REPORT 302

Short selling: Post-implementation review

September 2012

About this report

This report considers the impact of certain regulatory measures concerning the short selling of shares, which ASIC implemented in September 2008.

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Contents

A Introduction

Purpose of report

1 This report considers the impacts of interim short selling measures (hereafter referred to as the 'short selling measures'), which were implemented in 2008. These measures included, in summary:

(a) the temporary banning, with some exemptions, of the covered short selling of securities and managed investment products able to be traded on a financial market (stocks) from 21 October until 13 November 2008, with the ban on certain financial stocks lasting until 25 May 2009; and

(b) the imposition of an interim reporting regime for permitted covered short sales.

2 These measures were intended:

(a) to maintain the orderly functioning of Australian financial markets in exceptional circumstances;

(b) to enhance confidence and integrity in financial markets by providing greater transparency for both investors and regulatory bodies; and

(c) to avoid the extreme share price movements that might have occurred in the Australian market if Australia had maintained policies on short selling that were more permissive than its international peers at that time. This could have occurred due to overseas investors targeting the Australian market in the absence of a ban on short selling here.

3 This report assesses the success of the interim measures in achieving these objectives, and also considers the impact the interim measures had on the market, participants in the market and other stakeholders.

Background

4 Global financial markets were under severe stress in 2008. Countries around the world responded by taking steps to strengthen their financial systems. One of these steps was the restriction on short selling.

What is short selling?

5 There are two general types of short sale transactions:

(a) *covered short sales*: a person sells a financial product where they can rely on an existing borrowing arrangement to have a 'presently exercisable and unconditional right to vest' the product in the buyer at the time of sale; and

(b) *naked short sales*: the seller has no arrangement in place to borrow the financial product at the time of the sale and therefore does not have a 'presently exercisable and unconditional right to vest' the product.

Why do people short sell?

6 A short seller may engage in short selling for a number of reasons. A common reason is that the short seller speculates that the security is overvalued and its price is likely to fall in the future. A short sale transaction allows the short seller to profit from falls in value.

7 Another way in which people can profit from short selling is by taking advantage of pricing discrepancies in different markets—for example, by selling a product in one market (where its value is higher) and buying it in another (where its value is lower). This is usually referred to as ‘arbitrage’.

8 Some short sellers may engage in non-speculative short sale transactions to manage certain financial risks. In this type of transaction, the short seller takes a short position in a security to offset an exposure to risk in a long position held in that security. This allows the short seller to mitigate movements in the security’s price over time.

9 Offsetting or mitigating an exposure to risk is generally referred to as ‘hedging’ and is regarded as a legitimate and necessary risk management tool. Hedging also allows short sellers to combine speculative transactions with strategies to offset certain risks in such speculation. This can result in a number of long and short positions being opened and closed over dissimilar time periods and often results in high volumes of transactions.

10 One group of market participants that typically engage in short selling for hedging purposes are market makers. Market makers quote prices at which they are willing to deal in financial products, providing liquidity to traders. Examples of market makers that may hedge trades by short selling shares include market makers of exchange-traded options (ETOs) and issuers of contracts for difference (CFDs).

11 Under normal market conditions, regulated 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.

Other aspects of short selling

12 Short sellers also provide liquidity in markets, acting as sellers, then buyers, and increasing market depth. If short selling were to be prohibited, it would be reasonable to expect market liquidity to fall, all other things being equal.

13 Also, it is possible that short sellers, as agents of price discovery, may provide certain market benefits by limiting the extent of market bubbles.

Regulation of short selling in Australia before September 2008

14 Short selling is regulated under s1020B of the *Corporations Act 2001* (Corporations Act). Section 1020B provides, among other things, that all securities and certain specified financial services products (together 'products') may only be sold in Australia if the seller has, or believes on reasonable grounds that it has, at the time of sale a presently exercisable and unconditional right to vest the products in the buyer.

15 Before September 2008, the Corporations Act provided a number of exemptions to this prohibition, which included:

(a) odd lot transactions (previous s1020B(4)(a));

(b) arbitrage transactions (previous s1020B(4)(b));

(c) prior purchase transactions (previous s1020B(4)(c));

(d) transactions where arrangements have been made before the time of sale that will enable delivery of the products in time for settlement (previous s1020B(4)(d)); and

(e) transactions made under a declaration from the operator of a licensed market in accordance with the operating rules of the market (previous s1020B(4)(e)).

16 Also, prior to the short selling measures—on Thursday, 6 March 2008—ASIC issued Information Release (IR 08-03), which reminded market participants of their obligation to lodge substantial holding notifications where they acquired a relevant interest in securities under a stock lending arrangement. This increased the profile of the requirement to have stock borrowing arrangements in place to cover covered short sales, and also the obligation to inform the market of substantial borrowed stock holdings.

