20 November 2008

Mr John Hawkins
Committee Secretary
Senate Economics Committee
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600

By email: economics.sen@aph.gov.au

Dear Mr Hawkins

Corporations Amendment (Short Selling) Bill 2008

The Australian Financial Markets Association (AFMA) welcomes the opportunity to provide comments to the Senate Economics Committee Inquiry on the Corporations Amendment (Short Selling) Bill 2008 (Bill).

AFMA represents the interests of participants in Australia's wholesale banking and financial markets. Our members include banks, stockbrokers, treasury corporations, fund managers, traders in specialised products and industry service providers. Their business places them at the centre of the equities market; brokering transactions, arranging and underwriting capital raisings, structuring products, trading and investing. They have a vital interest in the development of short selling regulation that promotes market transparency, market confidence and market integrity.

AFMA hopes that the attached submission provides a useful presentation of issues to be taken into account in considering the Bill and suggestions on how it may be improved. We would welcome the opportunity to address the Committee. Please do not hesitate to contact David Love, Director - Policy, at dlove@afma.com.au or (02) 9776 7995 if further assistance or clarification is desired.

Yours sincerely

Duncan Fairweather

Duncan Fairweather
Executive Director

1. Executive Summary

Disclosure and Reporting of Short Sales

- AFMA agrees with the Government that short selling transparency can enhance market efficiency through the price formation process and enable more effective supervision of market activity. This is because short selling intensifies market scrutiny and discipline on listed companies, while the risk of using short selling as an instrument for market abuse is reduced when there is appropriate transparency.

- Short selling transparency can only achieve these outcomes if the data provided is comprehensive, consistent, and reliable which can be readily interpreted by investors and other stakeholders. Information must be of a type which is usable and of value to market participants.

- AFMA considers that market transparency is best achieved through investors disclosing their aggregate short selling positions on a stock by stock basis to the market regulator on a periodic basis.

- Subsections 1020AB(1) and 1020AC(1) of the Bill presently indicate that a client to broker to market operator reporting regime should be implemented. This is the disclosure and reporting model that the Australian Securities and Investments Commission (ASIC) has put in place through its interim short selling regime. This reporting regime is resulting in gross data being collected and reported to the market on a daily basis. The reporting model is considered to be a sub-optimal policy solution and concerns with it are described below. We consider that this reporting model should not be made permanent.

- AFMA's principle concern is with the Bill's formalisation of one reporting model rather than adopting a principles-based approach. This approach would allow an effective disclosure and reporting regime that is in concert with the policy objective of market transparency to be developed and put in place through the regulations to be made under this law.

ASIC Powers

- Granting ASIC the express power to impose a temporary restriction is a sensible measure to provide legal certainty. However, the proposed new subsection 1020F(8) contains a number of broad powers allowing ASIC to introduce new and varied rules. 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.

Naked Short Selling

- The Bill, by replacing the current subsection 1020B(4) with a new subsection (4), makes it clear that a seller must have effective borrowing arrangements in place. Effectively, the new law will only permit a covered short sale to take place. This will make the current exemption that permitted limited naked short selling no longer available.

- The Bill enables ASIC under paragraph 1020F(1)(c) to impose future bans on covered short selling. AFMA members are concerned that with the repeal of subsection 1020B(4) critical market operation exemptions are removed.

- The lack of properly developed exemptions in the Corporations Act is a problem. Exemptions are a part of ASIC's temporary regime and are required in the event that future prohibitions of covered short selling are imposed. Accordingly, such exemptions should be included in the Bill.

2. General Remarks

Share market volatility during the credit crisis has highlighted the need for government and the industry to work together to ensure that conditions exist under which investors have confidence in the efficiency and fairness of the market. Australia's regulation of short selling is strict by international standards. Nonetheless, there is an evident desire amongst investors and many listed companies for greater transparency of short selling activity. Confidence in the integrity of the market is vital to support its economic functions; especially price discovery, investment facilitation, risk management and the provision of capital finance for Australian businesses. Therefore, this challenge to improve transparency must be met head-on and addressed in a comprehensive manner.

The success of new regulation to enhance transparency will depend on the identification and collection of market data that would best assist investors, traders, analysts and companies in undertaking their various (but related) activities. In other words, policy makers must be clear about the type of information that would be used by the various stakeholders to improve their decision making processes and then devise legislation and rules to implement the required information collection and dissemination processes.

In formulating our view, we have considered the lessons learnt from the implementation of ASIC's interim disclosure and reporting rules and overseas experience, especially in relation to the collection and use of information on short selling activity. This practical experience is helpful in identifying proposals that are feasible and should in practice improve the regulation of short selling.

