Chapter 3

Provisions of the bill

3.1 The bill aims to do three things: clarify ASIC's powers, ban naked short selling and improve disclosure.

Clarification of ASIC's powers

3.2 To avoid any uncertainty about ASIC's action in (temporarily) banning short selling, the bill expressly states that the declarations by ASIC banning short selling were within its powers. It also empowers ASIC to regulate market transactions that have a substantially similar market effect as short sales.

3.3 This clarification seems to have general support, although the Australian Financial Management Association (AFMA) is concerned that the legislation may be giving ASIC, whom they regard as sometimes 'capricious', excessively broad and discretionary powers:

> The rules under which a future prohibition of covered short selling should operate should be governed by regulations which are the subject of policy development and control by the Government.[1]

Ban on naked short selling

3.4 The bill will ban naked short selling. This will mean a seller will need a legally binding securities lending agreement, or an exemption from ASIC, before short selling. There should be a low compliance cost from this change given the 'limited occurrence of naked short selling on Australian financial markets'.[2]

3.5 The ban is supported by the Association of Superannuation Funds of Australia[3] and the Australian Investment Management Association[4], and not opposed by the Investment and Financial Services Association.[5] AFMA would like to see more

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1 Australian Financial Markets Association, *Submission 5*, p. 5. Similar concerns are raised by the Australian Bankers' Association, *Submission 10*, p. 8.

2 *Explanatory memorandum*, p. 4. See paragraph 2.11.

3 *Submission 3*, p. 1.

4 *The Age*, 13 November 2008. AIMA is described as representing the views of the hedge fund industry.

5 Investment and Financial Services Association, *Submission 9*, p. 2.

exemptions allowed for various types of arbitrage and market-making.[6] The Australian Bankers' Association thinks any ban on naked short selling should only last for the duration of the current crisis.[7] Some submissions argued that the bill should confirm ASIC's 'no action' position of 24 September 2008.[8]

3.6 Some organisations are concerned about the status of exemptions. The current rules in the *Corporations Act* allow five kinds of short selling: 'odd lot', 'arbitrage transaction', 'uptick rule', 'approved short sale' and 'contract to buy'.[9] Under the bill only the last of these will remain. Treasury said 'it is intended that ASIC will be able to use its exemption power to allow certain naked short sales. It is envisaged that ASIC will use this power to allow some non-speculative naked short selling necessary to ensure the ordinary operation of Australia's financial markets.' Treasury argued that 'given the dynamics of the market' it is better for exemptions to be facilitated by ASIC rather than by the law.[10]

3.7 Several submissions argued that exemptions to the ban should be included in the Act and not merely be a matter for ASIC's discretion. AFMA thought that this is needed to remove uncertainty about the scope of exemptions. The Securities and Derivatives Industry Association suggested exemption for honest mistakes (eg placing a sell order instead of a buy order by mistake), client facilitation (market making) and 'seller unaware that the sale is short'. [11]

3.8 On the other hand, the ASX approved leaving the exemptions to ASIC's discretion.[12]

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6 Australian Financial Markets Association, *Submission 5*, p. 7. There is some support for this view by the ASX, *Submission 8*, p. 4.

7 ABA, *Submission 10*, p. 4.

8 State Street Bank and Trust Company, *Submission 6*, p.1. Australian Custodial Services Association, *Submission 7*, p.1. ASIC's 'no action' position was that it would not take action against a breach of short selling requirements in the case of a bona fide transaction from a stock lending portfolio, on certain conditions. ASIC announcement AD08-23, 24 September 2008.

9 Australian Financial Management Association, *Submission 5*, p. 6. *Corporations Act (2001)*, s1020B(4). 'Uptick rule': a naked short sale is permitted on certain conditions providing the price is not less than the market price. 'Approved short sales': short sales of securities approved by the market operator.

10 Treasury, *Submission 4*, p.2

11 For example, AFMA, *Submission 5*, p.6. Securities and Derivatives Industry Association, *Submission 14*, p.8. 'Seller unaware that the sale is short' could arise because of information barriers between traders in the same entity for compliance reasons.

12 ASX Ltd, *Submission 8*, p.4. This was stated as by contrast with the present situation where the market operator has discretion with the 'approved list' approach.

