



ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 106

Short selling to hedge risk from market making activities

April 2009

About this paper

This consultation paper sets out ASIC's proposals to grant relief from the short selling prohibition in s1020B of the *Corporations Act 2001* (Corporations Act) to permit market makers to naked short sell to hedge risk arising from their market making activities.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Document history

This paper was issued on 30 April 2009 and is based on the Corporations Act as at 30 April 2009.

Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. They are also at a preliminary stage only. Our conclusions and views may change as a result of the comments we receive or as other circumstances change.

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The consultation process

You are invited to comment on the proposals outlined in Section C of this paper.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information. We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our policy on naked short selling. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account if we prepare a Business Cost Calculator report and/or a Regulation Impact Statement: see Section D Regulatory and financial impact, p. 15

Making a submission

We will not treat your submission as confidential unless you specifically request that we treat the whole or part of it (such as any financial information) as confidential.

Comments should be sent by Monday 8 June 2009 to:

Andrew Templer, Investment Banks
 Australian Securities and Investments Commission
 GPO Box 9827, Sydney NSW 2001
 facsimile: 02 9911 5232
 email: policy.submissions@asic.gov.au

What will happen next?

Stage 1	30 April 2009	ASIC consultation paper released
Stage 2	8 June 2009	Comments due on the consultation paper
Stage 3	July 2009	Publish our decision on the proposed relief

A Background

Key points

- ‘Naked’ short selling is banned in Australia.
- A market maker is generally permitted to engage in ‘covered’ short selling of non-financial securities to hedge risk.
- At the present time, market makers can engage in covered short selling of financial securities to hedge risk only if certain conditions are met.

Hedging risk from market making activities

- 1 A market maker regularly states prices at which it proposes to buy or sell financial products on its own behalf: s766D. A market maker is generally required to hold an Australian financial services (AFS) licence authorising it to make a market for a financial product: s911A.
- 2 If a market maker enters a transaction with a counterparty that creates a ‘long’ exposure to an underlying product, the market maker may want to hedge the risk of this long exposure by short selling the underlying product to achieve a ‘delta neutral’ position in the product.

Short selling by market makers

- 3 ‘Naked’ short selling is prohibited in Australia—that is, a person selling section 1020B products must, at the time of sale, have ‘a presently exercisable and unconditional right to vest’ the products in the buyer: s1020B.

Note: For a discussion of what constitutes a presently exercisable and unconditional right to vest, see ASIC Regulatory Guide 196 *Short selling: Overview of s1020B* (RG 196).

- 4 Some market makers previously relied on exceptions to the prohibition in s1020B to naked short sell to hedge their long exposures where:
 - (a) arrangements were made before the sale to enable delivery of the products when due and the sale was made in accordance with the ‘up-tick’ rule (s1020B(4)(d)); or
 - (b) the products sold were constituents of the ASX Approved Product List and were sold in accordance with ASX Market Rules (s1020B(4)(e)).

Note: Section 1020B(4)(d) and (e) were repealed on 8 January 2009 by the *Corporations Amendment (Short Selling) Act 2008*.

5 A market maker is generally permitted to engage in ‘covered’ short selling of section 1020B products to hedge risk. A covered short sale is a sale where the person selling products has, at the time of sale, a presently exercisable and unconditional right to vest the products in the buyer because of a securities lending arrangement entered into before that time.

6 At the present time, the extent to which covered short selling of financial securities can occur is affected by notional s1020BD(1) as set out in ASIC Class Order [CO 08/751]. Relevantly, market makers can engage in covered short selling on certain conditions, including that:

- (a) the covered short sale is a bona fide transaction to hedge the risk of market making activities; and
- (b) their counterparty is not establishing or increasing a net economic short position.

Note: See notional s1020BD(2).

7 Market makers engaged in covered short selling under the exception referred to in paragraph 6 must:

- (a) record the sale as an exempt covered short sale; and
- (b) report the short sale to ASX.

B Rationale for exempting market makers

Key points

- ASIC has given relief permitting naked short selling in very limited circumstances and subject to conditions.
- Some foreign jurisdictions permit market makers to naked short sell to hedge risk from their market making businesses.
- Without relief, market makers are effectively required to maintain an inventory of borrowed products to make permitted covered short sales to hedge. They say this is commercially impractical.
- Applicants for relief suggest that relief is justified as market makers' hedging transactions are non-directional and there are negligible settlement failures associated with market making activity.

