Australian Government

The Treasury

Short Selling Disclosure Regime

Regulation Impact Statement

CONTENTS

1. BACKGROUND 1

2. OBJECTIVES 3

3. OPTIONS AND IMPACT ANALYSIS 4
3.1 Type of reporting 4
3.2 Format for releasing the information 8
3.3 Frequency of disclosure and public release 10
3.4 Threshold for aggregated reporting 11
3.5 Who is responsible for collecting the information 12

4. CONSULTATION 14

5. CONCLUSION AND RECOMMENDED OPTION 14

6. IMPLEMENTATION AND REVIEW 14

7. ABBREVIATIONS 16

1. BACKGROUND

Short selling is an activity where a person enters into an agreement to sell a security that the person does not currently own. Short sellers need to make arrangements to cover their delivery obligations to the buyer before they fall due (usually three trading days after the transaction is executed). This is normally done by:

- making a matching purchase at some point following the sale but before delivery falls due; or

- borrowing an equivalent amount of securities before delivery falls due, either before they enter into the sale or at some time between making the sale and when required to make delivery.

There are two types of short sale transactions: naked and covered. Broadly, a naked short sale occurs when a seller does not own and has not borrowed or arranged to borrow securities at the time of sale but intends to purchase or borrow stock in order to meet the delivery obligation. A covered short sale occurs when the seller has arranged to borrow the security in order to meet their delivery obligations prior to entering into the arrangement to sell the security. An investor will generally execute a short sale by requesting their broker to place a sell order on the market.

An investor may engage in short selling for a number of reasons. The most common reason is that they believe the security is overvalued and its price is likely to fall in the future. A short sale transaction will allow the person to profit from this fall. However, not all short selling activity is linked to investors trying to profit from falling prices. For example, some investors (for example, financial institutions) may engage in non-speculative short sale transactions to manage certain financial risks. Under this approach, the investor takes a short position in a security to offset an equivalent long position in that security that the investor is exposed to. This will allow the investor to protect themselves against movements in the security's price.

Under normal market conditions, some forms of short selling transactions are legitimate market practices used widely around the world. They are important tools in promoting liquidity and price efficiency in financial markets.

Following the collapse of Lehman Brothers in September 2008, there was widespread concern around the world that short selling contributed to price volatility and put downward pressure on the prices of stocks.

There has been significant speculation in Australia regarding the activity of short sellers in Australian listed securities.

There were some concerns that transactions of this nature may have a higher risk of settlement failure (because the seller does not possess the shares at the time of sale). There was also concern that naked short selling distorted the operation of financial markets by causing increased volatility and potentially facilitating market manipulation. There were concerns that the lack of transparency about the activities of short sellers might be causing a loss of confidence in the market.

In December 2008, the Government passed the *Corporations Amendment (Short Selling) Act 2008* ("the Act"). The Act established the framework for the disclosure of covered short selling positions. In addition, the Act banned naked short selling and clarified ASIC's power to make declarations with regard to all aspects of short selling.

The disclosure framework established under the Act requires short sellers to provide particulars relating to any short sale transaction to their broker (or any other party specified by regulations). The broker is then required to pass this information and any information relating to short sales entered into by the broker on their own behalf onto the market operator (or any other party specified by regulations). The particulars of the information to be disclosed and the timing of the disclosure are to be specified by regulations. It was thought best to determine the detailed aspects of short selling disclosure by regulations as only regulations could provide the flexibility to respond to an environment of rapid change, including technological innovation and ongoing developments in the conduct and structures of financial markets.

There are two principal methods of reporting short sales: positional and transactional. Positional reporting involves investors disclosing their net short position in a security whereas transactional reporting involves disclosure of any transaction that is a covered short sale. The two methods of reporting can be seen as complementary if each achieves different aspects of the objectives outlined in section 2.

As an interim measure, ASIC implemented transactional reporting of covered short selling positions with effect from November 2008. This regime has provided evidence of the extent of short selling on Australian financial markets. The data indicates that, on a daily basis, short selling affects only a fraction of a company's issued capital. For example, during March 2009 trades flagged as short selling transactions averaged 6.08 per cent of the total trading volume on the ASX. Since the lifting of the ban on the short selling of financial securities, the volume of short-selling activity has increased to generally between 4 and 8 per cent.

In addition, the RBA conducted a review on disclosure of equities securities lending. The review was initiated following the disruption caused by settlement delays in the cash equities market in January 2008. In February 2009, the RBA recommended a stock lending disclosure regime. The RBA's findings are relevant to short selling since a high proportion of securities lending transactions are motivated by the need to cover short-sold positions. However, it is impossible to determine exactly the proportion of stock lending transactions that are used for covered short sales, as parties may also enter into a securities lending arrangement for purposes other than short selling. This disclosure regime is not yet operative, so data is yet to be reported.

