Investment & Financial Services Association Ltd
ACN 080 744 163

20 November 2008

Mr John Hawkins
Committee Secretary
Senate Economics Committee
Department of the Senate
Parliament House
CANBERRA ACT 2600

Dear Mr Hawkins

Senate Committee Inquiry into Corporations Amendment (Short Selling) Bill 2008

Thank you for the invitation to provide a submission on the 'Corporations Amendment (Short Selling) Bill' 2008 (**'the Bill'**). IFSA supports the enhanced regulation of short selling. The following comments:

1. outline the critical role of short selling in maximising returns to investors;
2. identify what we believe are weaknesses in the Bill; and,
3. make recommendations on actions necessary to ensure the integrity and efficiency of the proposed requirements.

The Investment and Financial Services Association Limited (IFSA) is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 140 members who are responsible for investing over $1 trillion on behalf of more than ten million Australians. Members' compliance with IFSA Standards and Guidance Notes ensures the promotion of industry best practice.

1. Role of short selling

Short selling plays a fundamental role in enhancing market liquidity and boosting pricing efficiency. A simple explanation of short selling is:

> a sale of a security that the seller does not own, or a sale that is fulfilled by the delivery of a security borrowed by, or for the account of, the seller. Short sales are normally settled by delivery of a security borrowed by or on behalf of the seller.

Short selling is often performed by investment managers as part of a 'long/short' strategy for superannuation funds and managed investment schemes for risk management or hedging purposes, and where they believe a particular stock is overvalued. These strategies are also frequently implemented as a medium to long

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term investment position to generate optimal returns. These statements are supported by various academic research reports[1].

Given short selling's fundamental role in enhancing liquidity and boosting pricing efficiency, IFSA supports short selling with appropriate and prudent disclosure directly to the market supervisor or ASIC. Ensuring market price efficiency through active investment activities, such as short selling, produces positive externalities for the economy and particularly long-term diversified investors such as superannuation funds. The proposed amendments to the law which seek to improve the regulatory framework for short selling must ensure that the benefits of short selling are not diminished through the proposed amendments.

2. The Bill - Issues

The Explanatory Memorandum to the Bill states that the Bill contains three key measures. They are to:

1. clarify ASIC's powers to regulate short selling of financial products and transactions that have substantially similar market effect as short sales under the Corporations Act 2001;
2. prohibit 'naked short sales'; and
3. provide for the making of regulations for the timing and manner of the disclosure of short sales.

IFSA supports clarification of the law and the need to have a regulator that is able to monitor and act on market activity to promote the efficiency and integrity of the Australian market. While we do not oppose the prohibition of 'naked short sales', we do have concerns with the broad powers to be delegated to ASIC and the apparent watering down of accountability to the Minister that will be removed by the repeal of section 1020C by clause 3 of Schedule 2 of the Bill. In particular, we are concerned that:

1. the Bill leaves open the potential for significant conflicts of interest to arise where short sales are disclosed to the market operator through another intermediary such as a broker; and
2. where short sales data is provided to the market operator, that the law provides for an appropriate delay in the release of aggregated information to the market by the market operator.

The following statement both underlines the importance that Australian short selling requirements are consistent with other major capital markets and expands on the concerns identified above which have been raised with both Government and ASIC.

3. Disclosure to the market operator

The Bill requires the seller of securities, managed investment products and certain other financial products on a licensed market under a securities lending arrangement to provide particulars specified in the regulations to the market operator or another entity specified by the regulations (proposed section 102AC). We understand from the attached ASIC Advisory release of 13 November 2008 (Attachment A), that the detail of the proposed regulations appears to have already been determined.

[1] Jonathan M. Karpoff and Xiaoxia Lou, Do Short Sellers Detect Overpriced Firms? Evidence from SEC Enforcement Actions, Working Paper. September 6, 2008 Available at http://ssrn.com/abstract=1102853

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In its release of 13 November 2008 ASIC states that:

> The following measures have been agreed with ASX:
>
> 1. Trading participants will report to ASX each day all short sales including exempt covered short sales in financial securities. This will be a daily report to be submitted by 9.00am of short sales executed up to 7.00pm the previous trading day.
> 2. ASX trading participants should advise ASX that they have advised their clients to disclose short sales at the time the sale is requested and will take reasonable steps to reinforce this obligation.

We see significant potential for conflicts of interest to arise where disclosure to the market operator is made by a broker as is proposed by ASIC. IFSA does not support the disclosure and identification of short sales to other market participants, as a permanent reporting solution, without appropriate safeguards on confidentiality. We submit that the disclosure of short positions to brokers may result in commercially sensitive and active research related information being exposed to other investors and market participants including broker proprietary trading desks. This has the potential to distort the market, encourage market manipulation and free rider behaviour (including front running strategies), and ultimately act as a disincentive for active investment research.

While there are technology solutions that may address these concerns though ensuring the sell-type field is hidden from market participants in all relevant systems, neither the market participants nor the ASX are currently set up to deal with these concerns. IFSA primarily supports direct disclosure by the seller to the market operator.

Subject to appropriate technology solutions being introduced, IFSA would support the disclosure of short sale information to the market operator through another entity (brokers and custodians).

4. Delay in public release of data

Institutional asset managers may hold, or propose to acquire as part of an investment strategy, significant positions in various publicly traded market securities. In a competitive financial market those managers are engaged on the basis of their skill and expertise, which are proprietary assets of the company, to maximise investment returns to their clients.

