



# Short Selling

ASX Public Consultation

28 March 2008

## What this paper is about

ASX welcomes the Government's intention to pursue legislative change to address the ambiguity around disclosure of 'covered' short sales. ASX will continue to work closely with ASIC and the Government to ensure that the new reporting requirements are quickly introduced; that they are appropriately targeted; that international practices are taken into account and that any additional compliance burden on brokers and their clients is not excessive, bearing in mind the benefits of greater disclosure.

There are a number of initiatives which ASX can pursue to ensure that the reporting of short sales and other reportable sales where a borrowing arrangement is in place, results in improved daily disclosures to the market. In Section 1, ASX seeks feedback from market users on the daily reporting requirements.

ASX also seeks feedback in relation to short-term measures ASX could put in place pending legislative change. ASX has considered a range of short-term measures, some of these are referenced in this paper. Because ASX may be in a position to implement certain measures, there is an issue as to whether, in spite of the limitations associated with each option, it would be best to implement one or more of these measures pending the Government's proposed legislative amendments taking effect. Feedback from market users will assist ASX in deciding whether to proceed with any short-term measures, notwithstanding their limitations.

In Section 2, ASX seeks feedback from market users on several other issues associated with short selling. ASX will continue to work with Government to address these longer-term issues. Section 2 also sets out measures ASX has considered to enhance its management of settlement risk. ASX seeks feedback on a proposal to alter its settlement fail fee, and has identified two principles which would underpin a new fail fee structure.

The legislative definition of the transactions which need to be reported as short sales should capture both sell orders submitted when the seller does not own the amount of securities being offered and sell orders submitted when the seller only owns the securities through a borrowing agreement and is subject to a contractual obligation to return the securities to the lender. A formulation along these lines would be designed to capture all selling where borrowing and/or purchase takes place in order to meet delivery obligations.

The regulation of short selling is primarily dealt with in legislation. However, an exemption from the legislative prohibition on short selling enables ASX to permit and regulate certain short selling activity. This delineation between short selling activity proscribed by the legislation and activity regulated by ASX rules is arguably not well understood. Commentators have called for ASX to intervene more decisively so as to achieve greater reporting transparency as to the overall volume of all short sale activity, however the complex inter-relationship between the rules and the Corporations Act means there is limited scope for unilateral ASX action.

The scope for greater involvement by ASX in seeking to address the various concerns that have been identified can take several forms, including enforcement of existing ASX rules and monitoring of compliance by a sub-set of market users (ASX participants) with relevant legislation. Recent initiatives in this space include the reminders given to the market (29 February 2008, 6 March 2008)<sup>1</sup> as to how ASX's supervision subsidiary (ASXMS) interprets key existing obligations, namely the potential application of continuous disclosure obligations to margin loan arrangements and the obligations of ASX participants to achieve reporting by their customers of certain short sales. However, the efforts of ASXMS to achieve transparency of client dealings via obligations on intermediaries has been fraught with problems arising from definitional ambiguity in the legislative provisions.

ASX believes that the legislative amendments foreshadowed by the Government are an important step towards improving the short selling regime. The amendments will address the immediate issue of under-reporting of sales commonly regarded in the market as 'covered' short sales. ASX will continue to work with Treasury and ASIC to align the

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<sup>1</sup> <http://www.asx.com.au/about/media/index.htm>

market rules and Corporations Act reporting requirements in the short-term, and in the longer-term will work with Government to fix the remaining outstanding issues with the short selling regime.

Market users are invited to provide their views on the issues identified in this paper.

## Invitation to comment

ASX invites feedback on the issues discussed in this paper. Comments can be sent to:

**ASX Regulatory & Public Policy Unit**  
Level 7, 20 Bridge St  
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**Comments are requested by Thursday 24 April 2008.**

*This paper has been released by ASX Group which is responsible for making policy decisions in relation to the matters raised in this paper. ASX Market Supervision (ASXMS), a separate subsidiary of ASX Group, is responsible for the administration and enforcement of ASX rules.*

# 1. Transparency as to the Volume of Short Selling

ASX supports short selling as a legitimate and worthwhile trading technique which contributes to market liquidity, efficiency and price discovery. ASX is not proposing any changes designed to discourage short selling. However, ASX does recognise the narrow net cast by the current definition of short selling in section 1020B of the Corporations Act and, as a consequence, the limited ambit of the exemptions to the Corporations Act prohibition on short selling activities that are permitted when reported to ASX. Recent market conditions have made apparent the different consequences and risks arising from market practices that have developed in stock lending/borrowing and short selling when markets exhibit more extreme levels of volatility or consecutive declines in value. ASX is seeking views on short and longer-term initiatives which ASX can introduce to provide a higher level of transparency to these activities by reporting.