The ongoing concerns about the activity of short sellers on Australian financial markets have highlighted the need for the Government to establish a comprehensive, permanent disclosure regime to replace the interim ASIC disclosure regime. In March 2009, Treasury released a consultation paper outlining the main issues in relation to the disclosure of short selling. Industry and key stakeholders were given an opportunity to comment on the issues. Treasury received 33 submissions from investment funds, industry associations and members of the public. This information has been used to help Government develop the content of the regulations and ensure that the disclosure regime is cost effective.

Treasury also recognises the need for a degree of international consensus in relation to regulating short selling. On 19 June 2009, the International Organization of Securities Commissions (IOSCO) taskforce released a final report on the regulation of short selling. The report identified four general principles for the effective regulation of short selling. IOSCO's four principles are:

- short selling should be subject to appropriate controls to reduce or minimise the potential risks that could affect the orderly and efficient functioning and stability of markets;
- short selling should be subject to a reporting regime that provides timely information to the market or to market authorities;
- short selling should be subject to an effective compliance and enforcement system; and
- that short selling regulations should allow appropriate exceptions for certain types of transactions for efficient market functioning and development.

2. OBJECTIVES

The objective of the disclosure regime is to enhance market confidence and integrity by providing greater transparency to both investors and regulatory bodies about short selling activity on Australian financial markets. In particular, disclosure of short selling activity will:

- indicate the level of short selling in particular stocks;
- explain certain share price movements;
- provide an early signal that individual securities may be overvalued;
- indicate the proportion of sales in an individual security that will need to be reversed by new purchases (to cover the short seller's settlement obligations);
- enhance investors' willingness to participate in the market by removing uncertainty surrounding the level of short selling; and
- deter market abuse or reduce the opportunities for market abuse by enabling the market regulator to better identify instance of market manipulation.

The Government is not seeking to prohibit or discourage covered short selling activity. It is recognised that covered short selling activity, appropriately regulated, is beneficial to the operation of capital markets by increasing market liquidity and pricing efficiency.

The Government is also seeking to ensure that any disclosure regime is in line with the international consensus by complying with IOSCO's four high level principles on the regulation of short selling (as outlined above).

3. OPTIONS AND IMPACT ANALYSIS

3.1 Type of reporting

As outlined in the background section, there are two types of short selling reporting: positional reporting and transactional reporting. Positional reporting involves investors reporting their overall short position (as a proportion of issued capital) in relation to a particular stock. It differs from transactional reporting because it takes into account transactions that close out short positions. For this reason, positional reporting may provide a more accurate indication of the bearish sentiment within a particular stock at any point in time and also the amount of overhang in the stock that will need to be covered at some point by short sellers purchasing shares. In addition, for investors, this information may provide an indication of the level of risk involved in shorting the stock, particularly if total aggregate short positions are made available. For example, it may be risky for an investor to take a short position in a particular stock if a significant proportion of that stock has already been shorted. This is because there is a greater chance of being subject to a 'short squeeze' if market sentiment changes and the investor is required to close out its position in a short period of time. A number of countries (including the US, UK and many European countries) have adopted reporting requirements for short positions.

On the other hand, transactional reporting involves the reporting of the value of all short sale transactions in a particular stock during the day. As outlined above, the interim ASIC disclosure requirements are based around transactional reporting. They provide an indication of the proportion of trades in a particular security that are short sales and the overall level of short selling that takes place on the ASX each day. This assists investors and companies in explaining share price movements. For example, if a company's share price is particularly volatile, interested parties are able to refer to the transactional short selling information to gain an understanding of whether there has been an increased level of short selling activity in the stock. This information is also useful for regulators in carrying out market surveillance and investigating alleged cases of market misconduct. This is because the information is likely to be more detailed than positional information, as it identifies individual short sale transactions. Regulators can use this information as an audit trail when conducting investigations.

To some extent, investors may have the ability to obtain the information derived from positional reporting through alternative sources. As noted in the background section, the RBA announced on 24 February 2009 that it would amend the *Financial Stability Standards* to mandate the disclosure of stock lending information. In particular, the regime requires settlement participants to report directly to the ASX the net amount of a particular stock that the participant either has lent or has borrowed. This information will be published by the ASX following a short lag (still to be determined). An investor may be able to use this information as a proxy for the net short position in the stock and also the risk associated with short squeezes. It is accepted that stock lending information is an imperfect proxy for net short positions because of the potential for stock to be lent for reasons other than short selling. However, the shortcomings of stock lending information need to be weighed up against the potential limitations of any positional reporting regime in deciding whether to require positional reporting in addition to stock lending information.

Based on this, there are various regulatory options that could be progressed. These are mandating positional reporting or mandating transactional reporting or mandating both forms of reporting.