Disclosure of covered short selling

3.9 Treasury believes:

> The disclosure …will reduce market speculation and rumour about the activity of short sellers, enhancing market confidence and integrity.[13]

3.10 Submissions generally supported greater disclosure in principle. For example, the Australian Institute of Company Directors supports the initiative, but add that 'those who act in a concerted way could be required to report aggregated short positions'.[14] Greater disclosure is also supported by the Association of Superannuation Funds of Australia and the Australian Securities Exchange.[15]

3.11 However, the devil may be in the details of the timing and manner of disclosure, which will be covered by regulations, expected in early 2009.[16] There are two broad concerns. Firstly, there are concerns that it would be better to set out the disclosure regime in the bill rather than leaving it to regulations. Secondly, there may be problems with the currently preferred disclosure regime.

Laws versus regulations

3.12 The bill sets out a currently preferred, or 'default', option for the disclosure regime but the *Explanatory Memorandum* discusses four other options as well. Treasury advised that the Government will further consult stakeholders in developing the regulations, and does not yet have a settled position on how the details of disclosure should operate.[17]

3.13 There is a perennial argument between the certainty of law versus the flexibility of regulations. On the one hand, embedding the disclosure regime into the bill would give more certainty. However, it would remove the scope to fine tune the rules quickly in response to market developments or in response to ongoing market consultation. It would also delay implementation of the overall bill.

3.14 IFSA wanted key aspects in law, but was content for lesser elements to be in regulations:

> …quite an amount of information and requirements will be placed in regulations.…It is important that we have a framework for disclosure, and certain features of that framework, one being certainly the confidentiality of information if it is passed through a broker is something that should specifically and expressly be in the law. Secondly, the type of information

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13 Treasury, *Submission 4*, p. 1.

14 AICD, *Submission 2*, p. 2.

15 ASFA, *Submission 3*, p. 1; ASX, *Submission 8*, p. 1.

16 Treasury, *Submission 4*, p. 2.

17 *Proof Committee Hansard*, 24 November 2008; Treasury, *Submission 4*, p.1.

> which is made publicly available should be specifically in the law…How that information is collected and put together can be a matter for the regulations…Thirdly, and importantly, we think that the public disclosure of this information also should be a requirement which is placed in the law explicitly.[18]

3.15 More generally, IFSA argued:

> Regulations are essentially there to fill in some of the detail and put flesh on a skeleton. The law itself should have the fundamental and basic requirements and give direction on what should be in regulations. Obviously, the House has the ability to change legislation, whereas when it comes to regulations, unfortunately, they are presented to the House and can be disallowed in whole but cannot be amended, which cuts down the level of debate on appropriate provisions which could be in the regulations.[19]

3.16 On the other hand, other witnesses seemed comfortable with considerable usage of regulations:

> The allocation of subject matter between legislation and regulation seems appropriate to us.[20]

> Our view is that the bill can be a principles based piece of legislation in which the mechanisms for the short selling rules can be developed through regulations.[21]

The disclosure regime

3.17 Under the preferred disclosure regime in the bill, known as option 2, a seller will be required to disclose covered short sales to their executing broker (and a broker must ask whether a sale is a short sale), who will be required to disclose it to the market operator (such as the Australian Securities Exchange). The market operator in turn will publicly disclose information on short sales in particular securities.

3.18 Groups supporting option 2 included ASX Ltd, the Australian Institute of Company Directors, the Association of Superannuation Funds of Australia and Chartered Secretaries Australia. The Australian Bankers' Association advocated a

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18 Mr David O'Reilly, Investment and Financial Services Association, *Proof Committee Hansard*, 24 November 2008, p. 2.

19 Mr David O'Reilly, Investment and Financial Services Association, *Proof Committee Hansard*, 24 November 2008, p. 5.

20 Mr Malcolm Starr, Australian Securities Exchange, *Proof Committee Hansard*, 24 November 2008, p. 7.

21 Mr David Love, AFMA, *Proof Committee Hansard*, 24 November 2008, p. 12.

mixture of reporting gross short sales by investors to their brokers, and net short sale positions by investors direct to the market operator.[22]

3.19 The other options canvassed in the commentary on the exposure draft released on 23 September and in the *Explanatory Memorandum* are:

- (1) No regulatory action;
- (3) Direct disclosure of covered short sales by investors to the market operator;
- (4) Disclosure of stock lending arrangements, on the grounds that this would be a sufficient proxy for the level of covered short selling;
- (5) Review existing short selling regime.[23]

3.20 The alternative option attracting most attention is option 3. The Investment and Financial Services Association preferred it due to concerns about maintaining confidentiality where information is disclosed to other market participants. Mr A. Rofe (former chairman of the Australian Shareholders' Association) argued that option 3 was likely to have lower implementation costs than option 2, and that investors will be in a better position than brokers to report their net short positions, particularly when they deal through more than one broker.[24] Similarly, AFMA suggested that rather than reporting through brokers, it would be better to collect information from custodians and clearing houses.[25]

