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The Secretary
Senate Economics Committee
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CANBERRA ACT 2600

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Dear Mr Hawkins

Corporations Amendment (Short Selling) Bill 2008

Thank you for the invitation to attend a public hearing of the Committee in relation to the Bill. To assist the Committee's deliberations, we have prepared the following comments summarising ASX's position.

Executive Summary

ASX supports the Corporations Amendment (Short Selling) Bill 2008.

- The Bill provides a useful framework that has sufficient flexibility to enable the making of regulations as the primary source of key reporting obligations in relation to short selling.
- There are various different approaches that could be adopted to capture and disseminate short sale data. The legislation appropriately leaves the details of the reporting regime to be determined by regulations.
- ASX has weighed up the various advantages and disadvantages of direct reporting by short sellers to the regulator (ASIC) versus indirect reporting via market intermediaries (stockbrokers) to the market operator. ASX's view is that either of these approaches would be preferable to a hybrid of these 2 approaches involving direct reporting by short sellers to ASX.
- The legislative amendments banning naked short selling and removing the scope for market operators to reintroduce the provisions in the future are consistent with the view ASX has taken that this is the type of public policy decision best taken at the legislative level, but with scope for the regulatory authority (ASIC) to ameliorate any adverse consequences of a total ban.

Regulations as the Primary Source of Obligations on the Reporting of Short Selling

Currently, the restrictions on short selling are spread across Corporations Act provisions, ASIC Class Orders and ASX Market Rules. The proportion of important issues relating to short selling that are dealt with by ASIC via Class Orders has recently increased quite significantly as a result of limitations in the legislative framework and the need to act quickly to address market circumstances. The subject matter of these subordinate instruments has not been

confined to questions of detail around the content of disclosures but has necessarily extended to major public policy issues as to whether or not particular forms of short selling should be permitted or prohibited. ASX supports the approach ASIC has taken to the interim regulation of short selling pending improvement of the statutory framework.

ASIC Class Orders and ASX Market Rules have the flexibility to complement a core set of obligations. In ASX's view, it is desirable to have the basic framework set out in legislation and the detail as to what must be reported set out predominantly in regulations (but with continuing scope for ASIC modification consistent with the legislative intent). The reason is simply that regulations represent an appropriate middle course between other options such as setting out all relevant obligations in legislation (at one end of the spectrum) versus setting out all relevant obligations in ASIC class orders or market operator rules at the other extreme. Use of regulations as the primary source of detail provides the opportunity to ensure appropriate parliamentary involvement in the major public policy framework decisions about the objectives to be achieved whilst having different governance arrangements for assessing the more technical input required to be reflected in regulations. Regulations are an appropriate instrument, in our view, for making decisions about who should be reporting to whom, and in what detail, in order to satisfy the objectives that are explicitly or implicitly set out in the framework legislation. We consider that there is sufficient capacity, where the reporting obligations are set out in regulations, for adjustments to be made to cater for changes in market circumstances.

For these reasons, ASX supports the Corporations Amendment (Short Selling) Bill 2008. The Bill provides a useful framework that has sufficient flexibility to enable the making of regulations as the primary source of key reporting obligations in relation to short selling.

Direct Versus Indirect Reporting by Short Sellers

There are different views on what short sale information should be reported, and to what uses that information may be put. These differences add complexity to the already significant task of designing a reporting regime to meet the different needs of market users and regulators.

Reporting obligations must be consistent with the objectives that are ultimately agreed to be relevant. Equally important, there needs to be a focus on the costs to information providers of the various possible approaches. Achieving this balance is likely to involve making compromises between utility of the data, costs of capturing and reporting data and enforcement of reporting obligations. In broad outline, there is a choice to be made between; (a) direct reporting by short sellers to the relevant data aggregator, versus (b) indirect reporting by short sellers via market intermediaries (stockbrokers). The latter is the approach which is currently in place in relation to the stocks in which short selling is permitted.

