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20 November 2008

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

SECURITIES & DERIVATIVES INDUSTRY ASSOCIATION –
SUBMISSION ON CORPORATIONS AMENDMENT (SHORT SELLING) BILL 2008

Please find attached a Submission by the Securities & Derivatives Industry Association (SDIA) in relation to the Inquiry by the Senate Economics Committee into the Corporations Amendment (Short Selling) Bill 2008.

As the peak body representing institutional and retail stockbrokers and investment banks in Australia, SDIA is an important stakeholder in issues relating to the Australian securities market.

Should you require any further information, please contact me on (02) 8080 3200 or email dhorsfield@sdia.org.au .

Yours sincerely,

David W Horsfield
Managing Director/CEO

Encl.

SECURITIES &
DERIVATIVES
INDUSTRY
ASSOCIATION

SUBMISSION TO SENATE ECONOMICS COMMITTEE

CORPORATIONS AMENDMENT (SHORT SELLING) BILL 2008
20 November 2008

EXECUTIVE SUMMARY

1. SDIA supports Option 4 (Disclosure of Stock Lending transactions).
2. Stock Loan data is the best available proxy for information about the overall short position in a security.
3. Amendments to the CHESS system can be made with the least resource impact in order to be able to generate a daily figure for the outstanding stock loan position for each listed security.
4. Broker reporting (Option 2) results in information which has inherent flaws and is likely to be of limited usefulness to the market.
5. Broker reporting places an onerous burden on brokers and sellers and involves substantial resource costs.
6. The positive obligation imposed on financial services licensees to make an enquiry in the case of every sell order is an onerous burden. The legislation should contain exemptions from this obligation for situations where the enquiry is unnecessary or irrelevant in the circumstances.
7. Options 1, 3 and 5 are not supported.
8. If naked short selling is to be prohibited, the legislation should contain

express exemptions to permit error trades, client facilitation trading and any other situation where such trading can be shown to be beneficial.

9. The removal of the Uptick Rule is supported.

10. Changes to broker trading platforms, order management systems and settlement systems involve considerable resource cost due to the increasing cost of information technology. Mandatory changes should be co-ordinated as far as possible and sufficient lead time allowed for their implementation.

11. The legislation should be reviewed at the end of 12 months to evaluate whether the new rules are working and delivering the objectives identified.

12. The current uncertainty surrounding the administration of the short selling rules ahead of the enactment of the Bill needs to be clarified.

Introduction

The Securities & Derivatives Industry Association (SDIA) is the peak industry body representing institutional and retail stockbrokers and investment banks in Australia. It has 67 members accounting for 98% of market turnover by value. SDIA members are reliant on and have a strong commitment to the integrity and high standing of the Australian securities market.

SDIA welcomes the opportunity to make a submission to the Senate Economics Committee on the Corporations Amendment (Short Selling) Bill 2008. This submission is in line with the contents of a submission made earlier in relation to the Exposure Draft and Commentary of the Corporations Amendment (Short Selling) Bill 2008.

Covered Short selling has been demonstrated to be beneficial to the securities market in a number of ways. It provides a significant degree of liquidity to the market and aids price discovery. Short selling also represents an extremely important tool for economic risk management.

In our view, the difficulties, whether real or perceived, presently being articulated stem from the lack of transparency regarding the true level of the aggregate short position in a security. The existing legislation has not worked adequately to achieve this transparency, and SDIA supports legislative amendments which would remedy those shortcomings. If the true short position were more transparent, then participants in the market would be in a position to react

accordingly. There would be less likelihood of the perception that the market was being unfairly distorted, as opposed to reflecting ordinary forces of supply and demand.

In view of the potential for the granting of licences to additional equity markets, and given that obligations may need to be imposed on persons not subject to Market Operating Rules, SDIA supports a response by means of legislation. We note that the Bill sets out the basic framework, with much of the detail left to be prescribed by way of Regulation. The detail of the Regulations will therefore be of utmost importance in assessing how the proposed legislation will work operate in practice, and a final view of the legislation will not be possible in the absence of this detail.

SDIA notes also that the subject of short selling law reform has emerged against a backdrop of suggestions of possible **market manipulation**. In our view, considerations of market manipulation tend to confuse the issue of what should be the appropriate form of regulation. Market manipulation is already an offence, and there are in our view sufficient legislative tools available to deal that offence.