This submission will address the three components of the Bill relating to ASIC powers, the naked short selling ban and the disclosure and reporting of covered short sales in the order they are presented in the Committee's invitation for submissions.

3. ASIC Powers

ASIC has powerful discretionary modification powers under the existing subsection 1020F(1) of the Corporations Act. ASIC's unfettered discretionary modification powers, particularly under Chapter 7 of the Corporations Act have been a long standing topic of legal commentary and doubt because of the degree to which they may usurp Parliamentary prerogatives as well as public policy concern with good practice and process by ASIC.

The Bill amends section 1020F to give ASIC expanded discretionary power to amend the law. This is an issue of concern in the context of industry's recent experience with ASIC on the short selling issue.

ASIC Discretionary Powers and Consultation

The public policy concerns have formed part of a better regulation review and fall under the Government's Better Regulation policy. Within this government policy framework ASIC has put in place a series of Better Regulation measures. These measures include its Better Regulation Initiatives, in which ASIC commits itself to the following aims:

- reducing the regulatory burden on business;
- getting better outcomes for consumers and investors;
- making our regulatory approach and processes more transparent;
- minimising duplication;
- better analysing the impact of what we do;
- making it easier to deal with us;
- making our regulation easier to understand, and our publications clearer and easier to find; and
- communicating clearly and effectively about what ASIC does[1].

ASIC in responding to the Government's expectations has also stated in its Statement of Intent[2] that it will aim for its guidance to:

- meet the real needs of industry participants;
- only be issued after:
    - effective consultation with stakeholders affected by it;
    - detailed examination of cost and other impacts;
    - consideration of options, including for industry based solutions;
- focus on outcomes and maximise opportunities for industry choice and innovation in how outcomes are to be achieved; and
- be clear and readily accessible.

ASIC has fallen short of several of its own aims in dealing with the development and implementation of its temporary short selling prohibition and disclosure regime, particularly in relation to consultation with stakeholders. Its practice and process was capricious on this issue. This is in part because it was asked to quickly carry out complex policy development, a role for which the Treasury has the strategic policy understanding and is appropriately equipped to deal with.

The question of restricting short selling practices was a matter high on the Australian public policy and regulatory agenda from April 2008. The period between April and September provided time for the Government and ASIC to

[1] Better Regulation ASIC Initiatives, ASIC, April 2006
[2] Statement of Intent, Tony D'Aloisio ASIC Chairman, 27 June 2007

anticipate market developments, and develop effective contingency measures. ASIC did not carry out consultation with industry before announcing its temporary report rules late on Friday 19 September, followed up by a sudden change of course on Sunday 21 September 2008 when a temporary ban on short selling was introduced. As a result of the failure to carry out prior industry consultation, the ASIC rules required very hurried amendment to make them workable in time for market trading in the following week as a result of industry expertise being brought to bear after the announcement. Numerous technical and operational issues have had to be addressed in close consultation between industry and ASIC since 21 September. Greater planning and preparation should have gone into developing ASIC's temporary short selling regime.

This industry experience with due process not being followed over a policy issue with major market impacts, causes concern with the grant of further discretionary powers to ASIC. This approach to regulation is unsatisfactory and does not follow the Government's Better Regulation policy. Development of policy should be carried in consultation with industry. Regulation Impact Statements are required to be presented to policy decision makers in time to inform their decisions. The statements must also accompany bills and subordinate legislation into Parliament, enhancing the scope for informed political debate and public accountability.

The objective of the amendment to section 1020F is to clearly indicate that ASIC has the power to impose restrictions and prohibitions on covered short selling in the future. Granting ASIC the express power to impose a temporary restriction is a sensible measure to provide legal certainty.

However, the proposed new subsection 1020F(8) contains a number of broad powers allowing ASIC to introduce new and varied rules. 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. Such rules should be developed in consultation with stakeholders and available before the event so that they can be factored into contingent business system plans.

4. Naked Short Selling Ban

Australia has long standing short selling rules. Considered in isolation from the recent ASIC interim rules, the *Corporations Act 2001* prohibits short selling of securities, subject to several exemptions. A person may not sell securities unless, at the time of the sale, the person has or believes on reasonable grounds that the person has a presently exercisable and unconditional right to vest the products in the buyer.[3] This wording gave rise to uncertainty regarding the extent to which so-called 'naked short-selling' was permitted, where the seller has either borrowed or arranged to borrow securities before placing the order on market.

