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

By email: shortsellingbill@treasury.gov.au

Dear Sir

CORPORATIONS AMENDMENT (SHORT SELLING) BILL 2008 - SUBMISSION ON EXPOSURE DRAFT AND COMMENTARY

Introduction

The Securities & Derivatives Industry Association (SDIA) is the peak industry body representing institutional and retail stockbrokers and investment banks in Australia. It has 65 members accounting for 98% of market turnover by value. SDIA is pleased to comment on the Exposure Draft and Commentary of the Corporations Amendment (Short Selling) Bill 2008.

Covered Short selling has been demonstrated to be beneficial to the securities market in a number of ways. It provides a significant degree of liquidity to the market and aids price discovery. Short selling also represents an extremely important tool for economic risk management.

In our view, the difficulties, whether real or perceived, presently being articulated stem from the lack of transparency regarding the true level of the aggregate short position in a security. The existing legislation has not worked adequately to achieve this transparency, and SDIA supports legislative amendments which would remedy those shortcomings. If the true short position were more transparent, then participants in the market would be in a position to react accordingly. There would be less likelihood of the perception that the market was being unfairly distorted, as opposed to reflecting ordinary forces of supply and demand.

In view of the potential for the granting of licences to additional equity markets, and given that obligations may need to be imposed on persons not subject to Market Operating Rules, SDIA supports a response by means of legislation. We note that the Exposure Draft sets out the basic framework, with much of the detail left to be prescribed by way of Regulation, details of which are not yet available. The detail of those Regulations when available may raise further issues calling for submission or comment.

SDIA notes also that the subject of short selling law reform has emerged against a backdrop of suggestions of possible market manipulation. In our view, considerations of market manipulation tend to confuse the issue of what should be the appropriate form of regulation. Market manipulation is already an offence, and there are in our view sufficient legislative tools available to deal that offence. The proposals ought not be viewed as an aid to preventing market manipulation. The issue that needs to be addressed by the proposed changes is remedying the transparency of the short position in securities, and we support the Exposure Draft focus on that objective.

The changes should also not be seen as designed to address settlement risk issues. Settlement risk may well have been an early consideration when the short selling rules were originally enacted, but this is no longer the case. Settlement risk has now been addressed by a range of other developments, including most recently, changes to fail fees and the application of Market Rule enforcement procedures in respect of repeated failures.

Submissions - Preferred Options

SDIA supports changes which would enable the market to best ascertain the true picture of the outstanding short position in listed securities in the most resource efficient manner.

SDIA submits that Option 4 (Disclosure of Stock Lending transactions) offers the best potential to achieve this objective, and hence should be the preferred option.

Our understanding from discussions with ASX is that, with some modification and system changes, the CHESS system can be adapted so that an appropriate tag can be applied to stock lending and stock loan return transactions. This would enable a figure for the outstanding stock on loan to be calculated and reported on a daily basis. Access to CHESS would also be able to be extended to all of the entities engaged in the stock lending market who may not currently be CHESS participants.

The outstanding stock loan position is, we believe, the best available proxy for the outstanding short position for a listed security. Contrary to belief in some quarters, the volume of naked short sales is not significant, and naked shorts are predominantly covered by buying back the securities intra-day. As the bulk of short sales are covered short sales settled with borrowed stock, then it follows that open short positions should all essentially be included within the outstanding stock lending position.

Securities may be borrowed for reasons other than to cover short sales. For example, stock may be borrowed for the purpose of dividend reinvestment plan arbitrage, where one party will borrow stock in order to participate in a company's dividend reinvestment plan, where the lender may be unwilling or unable to do so itself. There may be other uses to which borrowed stock is put from time to time.

Therefore, the outstanding stock lending position does not precisely reflect the outstanding short position, and may need to be discounted to reflect the other uses of borrowed stock. However, market participants would generally regard stock loan information as giving the most useful indication of the outstanding short position, notwithstanding these potential imperfections.

As Option 4 involves modifications to infrastructure already in existence (CHESS), then in terms of resource impact, the burden of implementing Option 4 should be relatively low.

It is noted that the preferred option in Treasury's Commentary on the Draft Bill is Option 2, based on broker reporting. SDIA notes that the regulatory regime in place up until now, by virtue of the combination of the Corporations Act and the ASX Market Rules, has been based on daily reporting by brokers of their "net short sale" position. SDIA also notes that the US position is also based on position reporting by brokers, albeit on a twice monthly basis.

There are some significant shortcomings with Option 2 which in SDIA's view would make the reported positions unreliable as an accurate picture of the outstanding net short position. The shortcomings of Option 2 stem from the following:-

- ***Use of multiple brokers.*** A client who sells short through one broker may later buy back the securities through another broker. Clients, particularly wholesale clients, can and frequently do use more than one broker. Order flow is often shared between brokers on a panel. Order flow will be directed to brokers based on a number of considerations, including quality of execution, the ability to source the other side of the order, and as a reward for quality research.