In this Section, ASX seeks the view of market users in relation to various non-legislative short-term measures which could be implemented by ASX. Feedback from market users will assist ASX in deciding whether to proceed with any of these measures, pending the introduction of the Government's proposed legislative amendments. These initiatives have a number of shortcomings, and are not ASX's preferred position. ASX's preferred position is to work with Treasury and ASIC to align the market rules and Corporations Act reporting requirements in the short-term, and in the longer term to work with Government to fix the remaining outstanding issues with the short selling regime. However, ASX is willing to consider short-term measures should market users believe in their merit. In the longer term, legislative amendment will be needed to clearly establish what activity is captured by the short selling prohibition in the Corporations Act, what activity falls within the various carve-outs to the prohibition, and what activity falls outside the operation of the provisions altogether.

Also in this Section, ASX seeks market views on the construction of the daily short sale report. ASX outlines rule amendments which will be introduced to ensure that information captured by the new legislative provisions is reported to ASX for daily publication.

ASX has previously advised ASIC and Government that the source of the current under-reporting of short selling was a case of 'definitional ambiguity' in the legislative prohibition on certain forms of short selling. ASX therefore welcomes the Government's statement that amendments will be made to the Corporations Act to require reporting of sales where borrowing takes place in order to meet settlement obligations.

Short selling is colloquially categorised as either 'naked' or 'covered'. It is generally agreed that a 'naked' short sale is a sale where the seller does not own and has not borrowed or arranged to borrow securities at the time of the sale, but intends to purchase or borrow securities in order to meet the three business day (T+3) settlement obligation.

There is less agreement as to what activity constitutes a 'covered' short sale. On one (narrow) interpretation, a covered short sale is where the seller has arranged to borrow securities, but will only take delivery of the securities after the sale has been executed.<sup>2</sup>

A broader approach would involve ignoring whether or not any borrowing takes place before or after entering a sale order, focusing instead on whether a borrowing and/or purchase takes place in order to meet delivery obligations. The legislative definition of the transactions which need to be reported as short sales should capture both sell orders submitted when the seller does not own the amount of securities being offered and sell orders submitted when the seller only owns the securities through a borrowing agreement and is subject to a contractual obligation to return the securities to the lender.

The legislative gap or loophole that currently exists in relation to short selling is that the prohibition is widely considered not to extend to sales of securities at a time when the seller owns such securities, even if the seller only owns them by

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<sup>2</sup> The act of taking delivery of securities, which typically involves the transfer of legal title to the securities, may simply involve a custodian transferring securities from one account holder to another, under the terms of a lending agreement.

virtue of having entered into a typical stock borrowing arrangement. Under such arrangements, the borrower actually purchases the securities from the lender, and contracts to re-sell the same number of securities to the lender at a specified time or on demand by the lender/seller.

As a result of stock lending being typically undertaken through these sale/purchase arrangements, the legislative provision dealing with reporting of short sales potentially has no application to many covered short sales (in which the 'short seller' may not be 'short' but may be the beneficial owner by the time that it effects the 'short sale') because the prohibition does not apply to transactions in which the seller has, at the time of the sale "a presently exercisable and unconditional right to vest the products in the buyer."

ASXMS recently reiterated that ASX's rules go some way towards plugging this legislative gap. They do so by putting an onus on brokers that have a contractual relationship with ASX (through the ASX Market Rules) to ensure that clients report the types of short sales which other market users would expect to see reported.

