REPORT 167

Response to submissions on CP 106 Short selling to hedge risk from market making activities

September 2009

About this report

This report highlights the key issues that arose out of the submissions received on Consultation Paper 106 *Short selling to hedge risk from market making activities* (CP 106) and details our responses in relation to those issues.

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.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

This report does not contain ASIC policy. Please see Regulatory Guide 196 *Short selling: Overview of s1020B* (RG 196).

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A Overview/consultation process

1 In Consultation Paper 106 *Short selling to hedge risk from market making activities* (CP 106), we sought feedback on our proposal to grant naked short selling relief to market makers who short sell securities and managed investment products to hedge risk.

2 The proposal was designed to promote liquidity in the Australian financial markets by facilitating efficient hedging by market makers, while maintaining market confidence by addressing risks associated with naked short selling.

3 This report highlights the key issues that arose out of the submissions received in response to CP 106 and our responses to those issues.

4 This report is not intended to be a comprehensive summary of all responses received. It is also not intended to be a detailed report on every question from CP 106. We have limited this report to the key issues.

5 A list of the non-confidential respondents to CP 106 can be found in the Appendix to this report. Copies of the non-confidential submissions are on the ASIC website at www.asic.gov.au/cp.

Responses to consultation

6 We received 13 submissions to CP 106 from industry associations, clearing participants, market participants and ASX. We are grateful to the respondents for taking the time to send us their comments.

7 All of the respondents supported our proposal to permit market makers to naked short sell securities and managed investment products to hedge risk from their market making activities.

8 The respondents submitted that the proposed relief would benefit Australian financial markets by improving liquidity and price discovery. They generally agreed that the proposed relief would reduce the costs of market making, in turn reducing costs to investors.

9 The respondents noted that historically there has been a very low rate of settlement failure in the Australian financial markets, and that of those failures only a negligible volume resulted from short selling by market makers to hedge risk. They pointed to ASX data showing that settlement performance has improved over the past year. This coincided with ASX introducing strengthened settlement controls. These measures include increased settlement delay fees, the introduction of a close-out requirement

and accelerated referral of settlement delays for disciplinary investigation. For further details, please refer to ASX Media Release 244/08 *Management of settlement risk—new measures announced* (26 May 2008).

10 Having considered the submissions, we decided to grant relief to permit market makers to naked short sell to hedge risk from their market making activities, although not on the exact terms proposed in CP 106. To mitigate the residual risk of settlement failure from naked short selling by market makers, the relief is subject to revised eligibility criteria and conditions.

B Eligibility criteria for relief

Key points

The eligibility criteria proposed in CP 106 at C1(a) to (d) (see Table 1 below), mirrored the covered short selling relief for market makers during the period of ASIC's covered short selling ban.

Our relief is restricted to naked short selling of products represented in the S&P/ASX 200 index. We will consider granting case-by-case relief for naked short selling of products that fall outside the S&P/ASX 200 index where those products are sufficiently liquid and the risk of settlement failure is minimised.

We have imposed a pre-trade requirement similar to the 'locate' requirement in the United States.

11 Table 1 (reproduced from CP 106, pp.11–12) outlines the circumstances in which we proposed to modify the short selling prohibition to provide an exception to market makers to naked short sell a security or managed investment product (shorted product).

Table 1: Naked short selling relief criteria proposed in CP 106

Criteria for proposed exemption	
C1(a)	The person makes a market in a financial product
C1(b)	The person issues or sells the financial product in the course of making that market
C1(c)	The person holds an AFS licence covering making a market in the financial product or is exempt from holding such a licence
C1(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
C1(e)	The shorted product is a constituent of the S&P/ASX 200 index
C1(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

Our responses to exemption criteria feedback

12 Following is a summary of submissions to our proposals in CP 106 and our responses to these submissions.

Criteria C1(a) to C1(d)

13 The eligibility criteria proposed in CP 106 at C1(a) to (d) mirrored the eligibility criteria in notional s1020BD(2) of the Corporations Act as set out in ASIC Class Order [CO 08/751] *Covered short sales* that provided an exception for covered short selling to hedge risk from market making activities during the period of ASIC's ban on covered short selling.

14 The respondents generally agreed that we should restrict relief to persons able to satisfy these criteria.

ASIC's response

We consider that eligibility criteria (a) to (d) are necessary to limit the circumstances in which our relief may be relied upon.

We revised criterion (b) to acknowledge that a market maker may need to short sell to hedge risk that arises by an acquisition of a financial product in the course of making a market.

Criterion C1(e)

15 Responses were mixed as to whether our relief should be restricted to naked short selling of products that are constituents of the S&P/ASX 200 index. Some respondents submitted that it was appropriate to limit naked short selling relief to only the most liquid products, while others said that other controls were sufficient to mitigate the risk of settlement failure without need for further restriction and that relief should allow naked short selling of products where market making activities are undertaken.

16 These respondents submitted that new measures introduced by ASX, together with the economic risks inherent in holding an economic net short position should be sufficient to ensure discipline among market makers to avoid settlement failure.

17 Some respondents expressed concern that the S&P/ASX 200 index is not an accurate measure of liquidity and that this restriction may disadvantage trading in products that fall outside of the index, including exchange-traded funds (ETFs) and some series of exchange traded options (ETOs). ASX noted that, as at 31 May 2009, there were eight ETOs over single products outside the S&P/ASX 200 index.

18 Other respondents were concerned that regular rebalancing of the index may remove products from the index, affecting a market maker's ability to efficiently hedge exposure to these products.

ASIC's response

We believe that it is necessary to restrict our relief to naked short selling of products represented in the S&P/ASX 200 index. We consider that there is a reduced risk of settlement failure and 'cornering' in liquid products and products for which there exists an active securities lending market.