B Assessing the problem and objectives of ASIC's action

17 As noted above, ASIC implemented interim short selling measures in September 2008. This section of the report explains the regulatory concerns that can arise out of short selling and sets out the nature of the short selling measures taken by ASIC.

Regulatory concerns with short selling in the context of the global financial crisis

18 The regulatory concerns that short selling may raise can be broadly divided into the following categories:

(a) creating a disorderly market;

(b) short selling contributing to market abuse; and

(c) naked short selling leading to higher risks of settlement failure.

19 While short selling is not necessarily problematic under normal market conditions, and may aid price discovery, there was considerable concern about the potential for speculative or panic-driven short selling to create a disorderly market, or facilitate market abuse, in the context of the market turbulence and economic uncertainty that was prevalent at the time.

Creating a disorderly market

20 One of the significant downsides to short selling is its potential to create disorder owing to the extent and speed of the 'corrections' caused by short sellers that perceive certain stocks are overvalued. Later—in June 2009—the Technical Committee of the International Organization of Securities Commissions (IOSCO) discussed this issue in its *Regulation of short selling final report*, June 2009.

21 Short selling may create disorderly markets in different ways. For instance, short sales may occur so rapidly that the price of a stock goes into significant decline before other market participants have an opportunity to step in with fresh buying orders.

22 In some circumstances, the speed or weight of selling may cause potential buyers to stand back from the market because they are uncertain about the cause and effect of the velocity of the stock price. In some cases, a precipitous decline caused by short selling may even encourage 'long' holders of stock into selling.

23 Concerns about short selling with regard to the orderliness of the market are thus twofold:

(a) first, that the process of decline may itself be disorderly; and

(b) second, that the outcome of the process may be an ‘overshoot’ on the downside great enough to trigger undesirable secondary consequences. These could include, for example:

(i) problems for an issuer (resulting, perhaps, from customers or lenders inferring concerns about its commercial prospects from the stock price decline);

(ii) further forced selling by institutions needing to meet regulatory solvency ratios; or

(iii) a possible impact on the wider economy, by restricting listed companies from obtaining equity capital from the market.

Market abuse and ‘rumourtrage’

24 Investors can profit from short selling by selling stocks short and then buying them back later at a lower price. Spreading negative rumours about a company can increase the profits of a short sale and lead to increased share price volatility and a disorderly market. This practice is sometimes referred to as ‘rumourtrage’. Short selling may be used to assist market abuse because it can exacerbate the negative effects of rumourtrage and further increase the downward pressure on the price of the stock. ASIC issued a media release on 6 March 2008, reminding market participants that spreading false or misleading rumours may be an offence under s1041E of the Corporations Act.[1]

25 Concerns about rumourtrage were exacerbated by the practice of some company directors and executives of taking large long positions in their own company’s stock, financed through margin loans. There was concern in the market that speculators might have aggressively sold down (including by short selling) the stock of a company in the expectation that relevant directors or executives would be forced to sell their shares in margin call, further weakening the company’s stock price. This concern led to the ASX issuing a companies update on 29 February 2008, which directed companies to consider whether Listing Rule 3.1 may operate to require companies to disclose the terms of directors’ margin loans in certain circumstances.[2]

[1] ASIC Media Release (08-47MR) *False or misleading rumours*, 6 March 2008.

[2] ASIC, ASX Media Release *Disclosure guidance for listed entities* (ASX Companies Update 02/08 enclosed), 29 February 2008.

Settlement failure

26 Settlement failure is a situation in which someone is unable to deliver stock to a buyer in the time specified by the market rules (T+3). The risk of settlement failure arises in relation to 'naked' short sales because, at the time of the short sale, the short seller does not own or have a right to vest the stock in the buyer. If the short seller is unable to obtain the stock prior to the settlement deadline, a settlement failure occurs.

27 If a short seller fails to deliver the securities at settlement, it may affect a person's right to exercise voting rights or to meet obligations for an onward chain of transactions. The impacts of settlement failures may be exacerbated by inadequate provision to ensure the timely settlement of short sales. We note the changes the ASX made to its settlement management procedures in May 2008 to reduce the incidence and duration of settlement failures.[3]

28 Although securities lending markets have grown in liquidity and sophistication in recent years, a short seller remains vulnerable to sudden shortages or the unexpected recall of stock.

Policy objectives of the regulatory measures

29 The objectives of the short selling measures were to:

(a) maintain the orderly functioning of the Australian financial market by implementing measures and appropriate exemptions to regulate short selling;

(b) enhance confidence and integrity in the Australian financial market by providing greater transparency of short selling for investors and market participants; and

(c) avoid the extreme share price movements that might have occurred in the Australian market if Australia had maintained policies on short selling that were more permissive than its international peers at that time. This could have occurred due to overseas investors targeting the Australian market in the absence of a ban on short selling here.