However, this approach suffers from ASX's inability to impose sanctions on clients that choose not to inform their broker as to whether or not a particular sell order is a 'short sale'. The Corporations Act requires a person to tell their broker if they are placing a sale order which is a short sale. However, a client who has adopted a narrow definition of a 'covered' short sale may take the view that their sale is not captured by the short selling provisions at all. Where this is the case, the client may take the view that they are not bound by any of the short selling regulations (including the requirement to notify the broker of a short sale). This has flow on effects for the application of ASX's Market Rules.

ASX believes that the legislative amendments foreshadowed by the Government are an important step towards improving the short selling regime. The amendments will address the immediate issue of under-reporting of sales commonly regarded in the market as 'covered' short sales.

ASX has considered two alternative short-term 'solutions' to overcome the problems associated with current short sale reporting provisions, pending the Government's legislative amendments taking effect. Two alternative approaches have been suggested:

1. **Increased transparency as to the level of stock lending/borrowing** – the objective would be to give market users information from which they could estimate the likely level of short selling. In order for this option to be of use to the market, there would need to be an established correlation between the level of stock lending and the level of short selling. ASX understands, based on anecdotal evidence from a number of brokers, that between 40% to 50% of all stock borrowing is effected for the purpose of meeting delivery obligations associated with short selling. Other feedback indicates that the ratio of stock lending to short selling is variable, both between securities and from day to day. ASX is not yet convinced that putting in place a system whereby ASX aggregates and publishes lending data supplied by custodians will contribute to transparency in relation to short selling activity. In fact, it is possible that in the absence of reliable short selling data, stock lending data may contribute to, rather than reduce, market uncertainty. Accordingly, ASX is not intending to pursue ASX Settlement and Transfer Corporation (ASTC) rule changes to impose any new reporting obligation on custodians prior to the legislative amendments. Such a view is consistent with the conclusions of the Financial Services Authority (FSA) in their 2002-03 review of short selling in the UK. The FSA accepted that stock borrowing was not a good proxy for short selling activity, although they did believe that publication of such data may have more general transparency benefits for markets. Market users are invited to provide feedback to ASX on the general transparency benefits which may flow from publication of stock lending data.
2. **Re-writing legislation via ASX rules** – another short-term measure could involve ASX amending its Market Rules by introducing a broader definition of 'short sale' to replace the current definition which refers to a short sale under section 1020B of the Corporations Act. The new Market Rule definition could be used as a trigger for reporting requirements which attempt to mirror those imposed by the legislation, but without the definitional issues. There are several significant drawbacks with this approach. First, ASX has the capacity to regulate certain short selling activity by virtue of an exemption from the general legislative prohibition on short selling. It would be unusual for ASX to seek to use its powers to alter the scope of the legislative prohibition. Secondly, ASX is unable to impose a requirement on a client to advise their broker

that a sale is a short sale. This means ASX may have considerable difficulty enforcing its rule. Accordingly, ASX is not currently intending to seek to re-write the short selling legislation via its Market Rules.

#### Request for comments:

ASX invites comments on any of the issues outlined above, including:

1. two alternative short-term approaches considered by ASX, and the reasons provided for not proceeding with these options.

#### Measures to improve transparency after legislative amendment

ASX Market Rule 19.6 requires Participants to inform ASX of their net short sold positions every day. This enables ASX to produce short sold lists that are disclosed to the market the following day. The ASX daily short sale list in respect of Approved Short Sale Products and Approved Short Sale ETFs under section 1020B(4)(e), is available at: <http://www.asx.com.au/data/shortsell.txt>. The ASX daily short sale list in respect of non-Approved Short Sale Products/Approved Short Sale ETFs, under section 1020B(4)(d), is available at <http://www.asxonline.com/infolink/index.htm> or <https://www.asxonline.com/participants/index.html>.

Reporting of short sale activity arguably serves two key purposes: effective supervision of market activity, and enhanced market efficiency and price formation. Some of the factors ASX has taken into account when considering reporting requirements for the latter purpose include the utility of the information, the practicality of providing the information, commercial confidentiality and the possible misuse of the information.

