



Alternative Investment
Management Association

Australia

AIMA AUSTRALIA

SUBMISSION TO THE TREASURY, AUSTRALIAN GOVERNMENT

CONSULTATION PAPER: MARCH 2009: SHORT SELLING DISCLOSURE REGIME

7 April 2009

**A submission prepared by the Regulatory Committee
of the Alternative Investment Management Association
Australia Chapter**

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Background on AIMA Australia

The Alternative Investment Management Association (**AIMA**) was established in 1990 as a direct result of the growing importance of alternative investments in global investment management. It is a not-for-profit educational and research body that specifically represents practitioners in hedge funds, futures funds and currency fund management - whether managing money or providing a service such as prime brokerage, administration, legal or accounting advice. AIMA Australia's global membership is in excess of 1000 members, comprising 3000 individuals in 46 countries.

The Australia Chapter of AIMA Australia (**AIMA Australia**) represents participants in alternative investments in Australia. AIMA Australia has over 60 members, including fund of funds managers, institutional investors, hedge fund managers, prime brokers, lawyers, auditors and other service providers.

As Treasury will be aware, AIMA Australia has been active in the debate and consultations over the last 18 months concerning the regulation of short selling in Australia. In particular, AIMA Australia published a Position Paper on Short Selling in April 2008, which set out the position maintained by AIMA Australia and explained many of the market uses and advantages of short selling in the hedge fund industry. AIMA Australia also made submissions to The Treasury in relation to the Exposure Draft of the Corporations Amendment (Short Selling) Bill 2008, dated 21 October 2008. A copy of those submissions, which in turn annex the AIMA Australia Position Paper is attached to these submissions for reference.

In particular we draw Treasury's attention to:

- the explanation of hedge fund market usages and the advantages to them of a short selling regime with sensible restrictions, as set out in the Position Paper, particularly at pages 4 to 6;
- AIMA Australia's proposed solution for sensible disclosure and transparency of short selling as set out on pages 7 and 8 of the Position Paper; and
- AIMA Australia's preferences concerning the reporting of short positions as set out in section 4 of the October 2008 submissions, particularly at pages 3 and 4.

In the present submissions, we have adopted the same numbering of sections and issues for comment, as in the Treasury Consultation Paper: "Short Selling Disclosure Regime" (**the Consultation Paper**).

1. Introduction

AIMA Australia's general position on disclosure reform in relation to short selling

AIMA Australia is grateful for the opportunity to make these comments and observations on the issues which have been raised by Treasury in the Consultation Paper. We wish to compliment Treasury on the format and content of the

Consultation Paper: AIMA Australia believes that it puts the key issues in relation to this most important operational aspect of reform squarely for the benefit of stakeholders.

AIMA Australia appreciates that the Consultation Paper, of necessity, focuses on a particular aspect of short selling regulation; namely, the proposed disclosure regime. Of course, the remaining parts of the short selling regulation regime will be of no consequence unless we achieve a workable means of regulating disclosure.

AIMA Australia's view of the critical object of disclosure reform

AIMA Australia sees as the critical object of disclosure reform the establishment of an efficient regime for disclosure of short selling, which produces valid and useful information, for the benefit of market participants and investors, at reasonable cost.

It is no use establishing a system which produces results which are not valid, in the sense of being a true reflection of market movements or the proportion of market positions which represent short sales.

Regulatory imperatives for reform in this area (getting it right, first time)

AIMA Australia's position on reform of the disclosure regime, and of course its answers to the particular questions and issues raised by Treasury in the Consultation Paper are based on AIMA Australia's basic contentions about short selling regulation. These are outlined in more detail in AIMA Australia's Position Paper, and in the October 2008 submissions, both of which are attached, but in essence are as follows:

1. AIMA Australia supports a complete ban on naked short selling.
2. However, AIMA Australia says that recognition needs to be given to the legitimate use and the market benefits of short selling, and in doing this recognition needs to be made of the fact that only a small percentage of overall directional trading is "short" by measure of open positions. Moreover, only a small proportion of hedge fund trading relies on short selling, and a large amount of the short selling in the Australian financial markets represents risk management and hedging activities of other investors.
3. Australia operates as a small-to-medium cog in a very large wheel: the global equities market. As the G20 Communique issued on 3 April 2009 emphasises, there is a need to establish the much greater consistency and systematic cooperation between countries, and the framework of internationally agreed high standards, that a global financial system requires." (Communique point 14).