[3] ASX Media Release *Management of settlement risk—New measures announced*, 26 May 2008.

C Impact analysis of the short selling ban

Banning of short selling in September 2008

30 In September 2008, many financial institutions around the world were experiencing difficulties due to their exposure to non-performing loans in the United States. Global securities markets were, as a result, subject to abnormal levels of volatility. This contributed to significant levels of short selling, particularly in financial stocks. In the context of the global financial crisis, where entities faced liquidity challenges but were otherwise solvent, a decrease in their stock price induced by short selling may lead to further credit tightening for these entities and, potentially, their bankruptcy.

31 Following the collapse of Lehman Brothers Holdings Inc in September 2008, there was widespread concern around the world that short selling contributed to market volatility and was putting sufficient downward pressure on market confidence to be systemically relevant.

32 On 19 September 2008, the Financial Services Authority (FSA) in the United Kingdom, the Securities and Exchange Commission (SEC) in the United States and the Ontario Securities Commission in Canada implemented a temporary ban on short selling of selected financial stocks. Several other countries, including Germany, Netherlands, France, Switzerland and Taiwan, also announced similar policy changes before the opening of the markets on 22 September 2008.

Table 1: Jurisdictions that took measures to ban short selling in 2008–09

Country	Type of ban	Stock coverage	Disclosure	Initiation	Lapse	Extended
Australia	Naked	All		19/09/08		
	Covered/naked	All		21/09/08	18/11/08	Yes
	Covered/naked	Specified financials		19/11/08	24/05/09	Yes
Canada	Covered/naked	Specified financials		19/09/08	08/10/08	Yes
France	Naked	Specified financials	0.25%	22/09/08		
Germany	Naked	Specified financials		20/09/08	31/05/09	Yes
Italy	Naked	All		23/09/08		
	Covered/naked	Banks and insurance		01/10/08	10/10/08	
	Covered/naked	All		10/10/08	31/05/09	Yes
Japan	Naked	All		29/10/08	31/03/09	
Korea	Covered	All		01/10/08		

Country	Type of ban	Stock coverage	Disclosure	Initiation	Lapse	Extended
Netherlands	Naked	All		22/09/08	21/12/08	
	Net position	Specified financials	0.25%	05/10/08	01/06/08	Yes
Singapore	Naked	All		22/09/08		
Switzerland	Net position	Specified financials		19/09/08		Yes
Taiwan	Covered/naked	All		01/10/08	05/01/09	Yes
United Kingdom	Net position	Specified financials	0.25%	19/09/08	16/01/09	
United States	Covered/naked	Specified financials	0.25%	19/09/08	08/10/08	Yes

Source: Don Hamson, *Assessing the efficacy and impacts of bans on short selling* (2009), Plato Investment Management, at 3 October 2011, <www.plato.com.au/_literature_95732/Assessing_the_Efficacy_and_Impacts_of_Bans_on_Short_Selling_-_by_Don_Hamson>

33 Based on the information available to ASIC at the time, there appeared to be a real possibility that a substantial share of global short selling activity (speculative and hedging) could be shifted to Australia—the third largest equity market in Asia. This was especially pressing because our market would be one of the first to open on that Monday, 22 September 2008.

34 At the time, ASIC stated that:

> …extensive short selling of stocks, particularly financial stocks, 'may be causing unwarranted price fluctuations. These fluctuations if unchecked, threaten the operation of fair and orderly stock markets.[4]

35 As such, in response to the prevailing market uncertainty—in a letter dated 19 September 2008—the Prime Minister noted the exceptional circumstances, and exempted ASIC from the requirement to complete a Regulation Impact Statement (RIS) on the proposed interim changes to the rules related to short selling. On that day, ASIC issued Class Order [CO 08/751] as an interim measure to ban naked short selling and to require the disclosure of covered short selling. ASIC considered it was inconsistent with the maintenance of an orderly and transparent market in Australia for covered short selling to take place without appropriate disclosure to the marketplace.

36 On 21 September 2008, ASIC issued Class Orders [CO 08/752] and [CO 08/753] to temporarily ban covered short selling. Together, these class orders effectively banned all short selling. The ASX also removed all securities from its approved product list for naked short sales.[5]

[4] ASIC Media Release (08-205MR) *Covered short selling not permitted*, 21 September 2008
[5] ASIC Media Release (08-204MR) *Naked short selling not permitted and covered short selling to be disclosed*, 19 September 2008.

37 However, ASIC recognised that a complete ban on short selling without exemptions would prohibit market makers and brokers from providing liquidity and facilitation services to the market. It would also restrict underwriters from providing services to companies in connection with fundraising activities. ASIC therefore provided exemptions to the general short selling ban with the aim of:

(a) facilitating fundraisings;

(b) providing client facilitation services;

(c) hedging existing positions;

(d) providing market-making services; and

(e) enabling sales of securities as a result of the exercise of exchange-traded options.