ASX proposes to amend its Market Rules to require a Market Participant to report to ASX all types of sales which a client is required to report to a Participant in the new legislative reporting provisions ("other reportable sales"). One of the immediate benefits to flow from both amendments will be that selling activity reported to ASX better reflects the market's expectations as to what constitutes short selling – i.e., in line with a broader approach that ignores whether or not any borrowing takes place before or after entering a sale order, focusing instead on whether a borrowing and/or purchase takes place in order to meet delivery obligations.

We anticipate that reporting to ASX would distinguish between a Participant's naked short sale position (for short sales under section 1020B(4)(e)) on the one hand, and their other reportable sale positions on the other hand. ASX would release this information, in respect of all listed securities, to the market on the following day.

Market users are asked to consider the current requirement for Market Participants to report "their *net* Short Sale position", and whether the amended market rules should retain the concept of a 'net' position in respect of the trades captured by the new legislative provisions, or whether the concept of a 'gross' position is preferable (or both).

NB: In respect of the current 'net' position requirement, ASX's rules require a Participant to report all outstanding short sale positions at the end of the day. These positions are 'net' in the sense that intra-day positions which have been closed-out (other than pursuant to a borrowing arrangement) by the end of that day are not reported. The concept of a 'net' position does not mean that a short position of one client or the Participant as principal, is netted against a long position of the Participant as principal or another client of that Participant for reporting purposes.

Alternative approaches for consideration include:

- The Market Participant has an obligation to report net 'naked' and net other reportable sale positions in all securities across all clients (i.e. excluding positions closed-out intra-day);
- The Market Participant has an obligation to report gross 'naked' and gross other reportable sale positions in all securities across all clients (i.e. including positions closed-out intra-day).
- The Market Participant has an obligation to report both gross and net 'naked' and gross and net other reportable sale positions in all securities across all clients.

**Current reporting requirements will continue to apply until ASX advises otherwise.** The current reporting requirements are summarised in ASX's 6 March 2008 media release, available at:  
<http://www.asx.com.au/about/media/index.htm>

**Request for comments:**

ASX invites comments in relation to short sale reporting, including:

2. what information should be included in the daily short sale report submitted to ASX and what detailed guidance should ASX provide on the calculation of that information to ensure uniformity of reporting?;
3. what information should be included in the daily short sale report published by ASX ?;
4. what time should the short sale report be published each day?; and
5. any other measures to improve transparency in relation to short selling activity.



## 2. Other Issues

### Overview

In this Section, we address issues unconnected with achieving greater transparency as to the level of covered short selling, namely:

- is the regulation of 'naked' short selling by ASX appropriate?, and;
- are the settlement risks associated with short selling (whether 'covered' or 'naked') being appropriately dealt with?

### Naked short selling and management of settlement risks

Short selling by persons who at the time of selling, are neither the owner of the relevant security nor have put appropriate arrangements in place to meet their T+3 delivery obligations is, unlike covered short selling, currently regulated entirely by ASX pursuant to a legislative delegation of power (Corporations Act section 1020B(4)(e)).

Policy issues which arise in this context include:

- do the requirements which ASX has put in place pursuant to this delegation of legislative power to a market operator adequately address a main regulatory objective underlying regulation of naked short selling, namely management of settlement risks?
- in particular, should the following aspects be reviewed:
  - the tests for admission into, and removal from, the 'approved list' of securities that can be short sold, subject to certain conditions?; and
  - the adequacy of the 'fail fee' mechanism in disincentivising decisions to incur a fail fee rather than satisfy delivery obligations?

### How short selling is regulated by ASX

Section 19 of the ASX Market Rules sets out the requirements which must be observed when short selling in accordance with section 1020B(4)(e) of the Corporations Act, as well as additional requirements which must be observed when short selling in accordance with other exceptions to the prohibition on short selling.

ASX allows naked short sales of approved securities (or in the case of short selling under section 1020B(4)(b) (arbitrage transactions), where securities on ASX can also be bought on another financial market), and covered short sales of approved securities and other securities, where such short selling is in accordance with the Corporations Act and the additional requirements in section 19 of the ASX Market Rules.

### Other restrictions ASX places on short selling

ASX Market Rules 19.5.3 and 20.7.1 prohibit short selling during a takeover. There are a number of reasons for this, but the primary reason is to prevent short selling during a period of diminishing supply of borrowable and deliverable stock which could lead to settlement failure. As the levels of takeover acceptances increase, the ability to borrow securities to deliver against short positions decreases. It becomes increasingly possible to be in a position of being unable to deliver against a short sold position at the time compulsory acquisition is declared.