Any reform of market regulation in Australia must therefore be consistent in principle, as well as in detail, with such reform efforts in other jurisdictions.

4. Reform, in order to be principled, must be based on market reality and on the facts and hard evidence, rather than on rumours, beliefs and expectations. Rumours and hearsay are the quicksand upon which well-intentioned reforms (particularly operational reforms such as a disclosure regime) will founder. Short selling is not an overwhelming factor in equities markets. Australia is not in some special way susceptible to market

disruption and the creation of artificially low prices by way of being "targeted" by those wishing to short sell. Markets cannot function properly, efficiently or provide accurate price discovery where there is any overt restriction on market practices i.e. a ban on short selling.

5. The primary beneficiaries of any reformed structure are, on an immediate basis market participants, but ultimately must be the investors involved. We should not be spending public money designing any reporting system which may be of primary benefit to regulators, rather than to investors. In this regard, we take issue with Treasury's contention in its introductory remarks, which we read as saying that regulators are equal stakeholders in this regard.
6. It is important so far as possible to "get it right, first time" in designing a reporting system. We appreciate that Treasury is trying to do this. We emphasise however that the very considerable time, effort and cost which will be involved by the industry as a whole, regulators and market operators in establishing and then enforcing compliance with a reporting regime will be wasted if that regime is not effective in the sense we have outlined above. That is, the reporting regime must produce valid and useful information for the benefit of market participants. Otherwise it is wasted effort.

Responses to Treasury's issues for comment

AIMA Australia provides the following comments and observations in response to the issues for comment raised in the Consultation Paper. For convenience of reference we have repeated Treasury's statement of the issue in each case.

- A. Do you support the disclosure of positional information in relation to short sales? If you support disclosure of positional information, do you believe the disclosure should be in addition to or in place of transactional information? Please explain why.*

AIMA Australia supports the disclosure of positional information in relation to short sales and it believes that disclosure in this form should be in place of transactional reporting.

Transactional reporting is completely undesirable for a number of reasons:

- (i) It does not produce a result which is accurate or useful to the market. An informal survey of local AIMA Australia hedge fund managers shows that none follow or take any notice of the current daily transactional data reported for short selling. Transactional reporting does not allow a proper or accurate assessment to be made of the total position occupied by short selling in the equity positions of any particular stock.
- (ii) Positional reporting could be undertaken by Australian Financial Services Licensees, in particular custodians and prime brokers. Although further studies need to be undertaken as to the cost of implementation, it is AIMA Australia's understanding that custodians and prime brokers could adjust to a system for position reporting of short selling by their various customers without undue delay or cost.

- (iii) Positional reporting by custodians or prime brokers as licensee would overcome the problem inherent in requiring executing brokers to report on a transactional basis, particularly where the broker operates outside this jurisdiction and is not subject to an Australian Financial Services Licence or oversight by ASIC.

B. Does the disclosure regime for stock lending established by the RBA reduce or remove the need for reporting of short positions? Please explain why.

No. A disclosure regime for stock lending may be a worthy pursuit for identifying potential settlement risks which are being created by significant stock lending activities. However stock lending disclosure should be viewed as a distinct regime to short selling disclosure. Stock lending is undertaken for a number of reasons, not all related to short selling, through several counterparties. It therefore adds very little useful insight into short selling practices for market participants or regulators. For further information, please see page 6 of AIMA Australia's submission dated 21 October 2008, which is attached.

C. Do you agree that investors should hold ultimate responsibility for the reporting of short positions? If not, please explain why and where you think this responsibility should lie.