38 The ban on covered short sales was lifted for non-financial stocks in November 2008, and the ban on covered short selling for financial stocks was lifted in May 2009.

39 Because of the need to swiftly align the regulatory measures in Australia with other international regulatory bodies to respond to the financial crisis, and in accordance with the exemption granted by the Prime Minister, no consultation was conducted prior to the introduction of the short selling measures.

Market impact

Who does the short selling?

40 Short selling is generally carried out by investors and market makers. For example, options market makers would make short sales to hedge positions in certain exchange-traded options. Many jurisdictions, including Australia, recognise the need for market makers to short sell to properly hedge other market transactions, and ASIC has provided relief for them when imposing short selling restrictions.

41 More generally, investors may engage in short selling in order to hedge aspects of their portfolios, take advantage of arbitrage opportunities, speculate on falling prices in a stock, or support certain trading strategies. An example of the latter would be an investor taking a long position in the stock of a company and a short position in the stock of another company in the same industry sector, where the investor believes that the performance prospects of the former company are better than those of the latter. This strategy may enable the investor to achieve positive returns even where overall market performance is negative.

Analysis of market liquidity during the short selling ban

42 A number of quantitative studies have analysed stock market liquidity during the short selling ban in both the Australian market and in overseas markets. These studies generally concluded that there was reduced liquidity in stock markets in the periods during which the bans were in place. The impacts on liquidity in markets may be measured by examining the turnover, spread and frequency of trades in the market.[6]

Analysis of market trading activity during the short selling ban

43 According to a study, *The effect of the ban on short selling on market efficiency and volatility* (2010) by Uwe Helmes, Julie Henker and Thomas Henker of the University of New South Wales, the short selling ban significantly reduced the trading activity of Australian financial stocks. Specifically, the average turnover of Australian financial stocks during the period of the ban declined by more than 40% compared with the pre-ban period. This contrasts with much smaller reductions in turnover in the study's control group of equivalent Canadian stocks that were subject to only a very brief short selling ban.

44 According to the same study, when the short selling ban ended on 25 May 2009, the turnover of Australian financial stocks rose sharply and remained significantly higher over the following two months. During this period, the average turnover of Australian financial stocks increased by 32%.

45 In relation to the effect of the short selling ban on the constituents of the broad S&P ASX 300 Index, trading fell, on average, by approximately 0.06% of shares on issue per stock included in the index.[7] When compared with the average number of shares traded per stock before the short selling ban of approximately 0.1365%, this represented a fall of 13.7%.[8] The number of trades per stock had fallen by approximately 279 trades per stock per day, compared with the pre-ban period.[9]

46 Overall, trading activity in the market fell during the period of the short selling ban. This result is consistent with reductions in market liquidity. Reduced trading activity may also have been driven, at least in part, by other characteristics of the market at that time, such as high levels of uncertainty and volatility, as well as the short selling measures.

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[6] Don Hamson, *Assessing the efficacy and impacts of bans on short selling* (2009), Plato Investment Management, , at 3 October 2011, <www.plato.com.au/_literature_95732/Assessing_the_Efficacy_and_Impacts_of_Bans_on_Short_Selling_-_by_Don_Hamson>.

[7] Don Hamson, *Has the short selling ban reduced liquidity in the Australian stock market?* (2008), Plato Investment Management, at 3 October 2011, <www.plato.com.au/LiteratureRetrieve.aspx?ID=95736>.

[8] Don Hamson, ibid.

[9] Don Hamson, ibid.

Analysis of bid–ask spread during the short selling ban

47 The bid–ask spreads of Australian financial stocks had already begun to widen leading up to the short selling ban.[10] Widening of spreads indicates a decline in confidence as market makers become increasingly reluctant to take on the risk of selling at a low price and being required to buy at a high price, particularly as the ability of market makers to hedge these positions efficiently was removed under the short selling ban.

48 Allowing market makers to continue some short selling (in the form of covered short selling) was intended to maintain the proper functioning of financial markets, including derivatives markets. However, the costs for market makers increased, and this was reflected in wider bid–ask spreads. During the ban, the average volume-weighted relative effective spread (effective spread) for Australian financial stocks was more than twice as high as the average effective spread during the pre-ban period: 0.99% and 0.42%, respectively.[11]

49 Similar effects were observed in various jurisdictions around the world that implemented short selling bans. During the crisis, stocks in jurisdictions that implemented short selling bans also experienced increased bid–ask spreads, and their peaks coincided with the salient events of the financial crisis.[12]

50 Overall, it is evident that bid–ask spreads widened during the period of the short selling ban. This result is consistent with the reduction in liquidity associated with a short selling ban. However, evidence supporting the view that the short selling ban itself increased spreads must be viewed in light of its imposition coinciding with a period of extreme uncertainty and volatility in the market. As such, it is difficult to conclude that the ban itself, as opposed to other prevailing market conditions, caused the increases in spreads.