ASX Market Rule 19.5.1, by reference to the Procedures, currently limits the number of approved securities which may be short sold to no more than 10% of the total number of all approved securities of an Issuer. The intention behind this rule is to prohibit naked short selling in circumstances which could increase the risk of settlement failure.



Market Rule 19.8.1 requires a Participant to inform its clients that the client must tell the Participant whenever it places an order for a short sale. This rule complements the Corporations Act provision which requires a client to inform their broker of a short sale transaction under s1020B(4)(b), s1020B(4)(d) and s1020B(4)(e).

The Market Rules also regulate the price at which securities can be short sold through a tick test. Both the Corporations Act and the ASX Market Rules have a regulation commonly called the "tick test".<sup>3</sup> This regulation means securities cannot be short sold under the exceptions in s1020B(4)(d) or s1020B(4)(e) where the sale is at a lower price than the preceding sale. For example, a security which has been trading at \$1.00 cannot be short sold for \$0.99; it can only be short sold at \$1.00 or more.<sup>4</sup>

Australia is one of the few remaining developed countries to have a tick test. Most other comparable markets (US, Canada, UK, Hong Kong) do not have this limitation or are in the process of removing their price limitations.

The ongoing utility of the tick test in Australia is an open question. The test is not a proxy for reducing the risk of settlement failure. Nor does it have a role in preventing market manipulation, providing that the extent of short selling is disclosed to the market, and that regulators enforce market manipulation provisions contained in both the Corporations Act and the ASX Market Rules.

The tick test in relation to covered short sales is contained in the Corporations Act, whilst the test in relation to naked short sales is contained in the ASX rules. It is arguably not feasible to amend or remove either of these tests in isolation.

#### Request for comments:

ASX invites comments on the tick test, in particular:

6. whether the test should be retained, including whether it should be retained for all securities, or only retained for some securities (e.g. those not in the Approved List), and why this should be the case; and
7. whether the test should apply to all types of short sale, or only in relation to some types of short sale, and why this should be the case.

#### Management of settlement risks – the Approved List

As noted above, ASX has approved a list of securities for naked short selling. Because the securities can be short sold before the trader has arranged to borrow stock to settle the sale, ASX places certain limitations on this short selling to minimise the risk of settlement failure, in the form of market capitalisation and liquidity tests.

Under Market Rule 19.7.1, ASX may designate a share or security to be an approved short sale product if:

- (a) 50 million securities of the class have been issued (excluding securities of the class issued but held by any entity which ASX considers is related to the Issuer);
- (b) the market capitalisation of the securities of the class on issue is not less than \$100 million;
- (c) in the opinion of ASX there is sufficient liquidity in the market for the securities of the class; and
- (d) ASX considers that the securities should be designated as an 'Approved Short Sale Product' for the purposes of these rules.

ASX will consider removing a security from the list of 'Approved Short Sale Products' if:<sup>5</sup>

- less than 50 million securities of the class are on issue (excluding securities of the class issued but held by any entity which ASX considers is related to the Issuer);

<sup>3</sup> The test is also known as the 'uptick' test and the 'downtick' test.

<sup>4</sup> In addition, when relying on the exception in s1020B(4)(d) the price for the sale must be higher than the preceding sale unless the price of that immediately preceding sale was higher than the next preceding different price at which sale was made.

<sup>5</sup> ASX Market Rules Guidance Note 34

- the market capitalisation of the securities of the class on issue is less than \$75 million and volume based liquidity is less than 5% in the preceding three months;
- the market capitalisation of the securities of the class on issue is less than \$50 million and volume based liquidity is less than 6.25% in the preceding three months; or
- ASX otherwise considers that the securities should be removed from the list of Approved Short Sale Products for the purposes of the rules.

As at February 2008, around 670 companies had a market capitalisation above the \$100 million threshold – meaning that over 1,300 companies were excluded from the Approved Short Sale list based on market capitalisation alone. The approved list comprised around 425 securities as at February 2008.