ASX would not oppose a continuation of this indirect model. Both ASX and brokers are continuing to make systems changes on the basis of this structure continuing to be mandated by the various ASIC Class Orders and consequential ASX Market Rules and Procedures. This indirect model involves ASX being required, as market operator, to assume responsibility for data aggregation and publication. Nor, on the other hand, would ASX object to an alternative model involving direct reporting by short sellers to ASIC. In this second scenario, ASIC would aggregate and publish the data. ASX's view, that either approach may be feasible, is subject to satisfactorily addressing the enforcement issues discussed below.

A hybrid of these 2 approaches involving direct reporting by short sellers to ASX (rather than to ASIC) would, in our view, not be appropriate. ASX does not need to know the identity of (nor to have contractual relationships with) end users (i.e. domestic and foreign managed funds and retail investors) in order to provide them with indirect access to the market infrastructure that ASX provides. Only the executing broker through whom an investor communicates its sell order to the market needs to know the identity of the investor in order for trading to take place. Accordingly, the issue of how the data aggregator and/or regulator could be expected to identify whether or not particular customers of brokers were complying with reporting obligations is not a trivial one.

Whilst it is perfectly reasonable for a market operator to have supervisory obligations imposed on it, as a condition of being licensed to operate, those supervisory obligations can only reasonably extend to the conduct of those organisations with whom ASX has a contractual relationship as an incident of operating the market (i.e. with organisations that are subject to market rules created by the market operator). Having a contractual relationship

with an organisation that is subject to potentially onerous obligations (Market Rules) – with ASX's contractual relationship with market participants under its Market Rules also being presently supported under the Corporations Act – affords the operator the opportunity to impose sanctions for non-compliance. No such opportunity exists in relation to end users of ASX's facilities. Whilst a regulatory authority (ASIC) with regulatory oversight of such end users would be a more logical body to enforce compliance with any (reporting) obligations imposed directly on holders of short selling positions, any such agency would also need to have the ability to identify such end investors in order to be able to monitor compliance with the new legislative obligations.

Whether it was ASIC or ASX that was charged with monitoring compliance by investors, the challenge would be considerable. Some idea of the magnitude can be gleaned from the numbers of different types of holdings in ASX's settlement systems. From that data it can be deduced that if the reporting obligation were confined to institutional investors (i.e. ignoring in excess of 1 million other holders of ASX securities), the number of organizations whose compliance would need to be monitored would run into the tens of thousands. This compliance challenge can be contrasted with the more manageable obligation currently imposed on ASX to oversight compliance with reporting obligations by approximately 100 brokers.

Added to this challenge is the issue of time to implement. The "plumbing" does not exist between either ASX and end users or between ASIC and end users to receive daily reports from thousands of institutional investors in many countries. These systems would have to be built. It is not surprising, therefore, that the interim regulation involves use of existing infrastructure (reporting via intermediaries to ASX), albeit coupled with imposition of significant new process changes for those intermediaries.

Another issue to be considered is the appetite for, and timing of, any transition to a regime requiring a different systems build to the path which intermediaries are currently undertaking as a result of the interim regime. Pending any Government decision as to whether a different approach will be reflected in the regulation, ASX market participants have been advised that the following is to occur from Q1 2009:

- ASX to provide a technical capability for ASX Trading Participants to "tag" or identify sale orders as long sale, short sale or exempt covered short sale;
- ASX Trading Participants to utilise the technical capability and "tag" or identify sale orders as long sale, short sale or exempt covered short sale where appropriate;
- ASX to publish aggregate gross short sales to all ASX Participants and the general public.

In summary, discussions about the class of persons upon whom obligations are to be imposed cannot be taken in isolation from practical enforcement and systems-building considerations.

Indirect disclosure via brokers, whilst sub-optimal from the perspective of an investor wanting the information to assist trading decisions (relative to reporting of open positions by the holders of such positions), may still be the best available mechanism to assist ASIC in exercising its responsibility to monitor whether end investors are engaging in manipulative or other illegal activity. The appropriateness or otherwise of persisting with initiatives that are quite burdensome to brokers (including the inquiries required to be made of customers and the associated systems changes) needs to be assessed by reference to both market efficiency and enforcement perspectives. One of the big challenges in devising practical reporting arrangements is to make a meaningful contribution to the objective of deterring manipulative short selling without deterring the vast majority of short selling that is perfectly legitimate.