Approach to regulation of short selling in Australia

- 8 In regulating short selling, ASIC is seeking to achieve a balance between:
- (a) promoting liquidity in the Australian markets by facilitating efficient, non-directional hedging by market makers; and
 - (b) maintaining confidence in the Australian markets by adequately addressing risks associated with naked short selling.
- 9 One such risk is the risk of failed settlements. To address the risk of settlement failure in the Australian markets, the Government has acted to ban most naked short selling.
- 10 Naked short sales tend to have a higher risk of settlement failure because at the time of sale the seller does not have a presently exercisable and unconditional right to vest the product in the buyer.
- 11 ASIC has previously given relief permitting naked short sales of section 1020B products in very limited circumstances and subject to conditions: see Table 1. Some of this relief reflects previous exceptions in regulations.

Table 1: Relief for naked short selling in Australia

What relief is available	Reference
Sale of a financial product that is done by the giving or writing of certain exchange-traded options	[CO 09/1051]
Sale resulting from the exercise of exchange-traded options	[CO 08/764]

What relief is available	Reference
Sale of unobtained financial products where, at the time of sale, the person is able to obtain at least the number of financial products of the same class by exercising exchange-traded options	[CO 09/1051]
Sales of certain bonds or debentures of a body corporate and government bonds provided the seller has in place arrangements for settlement	[CO 09/1051]
Sales of section 1020B products placed in an established securities lending program before the completion of a recall of loaned products	ASIC Advisory AD 08-23
Sales made by a broker to a client in the course of providing client facilitation services	Case-by-case on application
Sales of certain exchange-traded funds (ETFs) by ASX registered market makers in circumstances where ETFs can be applied for and created to ensure delivery at settlement	Case-by-case on application

International approaches to short selling by market makers

- 12 In a consultation report released in March 2009, the Technical Committee of the International Organization of Securities Commissions (IOSCO) recommends that short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development, including an exception permitting market makers to naked short sell to hedge risk arising from their market making activities.

Note: See *Consultation Report on Regulation of Short Selling*, IOSCO Technical Committee, March 2009.

- 13 In some foreign jurisdictions, a market maker is permitted to naked short sell to hedge risk from its market making business: see Table 2.

Table 2: Regulation of naked short selling in other jurisdictions

Jurisdiction	Description of regulation	Reference
United Kingdom	Market makers were exempt from short selling restrictions introduced in September 2008 and lifted in January 2009	MAR 1.9.2C E (2) of the Short Selling (No.2) Instrument 2008
Hong Kong	Market makers are permitted to make naked short sales to hedge risk arising in their market making businesses	Section 3 of the Securities and Futures (Short Selling and Securities Borrowing and Lending (Miscellaneous)) Rules
United States	Under the 'locate' requirement, a person must have reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due	Rule 203(b)(1) of Regulation SHO

Impact of the short selling prohibition

- 14 To provide market making services, the market maker must be able to manage risk by hedging its exposure to price movements in the underlying product immediately after entering a position as principal. Market makers often hedge using automated systems.
- 15 Currently, to make a permitted covered short sale of section 1020B products to hedge their risk, market makers must before the time of sale have an agreement to borrow the products under a securities lending arrangement.
- 16 Applicants for relief submit that market makers' automated systems immediately hedge positions established in the course of market making. Thus there is no opportunity to borrow products to cover a short sale between the time the position is created and the hedging short sale is executed.
- 17 To comply with the law, market makers are effectively required to maintain an inventory of long or borrowed products. Applicants for relief submit that it is commercially impractical for a market maker to borrow an inventory of section 1020B products needed to cover its market making activities at the start of each trading day because:
- (a) the market maker is unable to anticipate the volume of products it will require to cover possible future positions; and
 - (b) the market maker will incur borrowing and administrative costs, regardless of whether the borrowed products are actually used.
- 18 Applicants for relief submit that maintaining such an inventory affects the spreads (cost) at which market makers can price bids and offers in the derivatives markets.

Mitigating risk of settlement failure

- 19 Applicants for relief suggest an exception permitting market makers to make naked short sales is justified as market makers' hedging transactions are non-directional and there are negligible settlement failures associated with market making activity. This is illustrated by ASX data that equity settlement delivery initial fail rates averaged between 0.13% and 0.26% for the months between September 2008 and March 2009.
- 20 We currently do not have sufficient information about the proportion of ASX market turnover contributed by short sales made by market makers to hedge risk, being sales that would (if relief were granted) attract risk of settlement failure. We have asked specific questions designed to provide us with information that would allow us to accurately assess this level of risk in Section C.