Analysis of intraday price volatility during the short selling ban

51 In the absence of short sellers, and with reduced liquidity, it was to be expected that intraday price volatility for Australian financial stocks would increase. Average intraday price volatility had already begun to rise in early September 2008,[13] indicating that market conditions were becoming turbulent. The intraday price volatility may have been exacerbated as a result of the reduction in the efficiency of the price discovery mechanism due to the covered short selling ban.

[10] U Helmes, T Henker, & J Henker, *The effect of the ban on short selling on market efficiency and volatility* (2009), Bond University, <http://ssrn.com/abstract=1568435>.
[11] Helmes, Henker and Henker, ibid.
[12] Alessandro Beber and Marco Pagano, *Short-selling bans around the world: Evidence from the 2007–09 crisis* (2010), University of Amsterdam and CEPR and Universita di Napoli Federico II, CSEF, EIEF and CEPR, at 4 October 2011, <http://ssrn.com/abstract=1502184>.
[13] Helmes, Henker and Henker, ibid.

52 On average, during the period of the ban, intraday price volatility was 7.8%, which represented an increase in average volatility of approximately 77%.[14] During the post-ban period, the average high–low volatility for Australian stocks returned to the pre-ban levels of around 4.6%.[15] The return to pre-ban volatility was not unexpected as this indicated the re-emergence of a more orderly market.

What impact did the short selling ban have on stock prices?

53 Short selling data considered by ASIC suggested that the level of short selling lagged, rather than led, price falls. That is, as a general rule, short sellers appear to have short sold stocks that were already declining in price (rather than increases in short selling activity leading to or causing stock price declines).

54 There were reports that the introduction of the short selling ban may have intensified stock price declines because investors who wished to short sell stocks through imperfect or partial hedges were not able to do this after the ban. It is difficult to confirm or refute this. ASIC found that the rate of local stock price declines accelerated after the ban was introduced. However, this could have been due to deteriorating fundamentals. (The ban was introduced around the time of large corporate collapses in the United States, which further suppressed confidence globally.) There was no statistical or economic evidence that short selling was driving stock price declines before the introduction of the ban in Australia. However, it should be noted that, before the implementation of reporting frameworks for covered short sales, there was very little short selling data available to assess its market impact.

55 The conclusions described above for Australia were similar to those drawn by academics and the FSA for the US and UK markets. That is, the lack of connection between short selling and price declines was not unique to Australia. There were also academic papers written about the Australian market that corroborated these results.[16]

56 Overall, ASIC found that the impact of the short selling ban on the price of stocks could not be determined in isolation because a number of other concomitant measures played crucial roles in supporting local investor confidence:

(a) the government guarantee on deposits;

(b) the government guarantee on offshore debt raisings; and

(c) confidence in prudential regulation (APRA) and capital reserves.

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[14] Helmes, Henker and Henker, ibid.
[15] Helmes, Henker and Henker, ibid.
[16] Oliver Wyman, *The effects of short-selling public disclosure regimes on equity markets: A comparative analysis of US and European markets*, 2010; *Short selling*, Financial Services Authority (FSA), February 2009.

Settlement failure in the market during the short selling ban

57 In general, the rate of failed settlements in the Australian market has been low. In its *Short selling ASX public consultation* of 28 March 2008, the ASX notes that 99% of trades are settled within three business days, and the remainder normally settle within the following two business days. In the paper, the ASX also notes that settlement performance of the Australian market is 'very strong' based on an international comparison.

58 The proportion of failed settlements declined in the second half of 2008. For instance, of the 1,599 ASX stocks for which data was available, 770 were involved in settlement failures: Figure 1. Of these, 403 stocks had been short sold, while 367 had not. From the introduction of the ban onwards, the proportion of stocks involved in settlement failures declined substantially to reach a low of 262 by April 2009.