3.1.1 Positional reporting

The primary benefits of mandating positional reporting are outlined above. In particular, positional reporting provides the most accurate information to the market about the amount of bearish sentiment in a stock at any time. Changes in the overall short position may provide a signal to other investors that the stock is either under or over valued. Consistent with the objectives of the disclosure regime, this will assist in promoting pricing efficiency in the market.

Consistent with this, the vast majority of submissions to the consultation paper supported the introduction of a positional reporting regime for short sales. This support was across all stakeholder groups including brokers, fund managers, shareholder groups and regulatory bodies.

While noting the introduction of the securities lending disclosure, the majority of submissions did not believe that it removed the need for a disclosure regime specifically tailored for short selling positions. The submissions primarily noted the fact that stock lending is an imperfect proxy for short selling (as noted above). Given this, stakeholders were concerned that exclusive reliance on the stock lending information would still result in uncertainty in the market about short selling activity.

Two small fund managers did not support the disclosure of positional information, considering it would impose additional costs on a struggling industry, increase the possibility of front running and devalue the work currently undertaken by investment managers. They also argued that it would be difficult to enforce on offshore investors. This would place domestic investors at a comparative disadvantage to overseas investors. While they opposed positional reporting for the above reasons, they did concede that it would improve transparency. There was also some moderate opposition to the introduction of positional disclosure among some larger fund managers, although they reluctantly accepted that it was both necessary and inevitable.

In terms of the cost of complying with a positional reporting regime, most fund managers indicated that they expected the costs would be reasonably minor. For example, AIMA (which represents hedge funds in Australia) noted in its submission that "market participants [fund managers] within AIMA Australia believe implementation of a positional reporting regime would not be overly expensive for market participants". This is because most fund managers will have information already prepared on their short positions for internal reporting purposes. Submitting this information for regulatory reporting purposes would be unlikely to impose a significant additional cost on fund managers.

There is limited information available about the costs of a positional reporting regime for short sellers that are not fund managers. These may be individuals, financial institutions or other companies trading on their own behalf (for investment or risk management purposes). One company that uses short sales to hedge risks resulting from its covered short selling activities noted that a positional disclosure regime "which imposes increased reporting requirements on liquidity providers will necessarily impact retail investors via reduced market making activity, increased costs and increased IT systems latency". However, they were unable to provide an estimate of the likely costs involved in complying with any positional reporting regime. It should be noted, however, that like fund managers, investors entering into short sales on their own behalf should be monitoring their positions on a frequent basis for internal reporting purposes. This means that the information should already be available.

The introduction of a positional reporting regime is also likely to impose costs on the entity responsible for collecting the information, aggregating it and releasing it to the market. These costs are considered in section 3.5.

3.1.2 Transactional reporting

The existing transactional reporting regime is based around brokers receiving information from investors and reporting the information to the ASX, which then collates and releases the information. This is a cost effective method of reporting because it utilises existing infrastructure and communication channels. As noted above, the primary benefits of transactional reporting are regulatory in nature. In particular, it provides information to ASIC that will assist in the investigation of possible instances of market manipulation involving short selling. Further, daily reporting of information provides timely information to investors and companies about the level of short selling activity in the market. This assists in the removal of uncertainty in the market about short selling.

Consistent with this, both the ASX and ASIC supported the continuation of the transactional reporting regime in addition to any positional reporting regime that is established. Both parties indicated that transactional reporting was necessary for regulatory and market surveillance purposes because it provides an audit trail that enables regulatory bodies to identify which transactions are short sales. This can assist in the investigation of any possible market misconduct, in particular, market manipulation.

Shareholder groups, for example, the Australian Shareholders Association and RiskMetrics, and investor relations groups support the continuation of the interim transactional reporting disclosure. They believe that this is necessary to ensure that the market is fully informed about the activities of short sellers.

In general, brokers and industry bodies representing brokers (AFMA and SDIA) did not support the continuation of the interim disclosure regime for transactional reporting. Some industry associations, for example the ABA, were prepared to accept a permanent transactional regime only if the information was not released to the public (discussed below). These submissions noted that transactional reporting does not provide accurate information into the market place because it does not take into account transactions to close out short positions. For this reason, many submissions noted that it may have the potential to mislead investors seeking to use the information to derive an understanding of the short position in a particular stock. However, no submissions were able to provide specific evidence of investors being misled by the information to date.

Fund managers were divided in their views on the transactional reporting regime. The major industry body, IFSA, supported the continuation of the disclosure regime noting the regulatory benefits of the information. However, IFSA did not support the public release of the information (discussed below). Other fund managers including AIMA (which represents the hedge fund industry) did not support the continuation of the interim transactional disclosure requirements. They argued this position primarily on the ground that transactional information does not provide accurate information to the market about the actual level of short positions in a stock. As discussed above, they felt that this information may be misleading for investors; however, did not provide any specific evidence of cases where investors have been misled.