No. AIMA Australia believes that the AFS Licensee should hold ultimate responsibility for reporting short positions. See AIMA Australia's contentions as to the benefits of having custodians and prime brokers hold the primary responsibility for reporting, in section 4(b) on page 4 of AIMA Australia's submissions dated 21 October 2008, as attached. Placing the responsibility on intermediaries who are licensed, assists overall regulatory oversight of reporting of this activity, and overcomes the problem which arises where the executing broker or investor operates outside this jurisdiction. In the case where a custodian or prime broker is not used, then as a "residual" measure the investor itself would bear the prime responsibility for reporting.

D. Do custodians/prime brokers have sufficient access to information about their clients' short positions to enable them to accurately report this information? If so, what proportion of investors are likely to use custodians/prime brokers to report positional information? Do you think there are potential issues with reporting of short positions through custodians/prime brokers? If so, what are they?

Yes, custodians and prime brokers, as the ultimate record holders for safe-keeping and settlement of market transactions, capture all the necessary information for their clients' short positions in order to enable them to report accurately. AIMA Australia understands that the vast majority of investors are likely to use custodians or prime brokers to report positional information. In the case where a custodian or prime broker is not used, then as a "residual" measure the investor itself would bear the prime responsibility for reporting. AIMA Australia cannot see any substantial issues with the reporting of short positions through custodians/prime brokers. Reporting by this method enhances client confidentiality (to the extent consistent with proper market regulation), and is in the view of AIMA Australia superior to any other alternative. See the further discussion of this method of reporting in section 4 of AIMA Australia submissions dated 21 October 2008, as attached.

E. Do you have any views on ways to make enforcing the disclosure requirements (particularly against foreign investors) more effective?

AIMA Australia has no particular views on how to improve enforcement on foreign

investors or making them more effective. However we note that most if not all custodians and/or Prime Brokers, if based overseas, will have a sub-custodian relationship with an Australian domiciled entity for settlement procedures and any corporate actions. Presumably, these sub-custodians are ASIC AFS licensees. AIMA Australia believes that reporting through Australian financial services licensees is an effective and legally sound system for capturing most if not all forms of short selling. . If efforts to extend the obligation to executing brokers are introduced then some means of enforcing disclosure requirements against persons who are not normally subject to ASIC's jurisdiction, or are located or carry on business outside this jurisdiction, will need to be found. AIMA Australia believes that there is a certain degree of artificiality in attempting to extend the jurisdiction of ASIC or the ASX in this way.

- F. Who should collect and disseminate the information: market operators or ASIC? Please explain why.*

AIMA Australia firmly believes that the responsibility for collection and dissemination of information should rest with market operators rather than with ASIC. This is consistent with international practice, particularly in the USA and UK. ASIC's proper role is to act as the national regulator of the market, not as the disseminator of market information.

- G. Do you support the introduction of a threshold to exclude the reporting of small short positions? If so, what level do you consider to be the appropriate threshold for reporting of short positions? Please explain why*

AIMA Australia recognises that there is some support amongst various regulators and trade bodies for some form of threshold reporting to exclude small short sold positions because below this de minimus level, information is of little value to market participants or these small positions do not pose any form of systemic risk.

However AIMA Australia believes the setting of the threshold is extremely arbitrary and poses more implementation problems and may be more costly to operate, than the benefits or relief from a total reporting requirement. AIMA Australia would view threshold reporting as providing unnatural and potentially misleading results.

- H. What percentage of your total short positions would be excluded from reporting if the threshold was set at 0.25, 0.5, 0.75 and 1 per cent? Please explain why.:*

Treasury is correctly trying to identify whether there is an "appropriate" threshold for short selling reporting. AIMA Australia believes there is not an appropriate threshold other than what is currently set as the reporting level applicable to a "substantial investor"; namely 5% of a company's outstanding shares.

AIMA Australia believes setting an arbitrary threshold for reporting short selling can lead to unintended consequences. Setting an identical 1% threshold for companies whose market capitalisation and daily share trading volumes are vastly different may create a standard reporting framework, but takes no consideration for these different market characteristics, and if set too low, could be extremely prejudicial to larger companies.