Figure 1: Number of short selling and failed settlements

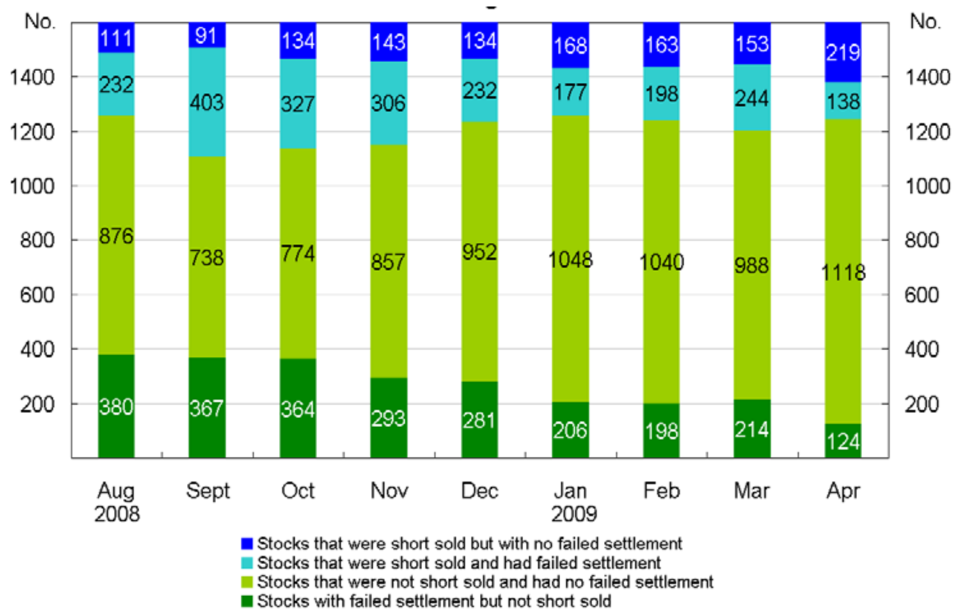
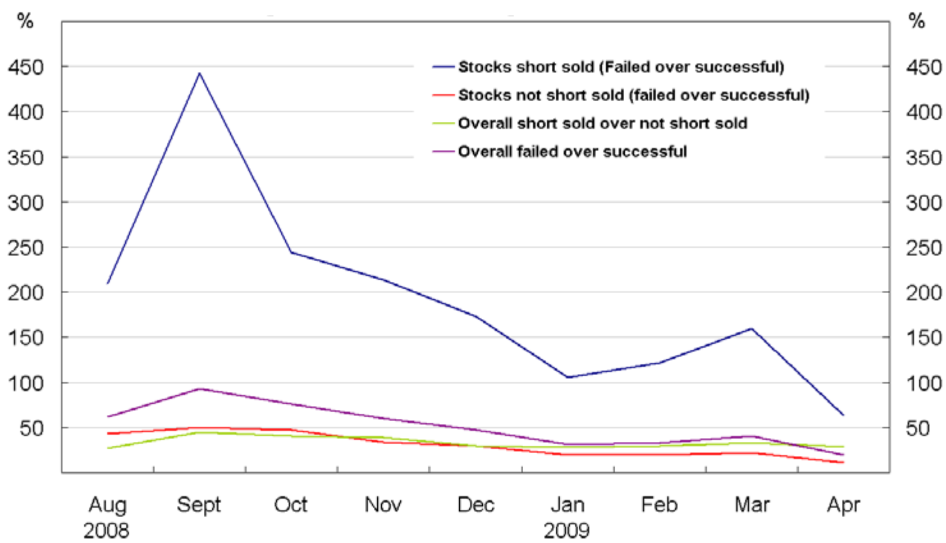


Figure 2: Percentage of short selling and failed settlements



Source of Figures 1 and 2: ASX and AFMA

59 Figure 2 illustrates that there was a decline in the overall number of stocks involved in failed settlements following September 2008. The percentage of stocks that were short sold and that had failed settlements peaked in September 2008 but afterwards fell to levels lower than before the introduction of the short selling ban.

60 It is noted that the ASX also took regulatory measures and increased the penalty applicable for settlement failure.

61 It appears that the ban and the changes in disclosure of short selling contributed to a decline in the number of settlement failures.

Impact of the short selling ban on market manipulation

62 In 2008, the ASX was responsible for market supervision duties and referred potential market manipulation to ASIC.

63 In April 2009, the ASX released its first ASX Markets Supervision (ASXMS) quarterly activity report.

Table 2: Comparison of ASXMS price queries and market manipulation referrals to ASIC

	Mar 08	Jun 08	Sept 08	Dec 08	Mar 08
Price queries made by ASXMS	78	147	71	109	211
Market manipulation referrals to ASIC	6	4	4	4	6
Listed entities supervised	2142	2148	2155	2146	2136

Source: ASXMS quarterly activity report, March 2009

64 Based on Table 2, for the five quarters ending March 2009, the ASX statistics did not seem to indicate that increasing levels of market manipulation were evident in the September quarter of 2008. It is also observed that the total number of ASX price queries in the September quarter was the lowest of any of the five quarters reported.

65 However, the lack of market manipulation referrals to ASIC cannot, in and of itself, lead to a conclusion that market manipulation was not occurring. We also note ASIC’s earlier initiatives, such as issuing Media Release (08-47MR), which we believe had led to a greater profile among market participants of the importance of market integrity, including the accuracy of information being passed on among participants.