3.21 On the other hand, the ASX opposes option 3 on the grounds that it would be impractical. The ASX would have to monitor compliance by tens of thousands of institutional investors rather than about 100 brokers.[26] ASX also objected to option 3 on the grounds that its supervisory obligations can only reasonably extend to those with whom ASX has a contractual relationship - and this does not necessarily include the end user.[27]

3.22 Chartered Secretaries Australia opposes option 3 on the grounds that it could result in non-compliance (not least because many offshore investors would be unlikely to be aware of the obligation); enforcement would be difficult; and confidentiality

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22 ASX Ltd, *Submission 8*, p.3; AICD, *Submission 2*, p.1; ASFA, *Submission 3*; CSA, *Submission 10*, p.2; IFSA, *Submission 9*, p.3; Australian Bankers' Association, *Submission 12*, p.6.

23 Treasury, *Exposure Draft of the Corporations Amendment (Short Selling) Bill 2008 - Commentary*, 23 September 2008.

24 A. Rofe, *Submission 13*, p.2. Similarly AFMA, *Submission 5*, p. 11.

25 AFMA, *Submission 5*, p. 10.

26 Mr Malcolm Starr, ASX, *Proof Committee Hansard*, 24 November 2008, pp 7-8. Dr Wood from IFSA suggested as a possible response to this problem only requiring data from the larger funds: *Proof Committee Hansard*, 24 November 2008, p.2.

27 ASX Ltd, *Submission 8*, p. 3.

would be at risk 'with individual notices rather than aggregated notices more likely to potentially disclose individual trading patterns'.[28]

3.23 The Investment and Financial Services Association, while seeing some advantages in option 2, sought assurances that confidentiality could be maintained:

> Disclosure through brokers has the advantage for the regulator and market supervisor of allowing real time tick-by-tick disclosure of all short selling with disclosure of the identity of the broker and the underlying investor. However it runs the risk of significant leakage of information to the market that could increase rumours and reduce market integrity. Reporting through brokers may be appropriate only if adequate technology solutions are in place to protect commercially sensitive information from market participants while ensuring full disclosure is available for the regulator and market supervisor.[29]

3.24 The Securities and Derivatives Industry Association (SDIA) opposes option 2 for practical reasons (uncertainty of relying on the client to advise; situations where a client uses several brokers), and because it regards the proposed obligation on brokers to inquire whether a sale is short as onerous. However SDIA agrees with arguments that option 3 is undesirable, and prefers option 4 (reporting of stock lending).[30]

What information should be reported?

3.25 Some submissions argued that the short selling information envisaged to be disclosed would not be the most useful to the market. The Investment and Financial Services Association, the Securities and Derivatives Industry Association, AFMA and the Australian Bankers' Association agreed that position data are more important than transaction data. AFMA submitted:

> In this context, information that is relevant to the market and regulators on an ongoing basis includes:
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> • the amount of stock that is shorted at a given time;
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> • the trend of short selling in short stock positions over time;
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> • the identity of entities that have substantial short positions.
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> This type of information is not currently available in the Australian market.[31]

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28 Chartered Secretaries Australia, *Submission 10*, p. 3.

29 Mr David O'Reilly, Investment and Financial Services Association, *Proof Committee Hansard*, 24 November 2008, p. 1. Similar concerns about confidentiality are raised by the Australian Bankers' Association, *Submission 10*, p.5 and ASX, *Submission 8*, p. 2.

30 SDIA, *Submission 14*, pp 5, 7 and 10.

31 Australian Financial Management Association, *Submission 5*, p. 10.

3.26 AFMA argued that ASIC's current gross flow data collection does not capture intra-day close-outs, and gives an inaccurate representation of short selling. AFMA argues that it would be better to collect information directly from entities that hold short sale positions, and this is consistent with the approach taken in other countries.[32]

3.27 The Australian Bankers' Association recommended reporting of net short sales positions by investors directly to the market operators.[33]

3.28 Views differed about the timing of the release of information to the market. Some submissions argued that daily release may compromise asset managers' proprietary research, and could lead to free riding behaviour and greater market volatility. To prevent this, IFSA recommended disclosure to the market of aggregate short sale positions weekly or fortnightly (disclosure to the regulator would not be delayed).[34] The Australian Bankers' Association noted that 'this approach reflects that adopted in overseas markets such as the United States'.[35] The Australian Securities Exchange suggested different timing for different audiences:

> Real time would be good for investigative purposes; delay may make some sense for recirculation to market users.[36]

Compliance costs and consultation

3.29 Treasury reported that the proposed measures had been exposed for a month and they:

> …received submissions from a wide range of stakeholders including investors, brokers, the ASX and ASIC. The submissions broadly supported the disclosure of covered short sales subject to diversity of opinion on the mechanism for disclosure…certain industry groups have flagged concern about the direct disclosure of short sale information to executing brokers.[37]

3.30 Compliance costs will depends on the details of disclosure requirements. Some market participants have suggested necessary IT and administrative changes may take up to a year:

> We are talking in many hundreds of thousands of dollars, if not millions of dollars, for various brokerage houses to put in place the types of reporting

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32 Australian Financial Management Association, *Submission 5*, pp 10-11.

33 IFSA, *Submission 9*, p.4. SDIA, *Submission 14*, p.5. ABA, *Submission 12*, p. 6.

34 Mr David O'Reilly, Investment and Financial Services Association, *Proof Committee Hansard*, 24 November 2008, p. 22. IFSA, *Submission 9*, p.4.

35 ABA, *Submission 12*, p.7.

36 Mr Malcolm Starr, ASX, *Proof Committee Hansard*, 24 November 2008, p. 8.

37 Treasury, *Submission 4*, p. 1.

> and IT systems that are needed. The automation of the current reporting regime is going to take a number of months at least.[38]

3.31 Compliance costs may particularly be an issue for the quarter of trades generated by automated processes, and where the one company has a number of trading desks.[39] The ASX notes that in setting up the reporting regime, 'the challenge would be considerable'.[40]

3.32 The Government has indicated it will 'effectively engage with industry to ensure the preferred approach is implemented in a way that minimises regulatory costs and formally review the measures after they have been operational for two years'.[41]

Preventing manipulation of the market

3.33 Concern about possible manipulation of the market is one of the motives for improving disclosure of short selling. Submissions noted that the bill does not address this 'challenging issue' directly.[42] ASX advised that there has been a significant increase in the number of market manipulation referrals by ASX to ASIC this year, and 'both ASIC and ASX have been vigilant in monitoring the market in order to detect and prosecute this type of behaviour.'[43]

3.34 The Australian Institute of Company Directors suggested that where a person (or group acting in a concerted way) engages in short selling they should be subject to disclosure modelled along the lines of the substantial shareholder notice regime.[44]

3.35 On the other hand, the Securities and Derivatives Industry Association argued that the bill is correctly focussed on improving transparency of information about short selling, and its purpose is not to prevent market manipulation since 'market manipulation is already an offence, and there are in our view sufficient legislative tools available to deal with that offence.'[45]

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38 Mr David Love, Australian Financial Management Association, *Proof Committee Hansard*, 24 November 2008, p. 13. See also *Explanatory memorandum*, p. 5.

39 Australian Financial Management Association, *Submission 5*, p. 9.

40 ASX, *Submission 8*, p. 3.

41 *Explanatory memorandum*, p. 34.

42 Australian Financial Management Association, *Submission 5*, p.10. Similarly ABA, *Submission 12*, p.9.

43 ASX, *Submission 8*, p. 4.

44 AICD, *Submission 2*, p. 2.

45 SDIA, *Submission 14*, p.3.

3.36 The Committee notes that one of the terms of reference of the current inquiry into market integrity by the Corporations and Markets Advisory Committee is to review the regulatory regime governing market manipulation.[46]

Committee view

3.37 In other circumstances the committee could see some merit in awaiting further market consultation so as to embed the disclosure regime into the bill rather than allowing it to be determined by regulations. However, in the current market turmoil, it is important to reduce market uncertainty promptly by underpinning the power of ASIC to regulate short selling, banning naked short selling and giving a clear indication that the amount of short selling will be disclosed in future.

3.38 The committee notes that passing the bill does not preclude further consultation with market participants on the most effective means of achieving the third objective of the bill. On balance, it believes the preferred option in the bill for a disclosure regime is probably the best of those discussed, but regards this as a matter that could be usefully explored further.

Recommendation 1

3.39 The committee recommends that the Minister, through Treasury, should continue to liaise with ASIC to ensure general rules and laws around brokerage activities will continue to be reinforced and monitored, particularly in light of new legislative arrangements.

Recommendation 2

3.40 The committee recommends that the Senate pass the bill without delay.

Senator Annette Hurley

Chair

46 Senator the Hon. Nick Sherry, Minister for Superannuation and Corporate Law, 'Action to Further Enhance Market Integrity', press release 19 November 2008.