Section 1020B(2) of the Corporations Act sets out the general prohibition against short selling in Australia. A short sale is one where the seller does not have 'a presently exercisable and unconditional right to vest the products in the buyer'. This is subject to five main exemptions:

[3] Subsection 1020B(2)

1. Securities traded by a financial services licensee who is a participant in a licensed market and who specialises in dealing in odd lots (the 'odd lot sales' exemption).
2. Securities sold as part of a bona fide arbitrage transaction (the 'arbitrage transaction' exemption).
3. Securities sold by a person who has entered into a contract to buy the securities, but has not completed the purchase at the time of the short sale (the 'contract to buy' exemption).
4. Securities sold where arrangements are made before the sale to enable the delivery of the securities of the class sold to be made to the buyer within three business days after the sale (the 'covered short sale' exemption). At the time of the sale, the seller must not be an associate of the body corporate that issued the securities. Pricing restrictions apply to these sales so that the short sale price is at or above the price of the last sale (the so called 'uptick rule'). The short sale must also be reported to the ASX.
5. Short sales of approved securities, as designated by the ASX, sold in accordance with the operating rules of the market (the 'approved short sale' exemption). At the time of the sale, the seller must not be an associate of the body corporate that issued the securities and the short sale must be reported to the ASX. The uptick rule also applies to this exemption.

Under the existing Corporations Act wording naked short sell was not a permitted exemption. However, there was limited scope to naked short selling because under ASX settlement rules sellers have three days to deliver the securities following the sale. A seller with a naked short position had to find securities to borrow to cover their position by the end of the T+3 settlement period. This situation enabled sellers to enter into a transaction to buy the securities within the three day period. If they settled late they incurred a relatively modest delay fee imposed by the ASX.

The Bill, by replacing the current subsection 1020B(4) with a new subsection (4), makes it clear that a seller must have effective borrowing arrangements in place that will only permit a covered short sale to take place. This will make the type of practice described in the paragraph above impossible.

The Bill enables ASIC under paragraph 1020F(1)(c) to impose future bans on covered short selling. AFMA members are concerned that with the repeal of subsection 1020B(4) critical market operation exemptions are removed.

The lack of properly developed exemptions in the Corporations Act is a problem. Exemptions are a part of ASIC's temporary regime and are required in the event that future prohibitions of covered short selling are imposed. Accordingly, such exemptions should be included in the Bill.

The serious problems caused by the exemptions being made unavailable are illustrated by the situation which arose when ASIC introduced its Class Order 08/752. In the Class Order, the temporary notional section 1020BD overrode the existing exemptions in section 1020B(4) where a covered short sale involved a securities lending arrangement. Urgent remedial action was required to put in place exemptions, amongst others, with regard to:

- Arbitrage transactions in relation to the securities of dual listed entities to make covered short sales of the relevant securities in Australia.
- Index arbitrage transactions.
- Market makers to cover their activities in relation to client facilitation, hedging over-the-counter (OTC) equity swaps, convertible securities issues and contracts for difference (CFD) products where the client holds a long position.

As the Bill is designed to remove uncertainty surrounding the scope of permitted short selling activities it should set out in the law, rather than regulation, exemptions that are necessary to ensure the efficient operation of the market. Critically, the Bill should include market making exemptions. These exemption measures can be modelled on those developed under ASIC's temporary prohibition and disclosure regime.

5. Disclosure and Reporting of Covered Short Sales

Market Transparency Policy Objective

It is important to be clear about the purpose of short selling regulation before designing legislation to give effect to this objective. The Government's policy objective stated in the Explanatory Memorandum is to increase transparency surrounding the activity of short selling in Australian securities. The objective is to provide useful information to investors and regulators and also contribute to confidence and market integrity. Disclosure is intended to:

- provide an early signal that individual securities may be overvalued;
- indicate that a proportion of the sales in an individual security will need to be reversed by new purchases (to cover the short seller's settlement obligations);
- enhance investors' willingness to participate in the market by removing uncertainty surrounding the level of short selling; and
- potentially deter market abuse or reduce the opportunities for market abuse.

We agree that short selling transparency can enhance market efficiency through the price formation process and enable more effective supervision of market activity. This is because short selling intensifies market scrutiny and discipline on listed companies, while the risk of using short selling as an instrument for market abuse is reduced when there is appropriate transparency. For example:

- Transparency helps investors to avoid over-paying for a stock (eg short selling may sharpen the market's focus on a company whose disclosures are not timely or are incomplete). Short selling allows the price discovery process to occur more quickly as differing views on the value of a stock compete in the market place.
- Transparency assists management by focussing a company's attention on the issues in its business that might be the cause of short selling or

by more quickly correcting inaccurate information on its business affairs.

