A E F ROFE AM

23 November 2008

The Committee Secretary
Senate Economics Committee
Department of the Senate
PO Box 6100
CANBERRA ACT 2600

Dear Sir

Inquiry into the Corporations Amendments (Short Selling) Bill 2008

In its present form the Corporations Amendment (Short Selling) Bill 2008 ('the Bill') is seriously flawed in that it:

- Fails to effectively achieve the objects stated in the Explanatory Memorandum to the Bill;
- Imposes unnecessary costs and regulatory burdens on market participants; and
- Runs the risk of increasing rather than reducing market volatility.

The Bill should be withdrawn from the Parliament and redrafted following further consultation with market participants and other persons affected by the Bill.

The review of market practices with a view to further enhancing the integrity and transparency of Australian financial markets by the Corporations and Markets Advisory Committee recently commissioned by the Minister for Superannuation and Corporate Law would provide an appropriate forum for such consultation.

This would be consistent with Option 5 discussed in Chapter 5 of the Explanatory Memorandum.

Apart from seeking to extend the power of the Australian Securities and Investments Commission ('ASIC') in relation to short selling, the Bill proposes to amend the Corporations Act 2001 by:

- Banning naked short selling; and
- Imposing additional disclosure requirements in relation to covered short selling.

Prohibition of naked short selling

Under current section 1020B of the Act, naked short selling is already prohibited subject to five exceptions specified in subsection 1020B(4).

Schedule 2 to the Bill proposes to remove four of these five exceptions.

The main justification given in paragraph 3.4 of the Explanatory Memorandum for removing these exceptions is that naked short sales have a higher risk of settlement failure.

The risk of settlement failure is already appropriately addressed in the ASX capital and risk management requirements for ASX participants.

There is no evidence that the activities covered by the four exceptions proposed to be removed contribute in any significant degree to settlement failure.

On the other hand there is some evidence that these activities contribute to market efficiency.

This view appears to be consistent with the views expressed in section 4 of the submission dated 20 November 2008 by the Australian Financial Markets Association.

It is submitted that the amendments to section 1020B proposed in Schedule 2 to the Bill are undesirable and unnecessary

Disclosure of covered short selling

The Explanatory Memorandum acknowledges that short selling, appropriately regulated, benefits the operation of capital markets by increasing market liquidity and pricing efficiency. The stated objective of Schedule 3 to the Bill is to increase transparency surrounding the activity of covered short sellers in Australian securities markets on the basis that this will provide useful information to investors and contribute to confidence and market integrity.

Schedule 3 purports to introduce disclosure requirements in relation to covered short selling but for the purposes of the Bill a covered short sale is taken to be a sale supported by securities obtained under a securities lending arrangement so Schedule 3 is primarily concerned with the disclosure of the existence of securities lending arrangements.

Once a sale of securities has been completed by the payment of the purchase price of the securities to the seller and the transfer of the legal title to the securities to the purchaser it is irrelevant that the sale was a short sale, whether naked or covered.

In the case of a short sale that is covered by a securities lending arrangement what is relevant is:

(a) the continuing obligation of the borrower to return the borrowed securities to the lender; and

(b) the continuing risk to the lender that the securities will not be returned (as clients of Opes Prime have learned).

Disclosure options

In drafting Schedule 3, the following five options were considered and are discussed in Chapter 5 of the Explanatory Memorandum:

- Retain the current regulatory arrangements and seek to encourage voluntary disclosure of covered short sales.
- Require sellers to disclose covered short sale transactions to their broker who would then be required to report this information to the market operator or other relevant entity.
- Require sellers to disclose covered short sale transactions to the market operator.
- Require disclosure of all stock lending transactions.
- Carry out a review of the regulatory framework governing all short selling transactions.

The second of these five options was adopted on the basis that it would ensure that the market is fully informed regarding the actual level of short selling activity.

It would also have the least impact on existing relationships between brokers and their clients and between brokers and the market operator.

On the other hand it is acknowledged that this option will impose significant costs on market participants and will involve extensive modifications to the ASX trading system and to the systems used by brokers, the extent of which are currently unknown and will not be known until the precise details of the disclosure regime are settled.

Furthermore it will be noted that the proposed legislation only requires disclosure by sellers who have entered into or gained the benefit of a securities lending arrangement and intend that the securities lending arrangement will ensure that some or all of the securities can be vested in the buyer.

There is no requirement for purchasers to disclose that the securities to be purchased will be used to satisfy an existing obligation to return securities under a securities lending arrangement. Thus the Bill fails to provide a mechanism for reporting and disclosing the outstanding balance from time to time of securities subject to securities lending arrangements.

Finally it is clear from the past failure by the market operator and the regulator to effectively monitor and enforce the disclosure requirements under the existing regime that it will be equally difficult for them to do so under Option 2.

Direct reporting by investors who engage in short selling (Option 3) has the advantage that those investors will be in a better position than brokers to report their net short positions in particular securities from time to time, particularly when they deal through more than one broker.

The benefits of the direct reporting option are discussed in more detail on pages 10 and 11 of the submission by the Australian Financial Markets Association under the heading *Meaningful Disclosure Regime*.

Because investors who engage in short selling will no doubt already have in place systems to monitor their net short positions, and because they comprise a subset of investors in general, the total regulatory cost of implementing Option 3 is likely to be significantly less than the cost of implementing Option 2.

Option 4 has the advantage that it would facilitate the reporting and disclosure of the outstanding balance from time to time of securities subject to securities lending arrangements.

And because entities that engage in securities lending will already have systems in place to monitor their lending positions, the cost of implementing Option 4 is likely to be less than that of implementing either Option 2 or Option 3.

Mechanics of disclosure

Submissions already received in relation to the Bill and the earlier Exposure Draft of the Bill indicate that questions regarding the mechanics of disclosure, eg when and how disclosure is to occur, what is to be disclosed, the manner and timing of public disclosure and whether disclosure is to be on a net or gross basis are considered to be of considerable significance to market participants.

These details are proposed to be included in Regulations which are yet to be finalised.

As the Explanatory Memorandum acknowledges, it is not possible to quantify the compliance cost impact of the Bill until the Regulations have been made.

It is premature for the Parliament to enact this legislation until these issues have been resolved.

Section 2 of the Bill envisages that Schedule 3, which contains the disclosure provisions, will not commence until a day to be fixed by Proclamation which may be up to 12 months from the day on which the Act receives the Royal Assent.

In the interim the issues of naked short selling and the disclosure of covered short selling have been adequately addressed by ASIC Class Orders.

No disadvantage would therefore be incurred by delaying the enactment of legislation until after 30 June 2009 when the Corporations and Markets Advisory Committee is scheduled to deliver its report on its review of market practices

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The above comments are from the perspective of an experienced retail investor in listed securities who is also a director of a small listed public investment company and two unlisted private investment companies and was formerly a director and chairman of the Australian Shareholders Association. However they do not purport to represent in any way the current views of the Australian Shareholders Association.

Yours faithfully

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