Golding, on (02) 9296 2164.