The market capitalisation and liquidity tests have remained relatively unchanged since their introduction in 1985. The original rationale for the number of shares and market capitalisation thresholds are not entirely clear, although size would generally be seen as a good proxy of liquidity (which is also included as a separate measure).

In general, there is no evidence that the existing criteria for admission to the approved short selling list has resulted in particular difficulties (i.e. market manipulation and/or settlement failures) that would suggest they are inappropriate.

In fact, compared to other major markets Australia seems to have relatively restrictive 'list' arrangements given the global trend towards liberalisation of short selling, which reflects a recognition of the benefits short selling can bring, including increased liquidity and adding to the efficiency of price discovery. While the passage of time with no change in the criteria has resulted in a de-facto easing of the thresholds, overseas precedent and domestic experience suggests an even less restrictive approach could be justified, albeit the modest scale of Australian listed companies from a global perspective should also be taken into account.

#### Request for comments:

ASX invites comments on the Approved List, in particular:

8. whether the current market capitalisation and liquidity tests remain relevant.

#### Management of settlement risks – the settlement fail fee regime

ASX requires settlement of all transactions within three business days (T+3). On average, 99% of trades are settled by T+3 and the remainder are usually completed within two business days. Where there is a delay in settlement, ASX refers to this as a 'failed' settlement. ASX levies a daily fine against Participants for failed settlement. The current fine is 0.1% of the trade value outstanding, with a floor of \$50 and a cap of \$2,000. More serious cases of settlement delays may also result in referral to ASX's Disciplinary Tribunal, which also has the power to fine a Market Participant. The Disciplinary Tribunal recently fined several Participants \$20,000 for failed settlement.

Despite the settlement performance of the Australian market being very strong based on global benchmarking of other major securities settlement facility operators and comparing favourably with other developed equity markets, ASX has taken the opportunity to review mechanisms to increase the incentives for timely settlement. Three options examined were:

- increasing incentives for participants to meet T+3 deadlines by restructuring the fail fee levies applied by the ASTC for delayed settlements. This would involve introducing a sliding scale that increases the effective penalty as the settlement delay lengthens.
- expediting existing supervisory processes for referring significant breaches of T+3 settlement requirements to ASXMS for investigation.

- ASX has considered the merits of re-introducing a 'buy-in' mechanism which is available in other markets such as London and Singapore.<sup>6</sup> Under such an arrangement the exchange or clearing house would step into the market and purchase shares to enable settlement to be completed, with the cost of closing out the short position (including substantial transaction costs) being borne by the Market Participant.

ASX is seeking feedback to assist it finalise the design of the revised fail fee regime. ASX has developed two general principles which it proposes will underpin the reformed regime:

- those Participants who make a genuine effort to meet their T+3 settlement obligations should not be unfairly penalised; and
- the fee penalties (both in terms of the percentage fee and any daily cap) should be set at a level to act as an effective disincentive for Participants to deliberately delay settlement rather than promptly borrow stock to ensure timely settlement.

ASX anticipates that any new fail fee regime would collect a broadly similar level of fines as the current arrangements, with higher fees in respect of more serious failures offset by a reduced number of settlement delays and a lesser duration of delays.

On the issue of re-introducing a buy-in mechanism, ASX has concluded that given delayed settlements are only a very small proportion of all transactions in the Australian market, and in the context of the other measures proposed above to improve incentives for timely settlement, the introduction of a buy-in mechanism is not necessary at this stage.

#### Request for comments:

ASX invites comments on the settlement failure fee regime, in particular:

9. comments on the principles which ASX proposes will underpin the new regime; and
10. views on other mechanisms to further improve timely settlement of equity trades.

#### Short selling in a multi-platform environment

ASX has previously advised ASIC and Treasury of issues which need to be addressed in developing a robust framework to regulate short selling activity if a multi-platform environment is introduced in Australia. Legislation or regulations will be required to standardise aspects of the short selling framework currently contained in ASX's Market Rules, including the ban on short selling during a takeover, the 10% limit on naked short sales, and the tick test for naked short sales.