I. *How frequently should positional information be provided to ASIC or the market operator:*

- *on a daily basis (with an exclusion from reporting if your positions have not changed)?*
- *on a weekly basis?*
- *on a fortnightly basis?*

Please explain why.

AIMA Australia strongly favours positional information being reporting fortnightly as this is consistent with successful international practice, particularly in the United States of America. Consideration could be given to a power requiring more frequent reporting where special market positions are deemed to apply. The decision as to when such conditions apply should be left to the market operator.

J. *Do you support banded disclosure requirements so that changes to positions within a prescribed band are not required to be reported? If so, what do you consider the range of the band should be? Please explain why.*

No, AIMA Australia does not support this proposal. We believe that banding of disclosure requirements is akin to the introduction of thresholds and is objectionable for the same reasons as we have outlined in our response to Question G above.

K. *Once the information is reported to ASIC or the market operator, should there be a delay before the information is then released to the public? Please explain why and how long you consider any delay should be.*

Generally we believe that the information should be released on the intervals discussed under our response to Question I above. Otherwise it does not seem necessary to introduce a delay in the release of the information.

L. *Do you support the disclosure of the information on an aggregated or disaggregated basis? Please explain why.*

AIMA Australia supports the disclosure of information on an aggregated basis. This is consistent with AIMA Australia's position in relation to the introduction of thresholds. It is also consistent with the US and Canadian positions described in Treasury's first paragraph under heading 2.5.

M. *If you support aggregated disclosure, are you concerned that aggregated disclosure could be misleading if a reporting threshold is also adopted? Please explain your reasons*

Yes. See our answers to L and G.

N. *Should the identity of holders of short positions be publicly disclosed? Please explain why. If you support the identity of the short sellers being publicly disclosed, do you believe this should apply to all short positions or only 'substantial' short positions? Please explain why and what you consider to be a substantial short position.*

AIMA Australia strongly opposes the identification of holders of short positions. As indicated by Treasury in its third paragraph under heading 2.5 this could provide a disincentive for investors to engage in short selling because of the possibility that

confidential trading information is released to the market or that the investor may be unfairly targeted by other participants in the market. If there is no regulatory justification for such identification, then it should not occur. In summary, it seems difficult to justify the identification of such holders on regulatory benefit grounds.

- O. Do you support the disclosure of transactional information in relation to short sales? If you support disclosure of transactional information, do you believe the disclosure should be in addition to or in place of positional information? Please explain why.*

No. Transactional information such as is presently reported as Gross Short Sale Reporting suffers from being incomplete, particularly as it does not account for the impact of purchases that close existing short sales, and may therefore be misleading. Furthermore, there is no evidence to support that there is any relationship between reported gross short sales and any adverse impact on share prices and thus any requirement to maintain this nature of reporting.

- P. Do you have any suggestions to improve the operation of the transactional reporting regime currently in place (excluding the public disclosure of reports discussed below)?*

No. The current regime of reporting Gross Short Sales is flawed and cannot be improved. It needs to be replaced by positional reporting provided by the appropriate parties in a cost effective manner.

- Q. If positional reporting is made mandatory, would you support the continued public disclosure of transactional information? Please explain why.*

No. AIMA Australia believes that once positional reporting is made mandatory there is no overall regulatory benefit in continuing public disclosure of transactional information. The current requirement for transactional reporting is onerous and should be replaced by positional reporting. Once that happens AIMA Australia believes there is no demonstrable regulatory or market benefit in continuing public disclosure of transactions.

- R. What do you consider to be the appropriate lag period before the information is made available to the public (for example, 1 day, 5 days)? Please explain why.*

If positional reporting is provided on a fortnightly basis then this information, once compiled, could be provided almost immediately. In the event that more frequent collection is enacted, then a lag of at least two weeks should be considered. Contemporaneous public disclosure of short selling position data can lead to greater incidences of rumour mongering, front running, and manipulative share trading, all designed to exploit short sellers.