- Transparency helps traders to assess the technical market conditions, having regard to positions that must be unwound or rolled-over in the future.
- Transparency discourages the use of short selling for illegitimate purposes, like market manipulation, by making the market aware of related transactions and by increasing the risk of detection by regulators.
- Given all of the above, transparency enhances investor confidence in the integrity and fairness of the market.

Short selling transparency can only achieve these outcomes if the data provided is comprehensive, consistent, and reliable which can be readily interpreted by investors and other stakeholders. Information must be of a type which is usable and of value to market participants.

Our experience is that it is a significant challenge to obtain data within the framework of the current law and ASX rules that would create the sought after benefits without inadvertently generating regulatory risk or unreasonable cost. However, having discussed these issues extensively with members, we believe there is a form of transparency that would meet the Government's stated objectives in a comprehensive and efficient manner.

Market Information

Short selling improves the functioning of markets by helping the market to more quickly correct the price of overvalued securities and can level out fluctuations in market prices. Indeed, the presence of active traders promotes the search for information on the issuers of securities and, hence, the more rapid adjustment of prices to the economic value of a business. Short selling may help temper share price increases, reducing the potential for overshooting on the upswing.

ASIC's ban on short selling allows some objective observations to be made, which provide evidence for the preceding comments. It is an observable fact that the Australian share market during October 2008 has been driven by investor views about the fundamental values of various stocks in a deteriorating macro-economic climate, not short term gaming of the market for profit. The market would have descended to its present level regardless of whether or not a short selling ban was in place. We have also observed high levels of volatility in share prices. Short selling would have provided a cushioning effect in cases where extreme price movements were occurring and provided more liquidity.

Short selling is undertaken for a variety of reasons, most of which are not speculative:

- *Arbitrage* – Short selling provides a mechanism to remove pricing anomalies in a timely and efficient manner.
- *Market Making* – Market makers who market make and facilitate client trades could not provide this level of continuous liquidity to the market in the absence of the capacity to short sell securities.

- *Risk Management* – Many investors seek downside protection, which is available through the derivatives market. Derivatives traders who provide hedging arrangements need to manage the associated risk that they accept from their clients. Short selling is an important part of their operational toolbox and their ability to meet their clients' hedging demands would be significantly constrained if unnecessary regulatory constraints were placed on short selling.
- *Capital Raising* – Short selling provides a risk management tool to assist capital raising in some instances; in particular, it can help facilitate the underwriting of dividend reinvestment plans, without which some companies would find it more difficult to raise capital;
- *Funds Management* – Short selling increases the range of complex strategies that might be adopted to more effectively meet investment objectives.

The various reasons for short selling means that care must be taken in presenting and interpreting the data for it to have value.

For example, it is estimated by AFMA members that around 25% of the trading volume in Australian equities is generated by algorithmic and statistical arbitrage trading. Long and short sale positions arise in comparable proportions over monthly timeframes. This trading is carried out by computer programs (algorithms) that trawl through information from streams of market data and then subject this data to statistical or quantitative analysis for making automated transaction decisions in the financial markets. These are typically fast moving model based trading systems dealing in small lots at high frequency. As they are machine initiated they are not reacting to specific market events such as company or market news or reflecting daily human intentions and motives. This brings greater liquidity and therefore efficient price formation to the Australian market. Simplistic presentation of gross short selling flow data from such a significant trading source is difficult for unsophisticated investors to interpret.

It is information on short positions taken by investors that is most relevant to price determinations in the market and, hence, drives price action. Consequently, data on short selling positions is the most useful piece of short selling information to an investor when they are evaluating market conditions. Moreover, it is valuable information to a regulator looking to detect an abnormal build-up in market pressure on a stock. Data on transactions do not provide a guide to actual positions in a stock and members advise their traders consider it is much less useful from a market transparency and efficiency perspective.

In this context, information that is relevant to the market and regulators on an ongoing basis includes:

- The amount of a stock that is shorted at a given time;
- The trend of short selling in short stock positions over time;
- The identity of entities that have substantial short positions.

This type of information is not currently available in the Australian market. Making such information available to the market would provide clear evidence of the positive role that short selling plays in the market.

Given the need to keep the regulatory burden on business within reasonable bounds, it is important for the Government to avoid imposing multiple layers of transparency regulation on the market; for example, by requiring real time tagging of orders and simultaneously requiring the reporting of stock lending transactions. The objective must be to provide a single, clear-cut source of data on short selling.

The Bill does not deal with the question of how rumours affect the market and the possibility that rumours can be maliciously manipulated to affect investor sentiment towards a stock. This is a challenging regulatory issue which merits further policy consideration. Nevertheless, making reliable, objective information available about the positions held in particular stocks, in the way advocated by AFMA, is a tool to combat misinformation.