These proposals ought not be viewed as an aid to preventing market manipulation. The issue that needs to be addressed by the proposed changes is remedying the transparency of the short position in securities, and we support the Bill's focus on that objective.

The changes should also not be seen as designed to address **settlement risk** issues. Settlement risk may well have been an early consideration when the short selling rules were originally enacted, but this is no longer the case. Settlement risk has now been addressed by a range of other developments, including most recently, changes to fail fees and the application of ASX Market Rule enforcement procedures in respect of settlement failures by brokers.

Submissions - Preferred Options

SDIA supports changes which would enable the market to best ascertain the true picture of the outstanding short position in listed securities in the most resource efficient manner.

SDIA submits that Option 4 (Disclosure of Stock Lending transactions) in the Regulation Impact Statement in Chapter 5 of the Explanatory Memorandum offers the best potential to achieve this objective, and hence should be the preferred option.

Our understanding from discussions with ASX is that, with some modification and system changes, the ASX Clearing and Settlement System (CHESS) can be adapted so that an appropriate tag can be applied to stock lending and stock loan return transactions. This would enable a figure for the outstanding stock on loan to be calculated and reported on a daily basis. Access to CHESS would also be able to be extended to all of the entities engaged in the stock lending market who may not currently be CHESS participants.

The outstanding stock loan position is, we believe, **the best available proxy for the outstanding short position for a listed security**. Contrary to belief in some quarters, the volume of naked short sales is not significant, and naked shorts are predominantly covered by buying back the securities intra-day. As the bulk of short sales are covered short sales settled with borrowed stock, then it follows that open short positions should all essentially be included within the outstanding stock lending position.

Securities may be borrowed for reasons other than to cover short sales. For example, stock may be borrowed for the purpose of dividend reinvestment plan arbitrage, where one party will borrow stock in order to participate in a company's dividend reinvestment plan, where the lender may be unwilling or unable to do so itself. There may be other uses to which borrowed stock is put from time to time.

Therefore, the outstanding stock lending position does not precisely reflect the outstanding short position, and may need to be discounted to reflect the other uses of borrowed stock. However, market participants would generally regard stock loan information as giving the most useful indication of the outstanding short position, notwithstanding these potential imperfections.

As Option 4 involves modifications to infrastructure already in existence (CHESS), then in terms of resource impact, the burden of implementing Option 4 should be relatively low.

It is noted that the preferred option in the Bill and Explanatory Memorandum is Option 2, based on broker reporting. SDIA notes that the regulatory regime in place up until now, by virtue of the combination of the Corporations Act and the ASX Market Rules, has been based on daily reporting by brokers of their "net short sale" position. SDIA also notes that the US position is also based on position reporting by brokers, albeit on a twice monthly basis. Therefore, daily broker reporting currently exists, and Option 2 would be a modification of this.

There are some significant shortcomings with Option 2 which in SDIA's view would make the reported positions unreliable as an accurate picture of the

outstanding net short position. The shortcomings of Option 2 stem from the following:-

- ***Use of multiple brokers.*** A client who sells short through one broker may later buy back the securities through another broker. Clients, particularly wholesale clients, can and frequently do use more than one broker. Order flow is often shared between brokers on a panel. Order flow will be directed to brokers based on a number of considerations, including quality of execution, the ability to source the other side of the order, and as a reward for quality research.

  As a result, under Option 2, a broker may well report the client's short position from the date of creation ad infinitum, if the client does not later notify it that the position has since been covered through a purchase through a different broker. The short position data may as a result tend to swell over time to the point that it is entirely worthless information. As short positions may sometimes be open for a period of months or even years, it would not be safe for a broker to assume that data can be purged after a certain length of time.

- ***Reliance on client.*** Broker reporting relies on the client notifying the broker that the sale is short. There is an inherent risk that clients may fail to do this, either deliberately or because of innocent error. There is no reason to believe that clients will deliberately fail to comply with an obligation to tell brokers that a sale is a short sale, however, the potential remains for this to occur. The client may also simply forget as a matter of human error. It is also possible that the order placer may not realize that their entity is short overall, especially if there are a number of traders each trading separate books within the one client entity.