In terms of the regulatory costs associated with transaction reporting, some changes to existing systems are required, especially for brokers to facilitate communication of this information to the ASX. In relation to the cost of compliance for a transactional disclosure regime for brokers, AFMA indicated that it is likely to cost between $360,000 and $450,000 in initial implementation costs and approximately $80,000 per annum in ongoing compliance costs. Further, SDIA indicated that one broker running an automated trading platform on a global basis was likely to incur costs between $500,000 and $1 million to implement transactional reporting. These are the costs for a major broking house (for example, a global investment bank) of which there are approximately 10 in Australia. The costs will be lower for the remaining approximately 80 smaller brokers though stakeholders were unable to provide a precise estimate.

The ASX noted that it already has infrastructure in place to capture transactional short sale information noting the synergies in collecting this information through its existing trading platform. As a result, the regulatory impact of transactional reporting is not significant from the perspective of the market operator. ASIC also noted advantages in implementing the transactional reporting regime through ASX's existing trading platform because it allows for greater enforceability of the reporting requirements, particularly among offshore investors. This is because the data is reported through intermediaries (brokers) that are directly regulated by ASIC through their licensing requirements and have a direct contractual relationship with ASX. This assists in ensuring greater compliance with the regime.

In addition, IFSA expressed concerns about the release of short selling information through brokers because of potential risks to confidentiality. For example, a broker may use the information provided by the client to establish a short position in a company through its proprietary trading activities prior to the client finalising their position. For this reason, IFSA supported disclosure of this information by investors directly to the market operator unless appropriate confidentiality requirements and technological solutions are in place to ensure brokers do not misuse the information. In its submission, ASIC noted that brokers already owe a fiduciary duty towards their clients and have an obligation not to misuse any confidential information provided to them by the client. To this extent, the regulatory regime already covers off risks associated with brokers using short selling information to front-run their clients. Further, fund managers were not able to identify any instances of brokers front-running their clients since the interim disclosure regime was introduced in November 2008.

Evidence collected by GSCS Information Services on market impact costs after the introduction of the interim disclosure regime indicates that Australia continues to experience low market impact costs relative to other countries. Market impact costs measure the difference between the execution price of an order and the market price of the security immediately prior to the order being placed. If the introduction of the interim disclosure regime had resulted in a large number of brokers exploiting the information, it would be expected that the market impact costs would have significantly increased.

Public disclosure of transactional information

Under the existing ASIC disclosure regime, the ASX publishes information relating to the total volume of shares in a security that has been sold by way of short sales. This information is published on the day following the execution of the sale. As noted above, industry (in particular, fund managers) has expressed a number of concerns about the publication of this information on a daily basis:

- *Misleading information*: People may draw misleading conclusions from transactional information because it does not take into account transactions that close out short positions (in the same way as positional data).

- *Front-running*: Fund managers generally accumulate short positions over a number of days. There are concerns that making transactional information publicly available on a daily basis may result in trading strategies becoming publicly known before the fund manager can finalise their position. This would reduce the returns available to fund managers from executing a particular strategy and may potentially make them vulnerable to short squeezes if market sentiment changes.

There are two options in relation to the public disclosure of transactional information: disclosure on the following day (consistent with the interim regime) and disclosure one week after the transaction date.

<u>Disclosure on the following day</u>

In terms of the benefits, public disclosure on the following day ensures the market has access to timely information about the amount of short selling activity on the market at any point in time. This is particularly important during very volatile market conditions where there is greater chance of speculation about short sellers damaging market confidence. Consistent with this, ASIC and the ASX, as well as shareholder groups and investor relation groups, supported transactional information being made public as a means of providing transparency to the market about the activities of short sellers.

However, fund managers continued to express strong concerns that disclosure of this information on the following day may be detrimental to the market because the information could be used to facilitate front-running. While fund managers were not able to provide specific evidence of any instance of front-running during the consultation process, it is noted that any person engaging in this type of behaviour is unlikely to make this widely known.

<u>Disclosure with a one-week lag</u>

The advantage of a one-week lag before the information is publicly released is that it reduces the risk that the information might be used for front-running. This comes at the cost that the market no longer has access to this information in as timely a manner. This cost is mitigated by the fact that the information will still be available to ASIC and the ASX on a daily basis. This will allow them to intervene in the market in a timely manner if they consider that circumstances warrant this. Publicly releasing the information, albeit with a one-week lag, would still allow investors and companies to gain an understanding of the proportion of short selling activity in a stock on any particular day. This would still assist in overcoming speculation that short sellers may be driving changes to stock prices.