Proposed section 1020AD(2) requires the public disclosure of short sale information "on or before the time specified in the regulations" and "in the manner specified in the regulations". Again, we understand from the ASIC Advisory release of 13 November 2008 (Attachment A), that the detail of the proposed regulations appears to have already been determined. In its release ASIC states that:

> The reporting to ASX will be coupled with reporting to the market as follows:
>
> 1. ASX will report short sales to the market after 9.00am the next trading day. The report will show, by security, the total volume of short sales executed on the previous trading day; and
> 2. The daily report will include exempt covered short sales in financial securities.

We believe such early information release compromises institutional asset managers' proprietary research, and would quite likely exacerbate market volatility. Institutional asset managers are hired for their skill at researching companies, and then implementing their investment ideas by buying and selling shares in those companies to maximise investment returns to clients. It is very common for an asset manager's trading in a company to last for a number of days, with trades carried over from day to day. Disclosure of short selling trades on the next business day will compromise an asset manager's ability to fully implement and gain the value from their research. Other market participants will be able to 'front run' or 'piggy back' off an asset managers disclosed partial trades, leading to greater selling volume and greater price volatility as these other traders compete in selling with the original asset manager in subsequent days.

The potential for such uncompetitive behaviour is further exacerbated by proposed section 1020AD(2) which, although expressed as an offence provision, appears to provide a defence to the release of data even before the next trading day. The words "**on or before the time specified in the regulations**", expressed in plain English, mean "no later than".

IFSA recommends disclosure of aggregate short sale positions to the market on a periodic basis (weekly or fortnightly) and that this information is available to participants at the same time. We believe that this requirement is of fundamental importance and should be included in the substantive law. Proposed section 1020AD(2)(b)(i) should be deleted and replaced with:

> "(i) periodically, and at least [weekly or bimonthly] from the date of receipt of the particulars specified in section 1020AB; and".

While disclosure to the market is delayed, disclosure to the regulator is not, such that the regulator can use the detail short selling information to monitor and stamp out any market manipulation.

This approach would be consistent with the US method of reporting. The delayed release of short selling information to the market was considered as part of the US response to market manipulation and abuses related to short selling. A copy of the letter from the US Investment Company Institute to the Chairman of the SEC, the Hon Christopher Cox, is attached for your information (Attachment B). The delayed public release of aggregated information aims to prevent artificial volatility in trading and to avoid further downward selling pressure caused by short sales.

5. Conclusion

Short selling plays a crucial role in legitimate investment strategies designed to maximise returns to investors, particularly, the members of superannuation funds and managed investment schemes.

IFSA is supportive of enhancing the transparency of short selling and securities lending practices where there is a principles based regulatory response promoting the integrity, efficiency and competitiveness of the Australian capital market. The Bill needs to provide a solid regulatory framework for short selling.

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IFSA's concerns with the disclosure of short positions to the market operator through a broker must be addressed and a periodic (weekly or bimonthly) requirement for disclosure of short sale information to the market should be included in the substantive law and not left to regulations or regulator discretion. Failure to do so will damage the competitiveness and integrity of the Australian market and is out of step with major financial markets.

Yours sincerely

David O'Reilly
Policy Director – Regulation

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ATTACHMENT A

AD08-65 ASIC lifts ban on covered short selling for non-financial securities

Thursday 13 November 2008

ASIC today said it would, as expected, lift the current ban on short selling of non-financial securities from opening of trading on 19 November 2008 but would continue the ban on covered short sales in financial securities.

ASIC put a 30-day ban on covered short selling of securities on 21 September and extended this ban on 21 October as market conditions remained difficult.

The ban on short selling of financial securities will remain in place until at least 27 January next year, consistent with many other jurisdictions, while ASX will maintain the ban on naked short selling indefinitely. ASIC confirmed that financial securities would be those comprising the S&P/ASX 200 Financials (including property funds) plus five other APRA regulated businesses.

Key details

ASIC announces the following effective from Wednesday 19 November:

1. Covered short sales of non-financial securities will be permitted;
2. The ban on covered short selling of financial securities will continue until 27 January 2009. Financial securities are those comprising the S&P/ASX 200 Financials and five additional securities (being those with APRA regulated businesses).
3. Existing exemptions for covered short selling, for example those relating to hedging and arbitrage transactions, will continue in relation to financials; and
4. The facilitation of the sale of securities being recalled from a stock-lending program (whether or not they are financials) will also continue.

Reporting and Disclosure

A key aspect of the disclosure and reporting framework for short sales is the requirement for a broker to ask a client whether a sale is a long sale or short sale. Clients are obliged to inform their broker if a sale is a short sale. On Wednesday 12 November ASIC provided **further information** to assist brokers and their clients to meet disclosure requirements that will apply from 19 November 2008.

The following measures have been agreed with ASX:

3. Trading participants will report to ASX each day all short sales including exempt covered short sales in financial securities. This will be a daily report to be submitted by 9.00am of short sales executed up to 7.00pm the previous trading day.

4. ASX trading participants should advise ASX that they have advised their clients to disclose short sales at the time the sale is requested and will take reasonable steps to reinforce this obligation.

The reporting to ASX will be coupled with reporting to the market as follows:

3. ASX will report short sales to the market after 9.00am the next trading day. The report will show, by security, the total volume of short sales executed on the previous trading day; and
4. The daily report will include exempt covered short sales in financial securities.

For information, the following are the five additional securities (being those with APRA regulated businesses):

Entity Name	**ACN**
Wesfarmers Limited	008 984 049
The Rock Building Society Limited	067 765 717
Wide Bay Australia Ltd	087 652 060
Futuris Corporation Limited	004 336 636
Calliden Group Limited	061 215 601