- S. Are you aware of any instances where the daily publication of transactional information has resulted in front-running or any other damaging consequences to the short seller? If so, please provide details.*

AIMA Australia is not aware of any such instances. However many hedge funds will not transact with Prime brokers unless a distinct quarantine is made within the brokerage company between PB information (trades, asset data, short positions, lending rates), on the one hand, as captured from hedge funds and, on the other hand, data used in the other parts of the brokerage units, particularly the proprietary trading desks, where they exist. Front running mainly occurs where there is a

breakdown in compliance within brokerage companies.

T. *Are you aware of any instances where the daily publication of transactional information relating to short selling as misled anyone or been of benefit to anyone? If so, please provide details.*

As a general proposition there will have been instances where the reported level of Gross Short Sales in a company was less than the short sales closed out providing a signal that was at odds with the overall activity in a company.

In relation to data accuracy, the reported Gross Short Sales of ANZ Limited on 19 November exceeded total turnover for that day, suggesting that the data is inaccurate and thus misleading.

For fund managers and other investors:

U. *How much would it cost you to comply with the current ASIC interim disclosure regime if it was made permanent (both in terms of initial costs and ongoing costs)? Please reply without including any costs already incurred.*

AIMA Australia's membership includes funds managers, brokers, custodians and prime brokers. AIMA Australia has no detailed information on the costs involved, and at this stage has not surveyed its members as to these questions. However AIMA Australia reiterates that on the information available, market participants within AIMA Australia believe implementation of a positional reporting regime would not be overly expensive for market participants and, as this is a vastly superior method of efficient and accurate reporting of short selling, this is the method which should be implemented.

V. *How much would it cost you to report positional information directly to the ASX or ASIC:*

- *on a daily basis (with an exclusion from reporting if a position has not changed)?*
- *on a weekly basis?*
- *on a fortnightly basis?*

AIMA Australia's membership includes funds managers, brokers, custodians and prime brokers. AIMA Australia has no detailed information on the costs involved, and at this stage has not surveyed its members as to these questions. However AIMA Australia reiterates that on the information available to it implementation of a positional reporting regime would not be overly expensive for market participants and, as this is a vastly superior method of efficient and accurate reporting of short selling, this is the method which should be implemented.

For brokers:

W. *How much would it cost you to comply with the current ASIC interim disclosure regime if it is made permanent (both in terms of initial costs and ongoing costs)? Please reply without including any costs already incurred.*

AIMA Australia's membership includes funds managers, brokers, custodians and prime brokers. AIMA Australia has no detailed information on the costs involved, and at this stage has not surveyed its members as to these questions. However AIMA Australia reiterates that on the information available to it implementation of a positional reporting regime would not be overly expensive for market participants and, as this is a vastly superior method of efficient and accurate reporting of short selling, this is the method which should be implemented.

X. *For custodians and prime brokers:*

How much would it cost you to report positional information directly to the ASX or ASIC on behalf of investors:

- *on a daily basis (with an exclusion from reporting if a position has not changed)?*
- *on a weekly basis?*
- *on a fortnightly basis?*

AIMA Australia's membership includes funds managers, brokers, custodians and prime brokers. AIMA Australia has no detailed information on the costs involved, and at this stage has not surveyed its members as to these questions. However AIMA Australia reiterates that on the information available to it implementation of a positional reporting regime would not be overly expensive for market participants and, as this is a vastly superior method of efficient and accurate reporting of short selling, this is the method which should be implemented.

For market operators:

Y. *How much would it cost you to comply with the current ASIC interim disclosure regime if it is made permanent (both in terms of initial costs and ongoing costs)? Please reply without including any costs already incurred.*

Not applicable.

Z. *How much would it cost you to collate, aggregate and release positional short selling information received directly from investors if the information is reported to you:*

- * *on a daily basis (with an exclusion from reporting if a position has not changed)?*
- * *on a weekly basis?*
- * *on a fortnightly basis?*

Not applicable.

AA. *Given that this measure will impose some compliance costs, are there any other regulations in this area that you would like to see improved or removed to reduce your compliance costs? If so, please explain what they are and why they need to be improved and removed.*

This subject is not currently under investigation by AIMA Australia.

Contact points

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