3.1.3 Conclusion

Based on the analysis of the costs and benefits outlined above, it is proposed to retain the existing interim transactional disclosure regime with public disclosure on the following day. While various industry groups expressed opposition to public disclosure on the following day, there was no concrete evidence to support their claims that it may lead to front running despite the regime being operative since November 2008. The balance lies in favour of providing greater transparency to the market.

In addition, it is proposed to introduce a positional reporting regime. This will ensure that all the regulatory objectives outlined in section two are satisfied. In reaching this outcome, considerable weight was given to the need to ensure that the market is fully informed about the activity of short sellers on Australian financial markets.

The positional reporting regime will ensure that investors have an understanding of the level of bearish sentiment within a stock. Investors can then use this information in making pricing decisions. Although both these reporting requirements will impose regulatory costs on industry, the benefits of transparency in promoting market confidence and integrity outweigh these costs.

Confidence in the integrity and transparency of the market are essential to enable the market to function efficiently. Given the level of concern about short selling, both transactional and positional reporting are needed to assure investors that market integrity and transparency are both protected.

The remaining options outlined in this section all relate to specific aspects of the positional reporting regime to be introduced.

3.2 Format for releasing the information

3.2.1 Aggregated or disaggregated information

Different formats of reporting positional information about short positions have been adopted in different jurisdictions.

In the US and Canada, short positions are disclosed publicly on an aggregated basis by market operators. Under this approach, the entity responsible for collecting the information aggregates all the short positions in relation to a particular security before releasing it to the public. This ensures the confidentiality of individual positions is preserved. This approach has merit in the US and Canada because all short positions (regardless of size) are reported (there is no threshold for excluding small short positions). As a result, the aggregated short position reported publicly should be an accurate reflection of the total short interest in the stock.

Disaggregated positional reporting involves investors disclosing to the market any substantial short positions they hold. These would be individual positions, so the market would be able to see the identity of any investor short selling a security. Reporting would be on a t+2 (two days following a trade) basis via the company announcements platform consistent with the existing substantial shareholder disclosure regime. This form of reporting has been adopted in other jurisdictions, particularly in the UK and Europe. This means that individual short positions are not aggregated before release and the identity of the holder is also disclosed to the market. However, only investors with substantial short positions would be required to report this information. The level used to determine what is a substantial short position is a judgement call depending on how much reporting is considered desirable. The threshold in the UK is currently 0.25 per cent, but there is a proposal to increase this to 0.5 per cent. Consistent with this, the Committee of European Securities Regulators has proposed a short selling disclosure regime that would require public disclosure of all individual positions in excess of 0.5 per cent and disclosure to regulators of all positions in excess of 0.1 per cent.

The submissions indicated that the average aggregated short position in a stock is between 2 – 3 per cent with most individual short positions being in the range of 0.25 – 0.5 per cent of issued capital 'and the majority may fall under even a 0.25% reporting threshold'. A large Australian fund manager indicated that approximately 70 per cent of their short positions are less than 0.5 per cent of the company's issued capital.

This gives rise to two regulatory options in relation to the reporting of positional information, namely, whether the information should be reported on an aggregated or disaggregated basis.

Aggregated reporting

Aggregated reporting would provide the market with an accurate indication of the overall level of short positions in the stock. This would assist the market in making informed decisions about the sentiment in that stock. In addition, aggregated reporting greatly reduces the risk that the disclosure regime could compromise or inhibit the legitimate trading strategies of fund managers. Consistent with this, the vast majority of submissions across all classes of stakeholders supported the introduction of an aggregated reporting regime.

The main disadvantage of aggregated reporting is the regulatory costs involved in the aggregation and dissemination of the information. These costs are discussed under in section 3.5.

Disaggregated reporting

The primary advantage of disaggregated reporting is that it would provide greater insight to the market as to which investors have significant short positions.

In addition, the compliance costs associated with disaggregated reporting are likely to be less than those for aggregated reporting. This is because disaggregated disclosure reports could probably be released to the market via the existing company announcements platform eliminating the need for additional market infrastructure. The ASX was not able to provide estimates of the costs it would incur to implement an aggregated disclosure regime, but indicated that they are likely to be significant.

In terms of disadvantages, disaggregated reporting fails to provide accurate information to the market about the overall level of short selling activity particularly when a threshold for reporting is introduced (see issue 3.4 below). In addition, disaggregated reporting runs a significant risk of discouraging short selling activity and distorting the market. This is because short sellers may face negative consequences if they are subsequently targeted by the media, listed companies or other investors because of their trading activity. In addition, public disclosure of disaggregated positions may compromise the proprietary value of trading and hedging strategies. Consistent with this, a broad range of stakeholders including industry groups (SDIA, AFMA, IFSA, AIMA and the ABA) as well as individual fund managers and shareholder groups were strongly opposed to disaggregated reporting.