For these reasons, whilst SDIA's members would be in a position to comply with a regime based on broker reporting, as is already the case, Option 2 is not in our view the preferred outcome. Option 4, being based on transactional data extracted from CHESS, would not be susceptible to the above two factors.

It may be considered attractive to pursue both Option 4 and Option 2, on the basis that a combination of the two sets of data would assist the market even further in ascertaining the true picture of the outstanding short position in a security. In view of the shortcomings referred to above, SDIA queries whether Option 2 would be of added value, or would in fact tend to confuse.

If Option 2 is to be pursued, the information required to be reported should be the broker's gross end of day short position (including that of clients) without any netting. Intraday movements should not be required to be reported, as this would

complicate the reported data and significantly increase the burden and cost of reporting.

One suggestion that has been made, in view of the likely distortion arising from the factors referred to, is for brokers to be required to report gross short sales for each day starting from a zero base. This would result in the reporting of new short positions created in the market per security during each trading day. This is the interim position imposed under ASIC Class Order arrangements following the lifting of the ban on covered short sales in non-financial stocks on 19 November 2008.

It is too early to say for certain whether the market will place any value in this information. However, our members have already indicated to us that the daily short sale information that is now being reported under the interim arrangements is of no usefulness to the market.

Positive obligation to inquire if sale is a short sale

In relation to the proposed Section 1020AE imposing a mandatory obligation on licensees to enquire of sellers in every instance whether or not the sale will be a short sale, SDIA submits that the obligation to make an enquiry in every instance is onerous. SDIA submits that in cases where it is apparent in the circumstances that the sale will not be short, it should not be mandatory to make the enquiry. Examples of cases where the enquiry is unnecessary include the situation where the client is a "long-only" fund, which means that it is prohibited by its mandate from selling short. Where such a fund has been placing orders throughout the day, as is quite common, the requirement to ask the question every time has proven to be a waste of time and highly annoying to the client

Even more significant is the case of ordinary retail ("mums and dads") investors. Retail investors are highly unlikely to be able to enter into stock borrowing agreements with stock lenders. Retail investors will mostly not even understand what stock borrowing or short selling is.

Where the terms of a retail client agreement prohibit short selling, and where the broker can see that the client owns the stock in CHESS, then asking the client whether the sell order is short serves no purpose and is a waste of time. Brokers have reported to SDIA, since the interim arrangements requiring the question to be asked in every case, that the enquiry is frequently proving to be highly confusing to ordinary retail clients.

SDIA submits that there should be a general exemption from the requirement to enquire of the client in cases where the question would be irrelevant in the

circumstances. In the alternative, there should at least be specific exemptions for identified cases such as those above.

Whilst SDIA supports the vesting of rule making powers in ASIC to exempt situations such as the above which are identified from time to time, we submit that situations which are already apparent should be exempted in the legislation from the outset. Given that failure to comply with the obligation under the legislation constitutes a criminal offence, it would be harsh and unfair to place parties under the risk of prosecution whilst applications for relief are prepared and lodged with ASIC for consideration.

Other Options in Explanatory Memorandum to Draft Bill

We note the other Options set out in the Regulation Impact Statement in the Explanatory Memorandum. In our view, Option 1 (Retain the Status Quo) does not address the shortcomings of the existing legislative provisions that have been identified regarding the reporting of covered short sales.

We agree with the shortcomings identified with Option 3 (Direct Disclosure by investors). The logistics and cost of establishing the mechanism of direct reporting by investors makes this option undesirable.

SDIA does not support Option 5 (Review of Short selling regime). We do not believe that a wider review of the short selling regime is needed at this stage. We believe that addressing the question of transparency shortcomings should prove to be an adequate remedy for the problems that have been identified, and implementing those changes will mean that further change is unlikely to be considered necessary.

Naked Short Selling – should this be banned?

The term "naked short sale" is taken to refer to a short sale where the seller either has no borrowing arrangements in place, or has a borrowing arrangement but has not secured the borrowed stock prior to the sale.

SDIA does not believe that the data supports the view that there is a significant level of naked short selling in the market. The bulk of short selling consists of covered short sales involving stock borrowing. In our estimate, naked short selling previously accounted for about 1 per cent of total short selling.