ASX is mindful of the legitimate concerns of some fund managers about the scope for increased transparency to cause market distortions. However, ASX remains of the view that if the enforcement and systems challenges associated with direct reporting of open short positions prove too difficult, a continuation of the interim reporting model introduced by ASIC with ASX's support, coupled with increased reporting of stock lending activity, may prove to be the most practical way of providing signals to market users about changes over time in the approximate level of short selling.

In view of the complexity of the decisions still to be taken around direct versus indirect reporting, we applaud the decision to structure the legislation in such a way as to enable the outcome of a debate on who should report to whom to be settled in the regulations.

Naked Short Selling

In September of this year ASX announced that it was removing the scope for naked short selling of securities on the Approved Short Sales Product List[1]. This decision was taken to complement the announcements made by ASIC at around the same time.

We consider that a ban on naked short selling in any listed securities would be better than a ban on naked short selling in less liquid stocks (the approved list approach), subject to one proviso: it is important that short selling associated with activities such as market making and arbitrage are not unduly impeded. This requires an ability to effect these limited classes of activity without there needing to be a legally binding securities lending contract in place in respect of specific securities at the time that the sale orders are placed. ASIC has facilitated this availability in its interim regime. The draft bill makes provision for a continuation of this approach.

On this basis, ASX supports the approach to naked short selling that is incorporated in the Bill.

Whilst the approved list approach is conceptually attractive – involving naked short selling being confined to stocks in which there is very little settlement risk by virtue of the liquidity in the relevant stock – actually ensuring that the component stocks are a consistently good proxy for low settlement risk (and, conversely, that stocks not on the list consistently represent an unacceptable settlement risk) is quite difficult.

As well as considering what safety valve needs to be created in the legislative framework to ameliorate unintended consequences of an otherwise total ban on naked short selling, there is an important public policy issue as to who should operate the safety valve. ASX supports the Government's decision to confer this function on ASIC. It eliminates scope for speculation that exercise of this responsibility by a market operator – which is the regime which existed prior to the temporary ban – may be exercised inappropriately with an eye to revenue considerations.

Securities Lending Data

There are serious limitations in relying on details of gross short sales as a proxy for open short positions. These limitations have been taken into account in proposals from some quarters for open short positions to be reported and, as a corollary, for those positions to be reported by the holders of the positions rather than by executing brokers. (Executing brokers are not in a position to determine such positions in circumstances where sell and subsequent buy orders are placed through different brokers.)

Mindful of these issues, ASX has continued to promote the desirability of enhanced disclosure of the level of securities borrowing and lending which, considered in conjunction with gross short sale data, is likely to enhance overall transparency of short selling activity. The two sources of information could provide the market with a more complete picture of short selling activity (albeit not in great detail) than either data source published in isolation. The securities lending data would provide an insight into the number of securities on loan, and hence could provide some insight into how many short sale positions are open at a point in time. The short sale data will indicate the level of activity in a given stock, on a given day, meaning activity levels can be charted over time.

Market Manipulation

There has been much attention this year given to concerns around possible manipulative trading strategies that combined short selling activity with the spreading of false and misleading rumours. Both ASIC and ASX have been vigilant in monitoring the market in order to detect and prosecute this type of behaviour.

We have been analysing broker trading behaviour and have sought additional information from Market Participants when required. The gathering and analysis of information to build a strong case takes time but there has been a significant increase in the number of market manipulation referrals by ASX to ASIC for possible investigation over the course of this year.

[1] Relying on a carve-out in the Corporations Act, ASX previously permitted naked short selling in securities which were on an approved list, and which were subject to liquidity and market capitalisation tests.

Concluding Remarks

I would be happy to elaborate on these comments at the public hearing scheduled for Monday 24 November 2008.

Yours sincerely

Malcolm Starr
General Manager
Regulatory and Public Policy