Conclusion

Based on the analysis of costs and benefits above, the preferred regulatory outcome is the reporting of positional information on an aggregated basis. In coming to this conclusion, weight was given to the strong concerns of industry (particularly fund managers) that disaggregated reporting could result in the trading strategies of individual investors being released to the market. In addition, disaggregated reporting does not provide the market with an overall indication of the short position in each security, which is a primary objective of the disclosure regime. This would mean that the disclosure regime is less effective in promoting pricing efficiency on Australian financial markets. The remaining issues will be analysed on this basis.

3.3 Frequency of disclosure and public release

This requirement will govern how frequently an investor is required to provide information to the aggregator for public dissemination. This issue is largely a trade-off between the timeliness of the information that would come about from more frequent reporting against the additional costs (both financial and non-financial) that would be incurred by short sellers and the aggregator. Three options are considered in relation to the frequency of reporting: daily reporting, delayed daily reporting and weekly reporting.

Daily reporting

Under this option, investors would be required to report their short positions to the aggregator at the end of each trading day. This information would then be released to the market the following day.

Daily reporting has the clear advantage of providing the timeliest information possible to the market. This is consistent with the objective of ensuring that the market is as fully informed as possible about the activity of short sellers. ASIC was the main supporter of daily reporting in the submissions.

The frequency of reporting should not have a significant impact on the financial costs to a short seller. This is because most short sellers should monitor their short positions on a frequent basis for internal reporting purposes. The additional costs involved in reporting that information on a daily basis versus a fortnightly basis are unlikely to be significant. For example, one relatively small fund manager indicated that increasing the frequency of reporting from fortnightly to daily would only increase their costs from $150 per annum to $1,000 per annum. However, it is noted that costs are likely to become more significant for larger investors with more complex operations (for example, a large investment bank with multiple trading desks). No information was provided through the consultation process on the compliance cost implications associated with the timeliness of the reporting for short sellers trading on their own behalf.

However, daily reporting presents a concern for fund managers because of the possibility that it may result in an appropriation of their trading strategies. This may occur if the information is made publicly available prior to the fund manager finalising their position particularly in cases where a fund manager acquires a position over a number of days. This concern was stressed by IFSA who noted that “early information release compromises institutional asset managers’ proprietary research”.

Information from stakeholders indicates that the frequency of reporting does not impact upon the costs that would be incurred by the party responsible for aggregating the information (discussed in section 3.5).

Delayed daily reporting

Under this option, investors would be required to report their short positions to the aggregator three business days after the execution of the trade (that is, on a T+3 basis). This information would then be released to the market the following business day (T+4).

An obvious disadvantage of this approach is that it results in less timely information being provided to the market than daily reporting. In addition, it does not protect the confidentiality of proprietary trading strategies to the same extent as weekly reporting. This was of particular concern to IFSA which argued that positional data should be released to the market on a bi-monthly basis.

The primary advantage of this approach is that it strikes an appropriate balance between providing timely information to the market and addressing industry's concerns that positional reporting might compromise the confidentiality of a short seller's proprietary trading strategies. While this approach seeks to strike a balance, industry is likely to consider that the balance is skewed too far towards timeliness. However, given the objectives of the short selling disclosure regime, which include helping investors understand movements in share prices, the balance may be thought to lie in favour of timeliness. Both ASIC and the ASX advocated greater timeliness to enhance regulatory oversight and promote market confidence. A number of stakeholders supported the introduction of delayed daily reporting including AFMA and the ABA.

Weekly reporting

Weekly reporting involves the short seller reporting their positions to the aggregator on a weekly basis (for example, every Friday). This information would then be released to the market following a one-day lag to provide the aggregator with sufficient time to process the information.

The primary disadvantage of weekly reporting is that short positions would go unreported if they are closed out within a week. This would deny the market the ability to see these positions. In addition, it would mean that the information is less timely by the time it reaches the market because it may relate to positions established at the start of the week.

As with delayed daily reporting, weekly reporting reduces the risk of a short seller's strategy being released to the market before they complete their position. In general, fund managers were the main supporters of a form of periodic reporting. Periodic reporting does not have any material impact on the costs to the aggregator of collating and disseminating the information (see issue 3.5 below).

Conclusion

Based on the analysis of costs and benefits above, the preferred regulatory outcome is the reporting of aggregated positional information on a delayed daily basis. This is viewed as an appropriate balance between the market's need for timely information against the potential detriment to short sellers of reporting the information. The remaining issues will be analysed on this basis.

3.4 Threshold for aggregated reporting

A threshold would operate to exclude investors with only small short positions from the obligation to report the information. It would be intended to make the system more cost effective by reducing the number of investors with reporting obligations. However, if some positions were excluded from reporting, this would reduce the completeness of the data and lead to an understatement of actual short positions. These costs need to be taken into account when deciding whether there should be a threshold and, if so, the level of the threshold.