- 21 If relief is provided, market makers will still be subject to the ASX Market Rules relating to failure to deliver products at settlement, including the imposition of fees in the event of a failure to settle: see ASX Circular 244/08.
- 22 Relief is proposed to be subject to conditions that are intended to further mitigate the risk of settlement failure from naked short selling by market makers: see Section C.

C ASIC's proposals

Key points

We propose to:

- permit market makers to naked short sell to hedge risk where they have arranged a 'hold' over the product at the start of the day;
- require that market makers who make naked short sales under the proposed relief report such sales to ASX;
- require market makers to acquire or borrow sufficient products by the end of each day to ensure that they can deliver all products sold during the day at the time delivery is due.

Naked short selling relief for market makers

- 23 ASIC is considering modifying the short selling prohibition to provide an exception for market makers to naked short sell a security or managed investment product in certain circumstances.
- 24 Relief, if granted, would be conditional. Under the proposed relief:
- (a) conditions would be based on restrictions and safeguards that presently apply to covered short selling in financial securities by market makers;
 - (b) market makers would only be permitted to execute naked short sales of liquid securities; and
 - (c) a market maker executing a naked short sale would have to enter a conditional hold over equivalent products of the same class. A market maker would therefore be required to obtain a conditional hold over a portfolio of products at the start of the day to 'cover' its market making activities.

Proposal

- c1 We propose to modify the short selling prohibition to provide an exception for market makers to naked short sell a security or managed investment product (shorted product) where:
- (a) the person makes a market in a financial product;
 - (b) the person issues or sells the financial product in the course of making that market;
 - (c) the person holds an AFS licence covering making a market in the financial product or is exempt from holding such a licence;

Proposal (cont.)

- (d) the sale of the shorted product is a bona fide transaction to manage, avoid or limit the financial consequences of the person's market making activities;
 - (e) the shorted product is a constituent of the S&P/ASX 200 index;
 - (f) the person has before the time of sale entered into a securities lending arrangement to ensure delivery of the shorted product on the date delivery is due, whether or not the securities lending arrangement is conditional upon the long owner of the product not calling for the shares.
- c2** We also propose to require that market makers who make naked short sales under the proposed exception report such naked short sales to ASX as short sales.

Your feedback

- C2Q1 Do you agree with our proposal to permit market makers to make naked short sales of section 1020B products to hedge risk arising in their market making businesses? Why/why not?
- C2Q2 If so, do you agree with our proposed conditions to the relief? Are these conditions too restrictive? Are there other conditions you consider appropriate?
- C2Q3 Do you consider that the proposed relief will be of benefit to the Australian markets? Why/why not?
- C2Q4 Do you agree that the risk of settlement failure associated with short selling by market makers is negligible? Why/why not?
- C2Q5 Do you agree that the risk of settlement failure would be adequately mitigated if the proposed relief were granted? Why/why not?
- C2Q6 Would limiting the relief to securities on the S&P/ASX 200 index be problematic? If so, why?
- C2Q7 Are there any other matters you consider we should take into account when deciding on the proposed relief?
- C2Q8 Should we modify our existing client facilitation relief (see Table 1) by adding a condition in the form of proposal C1(f)? Are there any other conditions we should include?

Ensuring delivery: further modification

- 25 We are considering a further modification that would require a market maker, by the end of each trading day, to have acquired or exercised rights under pre-existing securities lending arrangements to borrow sufficient section 1020B products to ensure that it can deliver all section 1020B products sold during the day at the time delivery is due.

Proposal

- c3** We propose to use our powers to require market makers who make a naked short sale under the proposed exception to have an arrangement in place, or enter an arrangement at or before the end of the sale day, to ensure delivery of the section 1020B products on the date delivery is due (i.e. actually borrow or acquire the product).

Your feedback

- C3Q1 Do you agree that if naked short selling relief is granted, market makers should be required to actually borrow sufficient section 1020B products at the end of each sale day to ensure delivery of the products on the date delivery is due? Why/why not?
- C3Q2 Do you agree that the risk of settlement failure would be adequately mitigated if market makers were required to borrow section 1020B products to cover net short positions in products at the end of the sale day? Why/why not?
- C3Q3 Should we modify our existing client facilitation relief (see Table 1) by adding a condition in the form of proposal C3? Are there any other conditions we should include?