As a result, under Option 2, a broker may well report the client's short position from the date of creation ad infinitum, if the client does not later notify it that the position has since been covered through a purchase through a different broker. The short position data may tend to swell over time to the point that it is entirely worthless as information. As short positions may sometimes be open for a period of months or even years, it would not be safe for a broker to assume that data can be purged after a certain length of time.

- ***Reliance on client.*** Broker reporting relies on the client notifying the broker that the sale is short. There is an inherent risk that clients may fail to do this, either deliberately or because of innocent error. There is no reason to believe that clients will deliberately fail to comply with an obligation to tell brokers that a sale is a short sale, however, the potential remains for this to occur. The client may also simply forget as a matter of human error. It is also possible that the order placer may not realize that their entity is short overall, especially if there are a number of traders each trading separate books within the one client entity.

For these reasons, whilst SDIA's members would be in a position to comply with a regime based on broker reporting, as is already the case, Option 2 is not in our view the preferred outcome. Option 4, being based on transactional data extracted from CHESS, would not be susceptible to the above two factors.

It may be considered attractive to pursue both Option 4 and Option 2, on the basis that a combination of the two sets of data would assist the market even further in ascertaining the true picture of the outstanding short position in a security. In view of the shortcomings referred to above, SDIA queries whether Option 2 would be of added value, or would in fact tend to confuse.

If Option 2 is to be pursued, the information required to be reported should be the broker's gross end of day short position (including that of clients) without any netting. Intraday movements should not be required to be reported, as this would complicate the reported data and significantly increase the burden and cost of reporting.

One suggestion that has been made, in view of the likely distortion arising from the factors referred to, is for brokers to report each day starting from a zero base, with the result that each report will only show the new short position created by the broker's trading for that day. It is questionable whether this information would add sufficient value to justify the cost and burden of reporting it.

Disclosure of Short Sales at Time of Sale

In the context of Option 2, should disclosure by brokers be adopted either in conjunction with Option 4 or on its own, a question which arises is whether or not short selling should be required to be disclosed at the time of sale.

Under the existing ASX Market Rules short selling provisions, for those short sales which fall under the Rules, the selling broker is obliged to flag the sell order with parameter S.

SDIA submits that disclosure of short sale information at the time of sale does not assist market participants in understanding the market for the security, and would instead amount to additional "noise". It may be that a covered short sale is in connection with a delta neutral position, such as a stock versus futures contract index arbitrage position, or a hedge for an equity swap. In the absence of knowing the reason for the short sale, the usefulness of knowing merely that the sale is short is very limited.

SDIA submits that the overall short position at the end of the day is the information of prime significance to the market, and should be the focus of the proposed provisions. There should not be a requirement for disclosure at the time of sale as well.

Positive obligation to inquire if sale is a short sale

In connection with a possible requirement for disclosure by brokers under Option 2, there is a question whether this should involve a positive obligation on brokers to inquire of a seller in the case of every order whether the sale is a short sale. This requirement is currently a feature of the interim regime under ASIC Class Order 08/751.

This is an onerous obligation which is proving costly in terms of time and resources, and is not always welcomed by the client. For example, a broker will often speak to the same client a number of times in one a day. Being required to make the same enquiry in each case is excessive and can be annoying to the client. There are also cases where the question would be unnecessary, such as where the client is a long-only fund, or where it is possible to see that the client is registered as holding the stock in CHESS.

There have been reported instances since the introduction of ASIC Class Order 08/751 where, in relation to unsophisticated “mum and dad” retail clients, the enquiry of the client by the broker has led to confusion and even distress as the client struggles to understand the meaning and purpose of their being asked whether they own the stock. Broadly speaking, retail investors do not have the ability to establish stock borrowing arrangements, or the tendency to engage in short selling strategies, whether covered or not. Hence, in many cases, the enquiry does not serve any useful purpose.

The existing ASX Market Rule 19.8.1 requires a participant to inform its clients that they have an obligation to notify the participant whenever they place an order for a short sale. ASX participants are obliged to put in place arrangements to ensure that they comply with this obligation. It should be sufficient for the broker to draw the attention of clients to their obligations by highlighting them in the terms of business or in other appropriate documentation.

Prior to now, there has been no obligation on clients to notify brokers that they were engaging in covered short sales. Hence it cannot be inferred that clients have been concealing covered shorts from their brokers before now, or that they have otherwise failed to comply with the obligation to notify their broker at the time placing the order. There is no basis to conclude that notifying the client of the relevant obligation at the outset will fail to adequately draw the client’s attention to their obligations, or that the clients will not meet those obligations in the absence of the broker being obliged to make enquiry every time the client places a sell order.