Impact of the short selling ban on investors and market competition

66 In general, all investors were affected by wider bid–ask spreads, increased volatility and a temporary decline in turnover in late 2008. However, it is difficult to separate the result of the ban from the general instability of the financial system at the time of the ban.

67 Long-term investors and retail investors appear to have been minimally affected by the short selling ban beyond the effects described above. Some may have gained confidence to hold their investments, while others may have been prompted to sell for fear of diminished liquidity.

68 Industries that depended on the demand of short sellers for borrowed stock suffered as a result of the interim measures. These included:

(a) securities lending firms, because demand for securities lending decreased with the prohibition of covered short selling;

(b) custodians that benefit from lending securities and may have been negatively affected by the ban on short selling; and

(c) fund managers that loan securities.

D Consultation

69 We invited six relevant industry associations to provide us with information about the effect of the short selling measures on their members. In particular, we asked them to set out their members' costs of complying with the measures. Four of these associations provided a submission to us. Of these, two associations, the Australian Financial Markets Association (AFMA) and the Australian Bankers' Association (ABA) provided quantitative information about these costs, while the others provided only qualitative information.

Compliance costs

Quantifying costs

70 It is difficult to attribute a dollar figure to the costs of the short selling measures, because a major problem faced by all researchers in doing this is that the ban was introduced at a time of significant global financial and economic stress, and was introduced as a result of that stress and to mitigate the risks of much worse developments.

71 However, there are a number of specific, quantifiable costs that the short selling measures imposed on participants in the market. We categorised these as:

(a) information technology (IT) or system build costs;

(b) compliance and legal costs;

(c) non-capital operating costs; and

(d) opportunity costs.

Many of the costs in paragraphs 71(a)–71(c) were related to compliance with the interim reporting regime, while the opportunity costs were incurred mainly as a result of the ban on covered short selling.

72 Where industry associations submitted dollar cost estimates, these were often provided in wide ranges or split into categories (such as for small, medium and large organisations). However, there were some commonalities in the information provided. Table 3 and Table 4 present information from two industry associations with members who were affected by the short selling measures.

Table 3: Costs of complying with the short selling measures—AFMA members

	Small organisation	Mid-sized organisation	Large organisation
IT or system build costs	$390,00	$500,000	$687,000
Compliance and legal costs	$135,000	$229,000	$438,000
Non-capital operating costs	$81,000	$125,000	$292,000
Opportunity costs	$1.5m	$6m	$15m

Source: AFMA consultation submission

Table 4: Average costs per market participant of complying with the short selling ABA members

	Costs
IT or system build costs	\$50,000–\$500,000
Compliance and legal costs	\$75,000–\$420,000
Non-capital operating costs	\$75,000–\$200,000
Opportunity costs	\$2.5m–\$6m

Source: ABA consultation submission

73 Responses from industry highlighted that senior staff and management time spent on interpreting requirements under the short selling measures was a major element of the costs incurred. Industry associations also noted that they themselves expended substantial resources in liaising with both their members and ASIC in connection with the short selling measures.

74 We note that many of the costs of IT or system builds may also relate to the implementation of systems to comply with the reporting framework included in the *Corporations Amendment (Short Selling) Act 2008*, rather than—or as well as—the interim reporting regime considered in this post-implementation review.

75 However, industry groups were in broad agreement that the greatest costs imposed by the short selling measures were lost business opportunities driven by the short selling ban. These opportunity costs included the loss of:

(a) fee income from products;

(b) brokerage revenues;

(c) returns from some proprietary trading strategies; and

(d) revenues from stock lending.

Scale of impacts on market participants

76 As at 17 October 2008, there were 54 active ASX, Australian Clearing House (ACH)[17] and ASX Settlement and Transfer Corporation (ASTC)[18] participants. All of these would have been affected in some way by the short selling measures. However, there would be significant variation among participants in the extent to which they were affected by the short selling measures and the costs of complying with them. In particular, many retail client-focused stockbrokers did not offer short selling services to clients and therefore did not need to develop systems to identify and report short sales.

[17] ACH is now known as ASX Clear Pty Limited.
[18] ATSC is now known as ASX Settlement Pty Ltd.

Other costs and impacts

Impacts on some investment managers

77 Firms, including alternative investment managers, that utilised short selling strategies (such as long/short equity and 130/30 type funds) were directly and negatively affected by the short selling ban. These investors were unable, during the period of the ban, to continue their investment strategies as normal. Instead, they were forced to use other, often far more costly, tools such as put options or over-the-counter (OTC) products to achieve short exposure.

78 As a result of this, many alternative asset managers were unable to effectively maintain their mandated investment strategies. This was especially the case for managers who, at the time of the imposition of the ban on covered short selling, did not have their targeted short exposure in place. This reduced those managers' ability to compete in the marketplace.