Because of the need to settle short sales, existing naked short selling is very largely intra-day. The naked short seller will most commonly buy back the securities later in the day in order to be able to settle the trades and not incur

failed settlement fees. Any effect on the price of a security of intra-day naked short selling is not prolonged.

For these reasons, SDIA believes that the perceptions about the impact of naked short selling are exaggerated. Accordingly, except in relation to specific instances referred to below, SDIA is not concerned at the proposed prohibition of naked short selling, but nor does it on the other hand consider there to be any significant grounds for concern if it were not prohibited.

We reiterate our earlier comments, that the objectives underlying the short selling provisions should not to be confused by the objective of preventing the incidence of settlement failure, as the latter is easily dealt with by other measures such as

the level of fail fees, the imposition of compulsory buy-in arrangements and the potential for disciplinary proceedings in the case of persistent settlement failure.

In the event that naked short selling is prohibited under the proposed legislation, there would need to be certain express exemptions for appropriate cases, such as the following.

- ***Error Trades.*** One such example is the case of error trades. A broker or client may intend to buy stock but inadvertently place a sell order in error. If the person does not own the stock, then the sale will constitute a criminal offence under the legislation. Apart from the possibility of potential prosecution, a financial service licensee will also be faced with the carrying out compliance obligations of breach recording and breach reporting to ASX and/or ASIC.

  Given that error trades are not uncommon from time to time as a result of ordinary human error, the above consequences are harsh and costly in terms of time and resources. A general exemption for honest mistake should be included in the legislation from the outset.

- ***Seller unaware that sale is short.*** It is not uncommon for an institutional seller, investment bank or stockbroker, to employ multiple traders each operating their own book within the same entity. It may be that information barriers are in place between traders within the same entity for compliance reasons. Therefore, a particular trader may not know, and may not be in a position to find out, that the overall position of the firm will be short as a result of the placing of a sell order.

  The proposed legislation should contain an exemption or defence in relation to the prohibition on short selling in this type of situation, otherwise the result will be an inadvertent commission of a criminal offence.

- ***Client Facilitation/market making***. Larger brokers offer client facilitation as a service. A client may ask for a price quote from the broker at which the broker will buy from/sell to the client the amount of stock in question. The client has the certainty that its order is completed at the stated price, and the broker takes on the market risk of price movement in the stock thereafter.

  Facilitation trades are usually closed out as soon as possible, due to the market risk, and in any event before the market close. It is rare for a facilitation trader to carry such a trade overnight and risk exposure to offshore market movements.

  Where a client wants to buy stock, a broker's facilitation desk will usually sell the stock to the client as a naked short sale, and buy back the stock as soon as possible afterwards. Clients want a price quoted on the spot – it is not practicable for the client to wait while the facilitation trader makes calls to stock lenders to secure a stock borrowing in order to be able to facilitate the client by a covered short sale. Stock prices can move quickly, and the opportunity for the client to trade may evaporate in the time taken for the stock borrow to be arranged.

  The alternative for facilitation traders would be to arrange for a secured borrowing of lines of stock at the start of each day. This increases the costs of client facilitation which must be either passed on to the client, or borne by the broker. The broker would need to pay the stock lender for securing lines of stock which may not even need to be borrowed. The quantity of stock available for lending would be reduced, as more stock was secured than was actually needed, with the result that price for borrowing stock would generally rise, and other parties seeking to borrow would as a result face increased costs and/or be unable to pursue trading strategies in the event that they could not locate sufficient stock to borrow.

SDIA therefore submits that there is a strong case based on economic efficiency grounds for naked short selling to be permitted to continue for client facilitation business by stock brokers.

Uptick Rule.

SDIA submits that the Uptick Rule no longer achieves any purpose and should be abolished.

In support of this, we note the following:-

- The tick rule has now been widely removed from most major stock exchanges, including the NYSE, Hong Kong Tokyo and London Exchanges
- there is evidence from overseas studies that removal of the uptick rule does not adversely affect market quality or liquidity
- enhanced disclosure of covered shorts would help to expose any inappropriate trading
- artificially driving down the price of a security in order to profit from the close-out of a short sale is already a serious criminal offence, and subject to internal and external (ASX and ASIC) surveillance and prosecution.
- The rule creates an unnatural market.