The ability of a market operator to provide for short selling in designated securities under section 1020B(4)(e) of the Corporations Act means that there could be different short selling regimes for ASX-listed securities in a multi-platform environment. Regulatory consistency is necessary to eliminate regulatory arbitrage or a regulatory 'race to the bottom'.

Taking into account the fact that managing settlement risk is one of the main purposes for regulating short selling, it is necessary to bear in mind that settlement risk is likely to remain concentrated in any eventual multi-platform environment, notwithstanding that trading would be fragmented, because multiple platform operators are likely to access ASX's clearing and settlement facilities for post-trade processing purposes. A settlement facility must therefore have the ability to manage this risk.

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<sup>6</sup> ASX formerly had a buy-in facility but this was removed with the introduction of CHES.

## Appendix 1 – Request for comments

ASX invites comments on any of the issues outlined in this paper, including:

1. the two alternative short-term approaches considered by ASX, and the reasons provided for not proceeding with these options;
2. what information should be included in the daily short sale report submitted to ASX and what detailed guidance should ASX provide on the calculation of that information to ensure uniformity of reporting?;
3. what information should be included in the daily short sale report published by ASX? ;
4. what time should the short sale report be published each day?;
5. any other measures to improve transparency in relation to short selling activity;
6. whether the tick test should be retained, including whether it should be retained for all securities, or only retained for some securities (e.g. those not in the Approved List), and why this should be the case?;
7. whether the tick test should apply to all types of short sale, or only in relation to some types of short sale, and why this should be the case?;
8. whether the Approved List current market capitalisation and liquidity tests remain relevant?;
9. comments on the principles which ASX proposes will underpin the new fail fee regime;
10. views on other mechanisms to further improve timely settlement of equity trades.

Comments can be sent to:

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Comments are requested by Thursday 24 April 2008.

## Appendix 2 – Short Selling FAQs

### *What is the rationale for short selling?*

There are several possible reasons for a trader to sell a security that they do not own. These include:

- speculation that the price of the security will fall, and that they will be able to buy the securities back at a profit;
- arbitrage opportunities (for example to exploit price differences between an option and the underlying security); and
- hedging purposes (for example to hedge an investment in one security by short selling a similar security).

### *Why ASX supports short selling:*

Short selling increases market liquidity and pricing efficiency.

Short selling adds liquidity to the market. The additional buying and selling which occurs as a result of short selling helps to reduce the spread, the difference between the price at which a security can be bought and sold. This lowers the cost of trading for everyone.

Short selling also adds to price discovery and market efficiency. Investors who think a stock is fairly priced or undervalued can buy a security. Through short selling, investors who think that a stock is overvalued are able to sell the security. This buying and selling activity helps to produce efficient market prices which reflect the views of both bearish and bullish investors.

### *Why is short selling regulated?*

There are two main risks associated with short selling: the risk of settlement failure because the short seller has been unable to obtain stock to 'cover' their short position; and the risk of market manipulation, for instance because a trader short sells a large quantity of securities with no intention of ever settling the trades (a practice which would also contribute to the risk of settlement failure).

### *How much short selling occurs?*

Academics estimated that *gross* short selling activity accounted for up to 31% share trading volume for NASDAQ stocks and 24% share volume for NYSE stocks in 2005.<sup>7</sup> This figure includes all short sales, including those positions which are covered, or closed out at the end of the day. Gross short selling figures are not currently available for ASX securities.

*Net* short selling in NYSE securities, meaning short sale positions that are not closed-out at the end of the day, has recently increased, from approximately 2% to around 3 to 4%.

Reported end of day *net*-short positions in ASX securities typically range from 0 to 2%.

### *How is short selling regulated overseas?*

ASX's analysis of short selling regulations in the US, UK, Hong Kong, Canada and Singapore demonstrates that short selling in Australia is highly regulated. While other countries have liberalised their short selling regimes, Australia has maintained tight controls over how many securities can be short sold and at what price they can be sold.

The UK regulator, the Financial Services Authority (FSA), stated that "imposing controls on short-selling is not the right way forward but that increased transparency surrounding the practice should be sought. Prohibition of 'naked' short selling would, in our view, be disproportionate. We do not consider that short selling should be restricted for illiquid stocks or newly floated companies."<sup>8</sup>

The table below provides a simplified snapshot of the different approaches in the regulation of short selling in some major international markets.