Request for more feedback

- 26 We will require more information from market makers on their practices and procedures when hedging risk, and what they anticipate might be the cost and implications of our proposed relief to make our decision. We understand this information may be commercially sensitive. We will only treat your submission as confidential if you specifically request that we treat the whole or part of it (such as any financial information) as confidential.

Your feedback

- C3Q4 What are your daily average costs of making covered short sales of section 1020B products to hedge risk arising from your market making business? Please include an explanation of the cost of borrowing products, your human resource costs and technology costs.
- C3Q5 What do you anticipate your daily average costs would be if the proposed naked short selling relief were granted? Please include an explanation of your anticipated cost of obtaining conditional holds over section 1020B products, your human resource costs and technology costs.
- C3Q6 How do your costs affect the spreads at which you are able to price the bids and offers you make in your market making business?

Your feedback (cont.)

- C3Q7 How many settlement failures have you been responsible for during the period 1 March 2008 to 21 September 2008 and the period since 21 September 2008?
- C3Q8 Of these settlement failures, how many were associated with your market making activities? Please describe the circumstances of each such settlement failure.
- C3Q9 For each week during February and March 2009, what is the total volume of section 1020B products you sold (both long sales and short sales) to hedge risk arising from your market making business?
- C3Q10 For each week during February and March 2009, what is the total volume of section 1020B products you sold short to hedge risk arising from your market making business?
- C3Q11 For each week during February and March 2009, what is the total volume of section 1020B products you reported that you sold short?
- C3Q12 For each week during February and March 2009, what percentage of your reported short sales were short sales made in the course of your client facilitation business?

D Regulatory and financial impact

- 27 In developing the proposals in this paper, we have carefully considered their regulatory and financial impact. On the information currently available to us we think they will strike an appropriate balance between:
- (a) promoting liquidity in the Australian markets by facilitating efficient, non-directional hedging by market makers; and
 - (b) maintaining confidence in the Australian markets by adequately addressing risks associated with naked short selling. One such risk is the risk of failed settlements.
- 28 Before settling on a final policy, we will comply with the requirements of the Office of Best Practice Regulation (OBPR) by:
- (a) considering all feasible options;
 - (b) if regulatory options are under consideration, undertaking a preliminary assessment of the impacts of the options on business and individuals or the economy;
 - (c) if our proposed option has more than low impact on business and individuals or the economy, consulting with OBPR to determine the appropriate level of regulatory analysis; and
 - (d) conducting the appropriate level of regulatory analysis, that is, complete a Business Cost Calculator report (BCC report) and/or a Regulation Impact Statement (RIS).
- 29 All BCC reports and RISs are submitted to the OBPR for approval before we make any final decision. Without an approved BCC report and/or RIS, ASIC is unable to give relief or make any other form of regulation, including issuing a regulatory guide that contains regulation.
- 30 To ensure that we are in a position to properly complete any required BCC report or RIS, we ask you to provide us with as much information as you can about our proposals or any alternative approaches including:
- (a) the likely compliance costs;
 - (b) the likely effect on competition; and
 - (c) other impacts, costs and benefits.

See 'The consultation process' p. 4.

Key terms

Term	Meaning in this document
AFS licence	Australian financial services licence
ASX	ASX Limited
[CO 08/751]	An ASIC class order, in this example numbered 08/751
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of the Act
covered short sale	A sale of section 1020B products where, at the time of sale, the person selling the products has a presently exercisable and unconditional right to vest the products in the buyer because of a securities lending arrangement entered into before that time
ETFs	Exchange-traded funds
financial security	A section 1020B product that is not a non-financial security
market maker	A person who makes a market for a financial product
naked short sale	A sale of section 1020B products where, at the time of sale, the person selling the products does not have a presently exercisable and unconditional right to vest the products in the buyer
non-financial security	A section 1020B product that is not a constituent of the S&P/ASX 200 Financials index and is not a share issued by any of Wesfarmers Limited, The Rock Building Society Limited, Wide Bay Australia Ltd, Futuris Corporation Limited and Calliden Group Limited
RG 196	An ASIC regulatory guide, in this example numbered 196
S&P/ASX 200 Financials index	The stockmarket index maintained by Standard & Poor's and ASX
S&P/ASX 200 index	The stockmarket index maintained by Standard & Poor's and ASX
securities lending arrangement	Has the same meaning as in notional s1020BD(7): see [CO 08/751]
security	Has the same meaning as in s761A
s766D	A section of the Corporations Act, in this example numbered 766D
section 1020B products	Has the same meaning as in s1020B(1)