Meaningful Disclosure Regime

One of the greatest challenges in collecting functional data on short selling is the task of producing consistent data from all market participants on their short selling activity. We believe that the best way to overcome this is to collect information directly from entities that hold short sale positions. For example, fund managers may report though custodians and retail clients through their CHESS sponsors. Fund managers have signalled their willingness to disclose their aggregate short selling positions on a stock by stock basis to the market regulator on a periodic basis.

AFMA considers that this direct disclosure approach is the best way to produce meaningful and reliable aggregate data on short sale positions in individual stocks. It is data that the market would find valuable and would use. The data would be consistent and easier for a wide range of investors to interpret, compared to the information now being presented to the market which masks information of real value to investors. It would also provide listed companies with a clear insight into the build-up of short sale positions in their stock (this is not discernable from transaction data). Meanwhile, the market regulators would receive information that would enable surveillance of significant and unusual changes in aggregate short sale positions in a given stock.

The direct disclosure by investors to the market regulator approach overcomes the serious shortcomings of the current client reporting through brokers model currently implemented under the temporary reporting and disclosure regime. ASIC's reporting model would become a permanent regime if subsections 1020AB(1) and 1020AC(1) were implemented in their present form. These provisions require a seller to advise their executing Financial Services Licensee (eg a broker) when a sale is a covered short sale. This advice is then to be provided to the market operator which in turn reports it to the market.

This cumbersome reporting mechanism has encountered a number of practical implementation problems. There are a variety of practical and operational problems encountered in complying with a real time tagging regime, which give rise to significant concern about the consistency and reliability of the data in terms of the objectives of transparency.

Traders may not be able to advise if a particular sale is a covered short sale at the time of the order placement because they have incomplete knowledge of the entity's total position or how sales are intended to be settled due to firm corporate law compliance measures that result in different parts of trading businesses being segregated from one another (such as through 'Chinese wall' arrangements). The previously mentioned algorithmic and statistical arbitrage trading are also examples of such problems. Other examples are where traders rely on daily stock availability sheets provided by their equity finance desks to support their trading activities. The trader may not know whether the stock availability is sourced. Further, when aggregating several orders together, some of which may be short, some of which are long, tagging the order will not give accurate information to the market on the level of short selling.

ASIC's approach to data collection is resulting in gross flow data collection. This is because such data does not capture intra-day close outs and is volatile over time. The result is an inaccurate representation of short-selling. While it is the prerogative of the regulator to obtain the information it sees fit, a conflict does arise with its investor protection statutory duty when ASIC requires such information to be made publicly available as this can mislead the unsophisticated investor because it is difficult to interpret.

From the professional market point of view, low value is attached to the information that is being collected under the ASIC regime. Transactional flow data is not as relevant as position data, as no observer of individual transactions can make a judgement as to the size of the open short positions in the market.

Information integrity is a critical part of market transparency. Other jurisdictions have recognised this point. The disclosure regime AFMA is advocating has an appealing consistency of approach with those taken in key jurisdictions overseas. In particular, the Financial Services Authority in the UK now requires short sellers to disclose net short positions of more than 0.25% in financial stocks. The Securities and Exchange Commission in the US also moved recently to require disclosure by institutional investors of the number and value of each stock sold short, subject to a de minimus condition.

In our view, investors should focus primarily on the fundamentals of companies when making investment decisions, rather than level of shorts in the market. However, if this is relevant to the assessment of intrinsic value, information on open short sale positions (rather than transactions) is the easiest to interpret.

Principles Based Approach Under the Bill

AFMA recommends that the disclosure provisions should operate on a principles based approach. The Bill at present formalises elements of Option 2 set out in the Explanatory Memorandum inconsistently with a principles based approach. Option 2 is similar to the interim reporting and disclosure regime that ASIC has adopted and whose shortcomings we strongly counsel against.

Effective disclosure regulations can be developed in consultation with the Government and subject to Parliamentary scrutiny by removing the prescriptive elements of the Bill in subsections 1020AB(1) and 1020AC(1)

which presently indicate that a client to broker to market operator should be implemented.

6. Conclusion

The recent decline in the share market has been driven by investor views on fundamental values of stock as the macro-economic outlook has deteriorated. Short selling reporting of whatever form would not have changed the path the share market has taken. However, investors would value and benefit from greater transparency around short selling which would engender greater confidence in market trading. Accordingly, we have emphasised in this submission the importance of providing data on short positions that might assist investment decision making and reduce the risk of unsophisticated investors being confused by trying to interpret flow data of the type being presented to the market under ASIC's temporary reporting regime.

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