Three possible regulatory options are available in relation to this issue: reporting with no threshold, reporting with a de-minimis threshold and reporting with a threshold of 0.25 per cent of issued capital.

Reporting with no threshold

Aggregated positional reporting without a threshold would have a number of advantages. It would achieve the objectives of regulatory oversight and transparency by providing a more accurate indication of total short selling occurring in the market. Any threshold is likely to be arbitrary and may impose additional compliance costs for fund managers by making the disclosure regime more complex. In addition, the application of a threshold may generate uncertainty in the market about the accuracy of the aggregated short positions because no one would know how many short positions were going underreported because they fell under the threshold.

The main disadvantage of this option is the regulatory costs associated with a greater number of short sellers being required to report their positions. This cost is not likely to be significant for institutional investors, as they are likely to already have this information available for internal reporting purposes. However, the cost is likely to be quite significant for small, retail investors who are captured by the reporting regime (even though their positions are very small) if there is no threshold. In addition, the higher volume of reported positions will increase the costs for the party responsible for the aggregation of this information.

Reporting with a de-minimis threshold

The primary advantage of incorporating a de-minimis threshold into the reporting regime is that it would exclude small retail investors from any reporting obligation. This would ensure that these investors are not required to incur these costs and also reduce the costs to the aggregator responsible for processing the information (see section 3.5 for an estimate of these cost savings). At this stage, it is not known how many retail investors engage in short selling and what the average size of their position is. The task of determining the appropriate threshold would be left to the aggregator to ensure some flexibility in the system.

The disadvantage of this option is that it would exclude some short positions from being reported. As noted above, this would result in the data being incomplete. This problem is mitigated in relation to a de-minimis threshold because of its very low level. The accumulated impact of these positions is unlikely to be material to the overall aggregated position reported to the market.

Reporting with a threshold of 0.25 per cent of issued capital

The primary disadvantage of introducing a threshold at this level is that it would be likely to exclude some positions from reporting obligations, making the aggregated information disclosed incomplete, and potentially misleading. The submissions indicated that a large number of short positions are very small. AFMA indicated in its submissions that "direct short positions by individual investors may often be very small and the majority may fall under even a 0.25% reporting threshold". Consistent with this, one fund manager with approximately $350 million in assets under management noted that 95 per cent of its short positions were less than 0.25 per cent of the company's issued capital. This means that even the introduction of a low threshold of 0.25 per cent runs the risk of excluding a material proportion of short positions. This would result in a continuing level of uncertainty in the market about the actual level of short positions in Australian companies because of the possibility that short positions have increased but have gone unreported because of the threshold. This would compromise the objectives of introducing the disclosure regime.

The main advantage of this approach is that it would mean a reduced number of short sellers with reporting obligations. As noted above, this would reduce the cost for the entity responsible for aggregating and disseminating the information.

Conclusion

Based on the analysis of costs and benefits above, the preferred regulatory outcome is the reporting of aggregated positional information with only a de-minimis threshold aimed at excluding small, retail investors from any reporting obligation. Any higher threshold may significantly compromise the integrity of the information provided. The remaining issues will be analysed on this basis.

3.5 Who is responsible for collecting the information

There are two entities that are potentially in a position to collect and aggregate positional information: ASIC or the relevant market operator (generally, the ASX). There is currently no infrastructure in place that allows for this form of reporting of aggregated short positions because of the processing required prior to the release of the information. This means that either infrastructure would need to be built or reporting would need to be done manually. ASIC or the ASX would then be obliged to release the information to the market in the format specified by the regulations. This would impose costs on either the ASX or ASIC.

In the UK, investors report disaggregated positional information to a regulatory information service. In the US, aggregated positional information is reported to market operators.

ASX

There might be some synergies in having ASX aggregate and disseminate positional information. This is because the ASX has better access to other market information that may be required to supplement the positional information. For example, the ASX will have access to stock lending information that can be used to verify the accuracy of aggregated positional information.

The ASX was opposed to being required to collect and disseminate aggregated short positions noting the regulatory costs. The ASX has indicated that it is not in a position to provide an estimate on the possible costs it would incur if it was required to perform this function. However, it is expected that they would be broadly similar to how much it would cost ASIC to develop the system (discussed below).

Further, the ASX noted that it was not practical for it to perform this rule because it has no direct relationship with the individuals that would be required to report the information. Finally, the ASX felt it was inconsistent with its role as a public company to be required to perform a function that is regulatory in nature.

ASIC

ASIC could be viewed as a more credible party to play this role given it is an independent regulator. It does not suffer the perceived conflict of interest for the ASX in playing a significant role in the regulation of short selling given the ASX profits from the activity (in the form of higher trading volumes). In addition, ASIC has greater regulatory powers to ensure the regime operates in the most efficient and cost-effective manner.