There are additional issues created where brokers deal with financial intermediaries rather than with the underlying clients of the intermediary. The commercial sensitivities of those arrangements are usually such that the broker’s direct dealings with the underlying clients are limited. It should be sufficient for a broker to inform the intermediary of the underlying client’s obligations and for the intermediary to notify the broker that they hold the necessary information and will inform the broker when a sale is short. These arrangements ought to be regulated along the same lines as the relevant provisions of the AML/CTF Legislation, which permit a reporting entity to rely on the client identification carried out by the financial intermediary.

Other Options in Commentary to Draft Bill

We note the other Options set out in the Commentary. In our view, Option 1 does not address the shortcomings of the existing legislative provisions that have been identified regarding the reporting of covered short sales.

We agree with the shortcomings identified with Option 3 in the Regulation Impact Statement of the Commentary. The logistics and cost of establishing the mechanism of direct reporting by investors makes this option undesirable.

SDIA does not support Option 5. We do not believe that a wider review of the short selling regime is needed at this stage. We believe that addressing the question of transparency shortcomings should prove to be an adequate remedy for the problems that have been identified, and implementing those changes will mean that further change is unlikely to be considered necessary.

Naked Short Selling –should this be banned?

The term “naked short sale” is taken to refer to a short sale where the seller either has no borrowing arrangements in place, or has an borrowing arrangement but has not secured the borrowed stock prior to the sale.

As noted earlier, SDIA does not believe that the data supports the view that there is a significant level of naked short selling in the market. The bulk of short selling is covered by stock borrowing.

Because of the need to settle short sales, existing naked short selling is very largely intra-day. Any effect on the price of a security of intra-day naked short selling is not prolonged.

Therefore, SDIA does not argue in favour of the retention of naked short selling, except in relation to certain express instances set out below, nor, on the other hand, does it consider there to be any significant grounds for concern if it were permitted to continue. We reiterate our earlier comment, that the objective of the short selling provisions should not to be confused with the objective of preventing the incidence of settlement failure, as the latter is dealt with by other measures such as the level of fail fees and the potential for disciplinary proceedings for persistent settlement failure.

If naked short selling is to be prohibited, there would need to be certain express carve-outs for appropriate cases. For example, an error by a broker or client may result in a sale of stock which is not owned. Another instance is client facilitation /market making, which is a valuable service to clients that will often involve a naked short sale. A client may ask for a price quote from the broker for an amount of stock, and will expect the broker to facilitate their order by fill the client on the spot and not have to wait whilst the broker secures a stock borrowing. Prices may move significantly in the meantime. Facilitation trades are usually closed out as soon as possible and before the end of day, and therefore do not pose a risk to the market.

Uptick Rule.

SDIA submits that the Uptick Rule no longer achieves any purpose and should be abolished.

In support of this, we note the following:-

- The tick rule has now been widely removed from most major stock exchanges, including the NYSE, Hong Kong Tokyo and London Exchanges
- there is evidence from overseas studies that removal of the uptick rule does not adversely affect market quality or liquidity
- enhanced disclosure of covered shorts would help to expose any inappropriate trading
- artificially driving down the price of a security in order to profit from the close-out of a short sale is already a serious criminal offence, and subject to internal and external (ASX and ASIC) surveillance and prosecution.
- The rule creates an unnatural market.

Resource Implications

As mentioned earlier, Option 4 is attractive from the point of view of resource impact in that the CHESS infrastructure exists, and the system changes likely to be needed to adapt the system should not be excessive.

The implementation of Option 2 in addition to Option 4 would involve a significant lead time to carry out system development and would also significant cost. Each broker would be required to undertake the necessary changes to their respective order management and settlement systems to track all short sales, all unwinding of short sales, and obtain aggregate positions for reporting on a daily basis. This will include changes to Direct Market Access (DMA) trading platforms operated by many brokers to provide clients with direct access to exchanges. DMA platforms are complex platforms and usually global, with the one platform beng used to access various exchanges. Consequently, implementing changes to these platforms usually needs to be done offshore and must be carried out in a way which avoids impacting on the operation of the system in other jurisdictions.

Depending on the extent of the obligations imposed, adequate time will need to be afforded to brokers within which to become compliant with the new requirements. This period of 15 months allowed under similar circumstances for compliance with the recent changes to the AML/CTF legislation would be an appropriate benchmark.

Review Period

SDIA supports the existence of a review period, with the obligations being reviewed at the end of 12 months to evaluate whether the new rules are working and delivering the objectives identified.

We would be happy to discuss any issues relating to this matter at your convenience. Should you require any further information, please contact Peter Stepek on (02) 8080 3200 or email pstepek@sdia.org.au .

Yours sincerely,

David W Horsfield
Managing Director/CEO