We will consider granting case-by-case relief for naked short selling of products that fall outside of the S&P/ASX 200 index where those products are of sufficient liquidity and the risk of settlement failure is minimised.

We have previously given case-by-case relief to permit market makers obliged to make a market for ETFs to make naked short sales of those ETFs on strict conditions: see Report 162 *Overview of decisions on relief applications (December 2008 to March 2009)* (REP 162).

Criterion C1(f)

19 Most respondents opposed this criterion, as it would permit a market maker to make a naked short sale if it had a conditional hold over the shorted products under a securities lending arrangement. Many respondents submitted that market makers would be forced to reserve more securities than they would ultimately need, creating inefficiency in the securities lending market. They anticipated that this artificially-increased demand for securities lending would likely lead to lenders charging an upfront premium for a conditional hold over products, eroding any cost savings the relief may have otherwise delivered.

20 A number of respondents suggested we instead include an eligibility criterion similar to the 'locate' requirement in the United States which requires the market maker to, before the time of the sale, have reasonable grounds to believe that arrangements are in place to enable delivery of the shorted product on date of delivery.

ASIC's response

We do not consider that the proposed conditional hold requirement is a suitable restriction. We believe that a more appropriate control measure is a pre-trade requirement that, at the time of sale, the market maker believes on reasonable grounds that a securities lending arrangement can be put in place, before the time for delivery of the shorted product, so that a financial product of the same class as the shorted product can be unconditionally vested in the purchaser by the time for delivery.

This requirement is similar to the 'locate' requirement in the United States: see Rule 203(b) of Regulation SHO, a US Securities and Exchange Commission (SEC) regulation aimed at restricting naked short selling.

We consider that these pre-trade requirements in combination with a post-trade requirement to acquire, or enter into a securities lending arrangement to acquire products by the end of the sale day (see further discussion below) will achieve an appropriate balance between facilitating efficient market making and preventing settlement failure.

C Obligation for market makers to comply with end of day cover requirement

Key points

Market makers will need to acquire sufficient products by the end of the day of sale to cover any naked short sales made in reliance on naked short selling relief.

We consider that we will achieve an appropriate balance between facilitating efficient market making and prevention of settlement failure through a combination of pre-trade requirements and a post-trade requirement to 'cover' naked short sales by the end of the sale day.

We will require that a market maker inform us if it has not complied with the end of day cover requirement.

21 We received mixed responses as to whether our relief should require market makers to acquire sufficient products by the end of the sale day to cover any naked short sales made in reliance on the relief.

22 Some respondents considered that this post-trade requirement was appropriate if ASIC granted naked short selling relief. Others supported our inclusion of this requirement only if we did not also include a requirement for a conditional hold. Some respondents did not support the post-trade requirement where ASIC restricted its relief to naked short sales of products in the S&P/ASX 200 index.

23 Some respondents expressed concern that this requirement would cause market makers to incur additional costs, while not further reducing the risk of settlement failure.

ASIC's response

As stated above, we consider that we will achieve an appropriate balance between facilitating efficient market making and preventing settlement failure through a combination of pre-trade requirements and a post-trade requirement to 'cover' naked short sales by the end of the sale day.

In addition, we will require a market maker to inform us if it has not complied with the end of day cover requirement. This reporting will allow us to monitor risk of settlement failure or 'cornering' in a particular product.

D Exemption from reporting naked short sales

Key points

We will not require market makers to report naked short sales made in reliance on our relief.

24 In CP 106, we proposed to require market makers to report to ASX naked short sales made in reliance on the relief. Many respondents submitted that this data is of little use to the market because hedging transactions by market makers are not directional. They also questioned its benefit to regulators and operators of settlement facilities, noting that the short sales are unlikely to be manipulative in nature.

25 Further, some respondents noted that market makers may face practical difficulties in complying with a real-time tagging requirement. They said that their current systems did not have the capability to accurately tag automated hedging transactions that are conducted almost instantaneously. These respondents were concerned they would incur significant cost to upgrade their systems for little benefit to the market.

26 Some respondents said that market making should be carried out in a clear and transparent manner and that reporting of naked short sales would be sensible.

ASIC's response

We will not require market makers to report naked short sales made in reliance on our relief. On balance, we do not consider that reporting of this information provides benefit to the market commensurate to the cost of its collection.

E Modifying our existing client facilitation relief

Key points

We believe that it is appropriate to modify the conditions of our client facilitation relief to better align with our relief for naked short selling to hedge risk from market making activities.

27 In CP 106, we asked whether we should modify our existing client facilitation relief. We previously gave client facilitation relief on a case-by-case basis and subject to conditions: see: Report 150 *Overview of decisions on relief applications (August to November 2008)* (REP 150).

28 The responses did not present a consensus view. Some respondents submitted that our client facilitation relief should be modified to better align with our relief for naked short selling to hedge risk from market making activities, while other respondents considered that a 'conditional hold' requirement would increase the cost of providing client facilitation services without reducing the risk of settlement failure any further.

ASIC's response

We believe that it is appropriate to modify the conditions of our client facilitation relief to better align with our relief for naked short selling to hedge risk from market making activities. A post-trade requirement to 'cover' naked short sales by the end of the sale day will further mitigate risk of settlement failure related to client facilitation transactions.

We will soon write to holders of our existing client facilitation relief about modifying the relief.

Appendix: List of non-confidential respondents

- ASX Limited
- Securities and Derivatives Industry Association
- Fortis Clearing Sydney Pty Limited
- Goldman Sachs JBWere Pty Limited
- Australian Bankers' Association Inc.
- Australian Financial Services & Securities Dealers Association
- Australian Securities Lending Association
- Australian Financial Markets Association