ASIC has indicated that its preferred outcome would be for the ASX to perform this function for the reasons discussed above. However, if it was required to do this work it would likely cost ASIC approximately $2.5 million in order to establish a system for reporting and aggregating positional information. This project would be likely to take 6 months to complete. ASIC has also advised that there may be some security issues in relation to the development of the system, particularly for short sellers that do not have an ABN. Additional costs might be incurred in overcoming these issues. Further, ASIC has advised that excluding small, retail investors through a de-minimis threshold would be likely to reduce these costs by approximately $200,000.

The ongoing costs of running the system once established would be likely to be approximately $115,000 per annum.

Conclusion

Based on the analysis of costs and benefits above, the preferred regulatory outcome is for the information to be collected and disseminated by ASIC. This will overcome any perceived conflict of interest that might result if the market operator was given this responsibility.

4. Consultation

In order to ensure stakeholder and industry concerns are appropriately addressed, the Treasury issued a wide-ranging consultation paper on disclosure of short selling. Submissions were received from a broad range of stakeholders, including large and small fund managers, ASIC, the ASX, the ABA, the ASA, IFSA, AIMA, SDIA, the AICD and members of the public. Stakeholders were invited to comment on the options outlined above. The Government used these submissions to assess the costs and benefits of regulatory options on various stakeholders and decide on the approach that would best achieve its objectives. The Treasury has made these submissions publicly available.

Treasury has also consulted industry and stakeholders on its tentative proposal for the short selling disclosure regime. These comments have been used to refine the draft regulations. Treasury will engage in further discussions with industry and stakeholders to address technical issues relating to the regime's implementation.

In addition, the Government engaged in public consultation on the legislation establishing the disclosure framework last year. As part of this process, there was also an inquiry into the legislation by the Senate Economics Committee. Prior to developing the legislation, Treasury engaged in targeted consultation with stakeholder groups. Discussions at this meeting focused on identifying current market practices, the scope for additional disclosure of covered short sales and the likely impact on industry of any regulatory change. By contrast to the consultation paper on the disclosure of short selling, these meetings were high level and did not seek specific comments from stakeholders. However, the feedback from these meetings, particularly as it related to implementation costs for investors and brokers, was used to develop the impact analysis section of the regulation impact statement that accompanied the legislation.

5. Conclusion and recommended option

Based on our analysis of ASIC's interim transactional reporting regime, it is recommended that the regime should be made permanent. The information is useful for regulators in carrying out market surveillance and investigating alleged cases of market misconduct. It also allows regulators to intervene in the market in a timely manner if warranted by the circumstances.

In addition to creating a permanent transactional reporting regime, it is also recommended that an aggregated positional disclosure regime with delayed daily reporting should be established. Positional reporting received widespread support from stakeholders and industry. Aggregated disclosure is to be preferred over disaggregated disclosure as it provides a more accurate reflection of the total short interest in a stock. Recognising the costs associated with the reporting regime, it is recommended that a de-minimis threshold also be introduced aimed at excluding small, retail investors from any reporting obligations. Aggregated data also reduces the risk of front running and negative publicity that were raised in relation to disaggregated data.

It is preferable that positional data should be aggregated on a deferred daily basis. Under this approach, the information will be released to the market by the aggregator four business days after the trade establishing the position was executed. This reduces the possibility that a trader's strategy may be appropriated before they are able to finalise their position.

As to the dissemination of positional information, it is recommended that ASIC should perform this role. ASIC would have the power to determine the appropriate level of the de-minimis threshold and also introduce other requirements to make the reporting process more streamlined if it considers this desirable.

6. Implementation and review

The regulations will not contain a sunset clause; however, a comprehensive review will take place within two years after the regulations have been implemented. The review will take into account the impact of positional reporting, transactional reporting and the RBA's stock lending regime and whether it is necessary to retain three tiers of reporting. The review will also seek feedback from industry and stakeholders on the operation of the disclosure regime. Depending on the feedback to be received, the review may recommend changes to the regime.

7. ABBREVIATIONS

ABA	Australian Bankers Association
ABN	Australian Business Number
ACSA	Australian Custodial Services Association
ACSI	Australian Council of Superannuation Investors
AFMA	Australian Financial Markets Association
AICD	Australian Institute of Company Directors
AIMA	Alternative Investment Management Association
AIRA	Australian Investor Relations Association
ASA	Australian Shareholders Association
ASIC	Australian Securities and Investments Commission
ASX	Australian Securities Exchange
IFSA	Investments and Financial Services Association
RBA	Reserve Bank of Australia
SDIA	Securities and Derivatives Investment Association