<sup>7</sup> Diether, K., Lee, K-H, and Werner, I. M., 2007, Short-Sale Strategies and Return Predictability, *Review of Financial Studies*, forthcoming.

<sup>8</sup> Financial Services Authority, Short Selling, Feedback on DP17, April 2003.

	ASX	NYSE	LSE	TSX	HKEx
Allow naked short selling	✓	✓	✓	✓	X
Limit naked short selling to approved securities	✓	X <sup>1</sup>	X <sup>1</sup>	X <sup>1</sup>	X <sup>2</sup>
Limit the amount of a stock that can be short sold	10%	X	X	X	X
Have an uptick test	✓	X	X	X	X
Reporting of naked (N) and/or covered (C) short sales	N/C	N/C	X	N/C	C
Frequency of publication (daily, fortnightly, monthly)	D	F	-	F	D

The following exchanges are included in the analysis: Australian Securities Exchange (ASX); New York Stock Exchange (NYSE); London Stock Exchange (LSE); Toronto Stock Exchange (TSX); and Hong Kong Exchanges and Clearing (HKEx).

1. Excludes or limits short selling where systemic settlement problems are experienced.

2. Covered short selling is limited to companies on the list of approved securities.

## SECURITIES LENDING

### *What is securities lending?*

Securities lending is the temporary transfer of securities from the owner of the securities to a third party, for a fee. The securities (or an equivalent number and type of securities) must generally be returned to the owner at the end of the loan term, or sooner if the owner requests that they be returned.

### *Who lends securities and why?*

Institutional shareholders such as superannuation funds, managed funds, and other long-term investors may agree to lend their securities to a third party in order to profit from the fee that they can charge for stock lending.

### *Who borrows securities and why?*

According to the Australian Securities Lending Association (ASLA), organisations borrow stock for four reasons:<sup>9</sup>

1. Borrowing for failed trades. Borrowings to cover fails are mostly small and short in duration (one to five days). The borrower keeps the loan open only until they can complete delivery of the underlying trade.
2. Borrowing for margin requirements. To meet margin requirements, for example at the Exchange Traded Options market. Securities can be borrowed cheaply and lodged as margin, rather than depositing cash.
3. Borrowing for market making and proprietary trading. Market makers and proprietary traders are by far the largest borrowers of stock in Australia and are responsible for the majority of securities lending transactions in this country. These traders sell stock for a variety of reasons, most of which are hedging related. Activities under this category include short selling, equity/share price index arbitrage, equity/derivative arbitrage, and equity option hedging.
4. Intermediary brokers. Intermediaries act between lenders and borrowers. For their services, the intermediary takes a spread. Many institutions find it convenient to lend stock to one or two intermediaries who then on-lend to many more counterparties. This saves administration and limits credit risks.

The International Securities Lending Association (ISLA) has estimated that the total value of securities on loan globally exceeds £1 trillion (\$A 2.2 trillion).<sup>10</sup>

<sup>9</sup> For further information, see [www.asla.com.au](http://www.asla.com.au)

<sup>10</sup> *An Introduction to Securities Lending*, available at: [http://www.isla.co.uk/sl\\_intro.asp](http://www.isla.co.uk/sl_intro.asp)

***Who is entitled to vote at a company poll if securities are on loan?***

When 'lending' beneficial ownership transfers from the lender to the borrower, meaning that the borrower has the right to all dividends and votes attached to the securities for the term of the loan.

The commercial terms of the loan agreement will generally require the borrower to reimburse the lender for all 'economic' rights of ownership, such as any dividends or corporate events that may occur during the loan period. The lender usually has a right to recall the securities if they want to vote at a company meeting.

***How is securities lending regulated?***

Securities lending arrangements are governed by the commercial agreement entered into between the lender and the borrower. The agreement commonly used in the Australian market is the Australian Master Securities Lending Agreement (AMSLA). There is no specific legislation governing securities lending, although generic legislative provisions, contained for example in the Corporations Act and the Superannuation Industry (Supervision) Act (administered by APRA), may apply to aspects of the activity.