Resource Implications

As mentioned earlier, Option 4 is attractive from the point of view of resource impact in that the CHESS infrastructure exists, and the system changes likely to be needed to adapt the system should not be excessive.

The implementation of Option 2 in addition to Option 4 would involve a significant lead time to carry out system development and would also involve significant cost. Each broker would be required to undertake the necessary changes to their respective order management and settlement systems to track all short sales, all unwinding of short sales, and if required, to obtain aggregate positions for reporting on a daily basis.

This will include changes to Direct Market Access (DMA) trading platforms operated by many brokers to provide clients with direct access to exchanges. DMA platforms are complex platforms and usually global, with the one platform being used to access various exchanges. Consequently, implementing changes to these platforms usually needs to be done offshore and must be carried out in a way which avoids impacting on the operation of the system in other jurisdictions.

Depending on the extent of the obligations imposed, adequate time will need to be afforded to brokers within which to become compliant with the new requirements. The cost of making changes to broker systems can be minimized if changes are made as far as possible in one step, rather than through a series of additional requirement imposed in an ongoing manner.

Review Period

SDIA supports the existence of a review period, with the obligations being reviewed at the end of 12 months to evaluate whether the new rules are working and delivering the objectives identified.

Recent Difficulties

Finally, we would like to outline some of the difficulties that our Members have faced since the short selling ban was imposed on 19th September 2008, which supports some of the concerns expressed above. While the regulation of short selling has been under consideration since the start of this year, the imposition of the ban in September was very sudden, unexpected and the lead time for our Members to adapt to the new regime was insufficient.

On Friday 19th September, ASIC announced the banning of all naked shorts. Then on Sunday 21st ASIC announced that both naked and covered shorts were

to be banned from the next trading day, Monday 22nd September. Members were very uncertain about the trading that was to be permitted. For example, members were not sure whether they could sell a call option, facilitate client trades or make markets. In the event, given the uncertainty around the market, ASX was forced to delay the opening of the market on Monday 22nd September some 2 hours to allow some information to be circulated.

Since that time we have met regularly with ASIC and ASX and have worked through several issues, some of which were raised earlier in this submission, for example facilitation trading. During this period, since the Bill is yet to be enacted (or any underlying regulations), the regulation of short selling has proceeded by way of ASIC Class Orders, individual relief and press release, together with ASX pronouncements. There is a lack of transparency of regulation. ASIC is addressing issues by way of case-by-case (firm-by-firm) individual relief. An example of this has been relief for short selling by brokers' proprietary trading desks. The criteria for applying for such relief were not well circulated by ASIC across the industry. We are urging ASIC to issue Class Order relief wherever similar relief applications are granted, rather than issuing individual relief. This would ensure consistency of regulation, and a more transparent process for the whole market. Secondly, on Monday 17th November, ASX notified all brokers that they had to advise ASX by COB 18th November confirming the arrangements in place to meet the obligation for brokers to notify all clients of the new arrangements from 19th November. This obligation was created by ASIC through a press release, and ASX then checked compliance with the obligation. It is open to interpretation whether there was a proper basis for this obligation.

This fast-moving regulatory environment has caused difficulties for our members. Or members had less than 24 hours notice (on a Sunday) of the original ban. Since the first day of its operation, changes have been made by ASIC to address anomalies, unintended consequences and genuine cases for relief. It has been very difficult to keep up with changes, and then for our members to adjust their business accordingly. The lack of transparency of the process has led to instances of regulatory arbitrage; where some participants were aware of the

changes and some not. SDIA has done all it could to fill this information gap through disseminating information to members, but where SDIA was not itself aware of the relevant matter, it was impossible for us to assist.

From our discussions with members, the recent events surrounding the ban on short selling has led to a reduction in order flow from offshore investors, which has had an impact on the liquidity of and trading volumes in the Australian market. The nature and suddenness of the interim measures has impacted on the standing of the Australian market in the eyes of offshore institutions, and those investors may take some time before returning to this market. It will not have assisted the objective of fostering Australia as a regional financial centre.

Thank-you for the opportunity to raise these matters with the Committee. We would also be grateful for the opportunity to appear before the Committee to assist it. Should you require any further information, please contact me on (02) 8080 3200 or email dhorsfield@sdia.org.au .

Yours sincerely,

David W Horsfield
Managing Director/CEO