Impacts on other entities hedging exposure

79 As well as some investment managers, the short selling measures may also have affected other organisations that would normally use short selling to hedge market exposures. This would have included issuers of some derivative financial products such as contracts for difference (CFDs). While we do not have any specific information about the extent of the impact of the short selling measures on these entities, it is reasonable to assume that they incurred costs by either:

(a) being obliged to use other, more expensive hedging arrangements; or

(b) being prevented from engaging in activities that relied on being able to hedge market exposure using short selling.

Listed financial services firms

80 While some industry feedback criticised the impact of the short selling measures, other comments acknowledged their confidence-building impacts at the time of the ban. For example, many listed financial services firms were concerned about the potential for 'predatory' short selling and the impact this could have on stock prices in an environment of heightened concern about the resilience of the Australian financial system.

Regulation Impact Statement

81 When the Government consulted on the formal implementation of a short sale transaction disclosure regime, implemented via the *Corporations Amendment (Short Selling) Act 2008*, it received feedback—which was included in the relevant Regulation Impact Statement (RIS) *Short selling disclosure regime 2009*—that the cost of compliance for a transactional disclosure regime for brokers was likely to cost between $360,000 and $450,000 in initial implementation costs, and approximately $80,000 per year in ongoing compliance costs.

82 Feedback included in the RIS also indicated that one broker running an automated trading platform on a global basis would be likely to incur costs between $500,000 and $1 million to implement transactional reporting. These cost estimates were for major broking houses (e.g. global investment banks), of which there are approximately 10 in Australia. The costs would be lower for the remaining smaller brokers, of which there are about 80, although these stakeholders were unable to provide precise estimates.

83 The ASX noted that it already had infrastructure in place to capture transactional short sale information. As a result, the regulatory impact of transactional reporting was not significant from the perspective of the market operator.

Impact on Australia's reputation as a financial centre

84 Some industry feedback compared the breadth of the Australian restrictions on covered short selling with that of other jurisdictions, and argued that Australian restrictions had a much wider reach and duration than those in other markets. Other industry comment raised concerns about what was regarded as a lack of consultation and the suddenness of the imposition of the short selling measures.

85 Both these claims were cited as damaging Australia's reputation as a stable, well-regulated financial centre. However, it is difficult to determine what, if any, reputational impact the short selling measures had.

ASIC relief

86 To limit the negative effects of the short selling measures, a number of exemptions were provided to facilitate the orderly operation of financial markets.

87 Typically, these exemptions were granted to market participants that were hedging market exposures in equities, or market makers in other products (such as CFDs and exchange-traded options) or that were providing client facilitation services.

88 While industry feedback recognised the benefits of the exemptions granted by ASIC, many argued that these were too limited. In particular, it was argued that the limited relief granted for market making and underwriting transactions from the prohibition on naked short selling should have been extended to arbitrage transactions. However, it should be noted that ASIC did grant exemptions for some types of arbitrage transactions, including dual-listed arbitrage and index arbitrage.

89 The exemptions granted by ASIC are set out in Regulatory Guide 196 *Short selling* (RG 196). Table 1 in RG 196 summarises the relief ASIC has granted to enable legitimate naked short selling. These exemptions, granted while the short selling measures were in place, have remained in effect since the implementation of the reforms contained in the *Corporations Amendment (Short Selling) Act 2008*, to facilitate legitimate market activities.

E Assessment: The success of short selling measures in meeting ASIC's objectives

90 As discussed in Section B, the objectives of the short selling measures were to:

(a) maintain the orderly functioning of the Australian financial market by implementing measures and appropriate exemptions to regulate short selling;

(b) enhance confidence and integrity in the Australian financial market by providing greater transparency of short selling for investors and market participants; and

(c) avoid the extreme share price movements that might have occurred in the Australian market if Australia had maintained policies on short selling that were more permissive than its international peers at that time. This could have occurred due to overseas investors targeting the Australian market in the absence of a ban on short selling here.

Objective 1: Maintain orderly functioning of the financial market

91 As stated above, around the time of the collapse of Lehman Brothers in September 2008, there was widespread concern that short selling was contributing to market volatility and was putting enough downward pressure on market confidence to be systemically relevant to the global financial system and economy.

92 Similarly to the FSA and the SEC, ASIC introduced a ban on short selling to maintain an orderly market and reduce the downward pressure on Australian stocks.

93 ASIC believes that the short selling ban achieved this objective by:

(a) mitigating the risk of the formation of a disorderly market by limiting the scope to use short selling as a method for market abuse;

(b) limiting the opportunities for 'abusive short sales', including rumourtrage;

(c) not exacerbating the precipitous downward pressure on the market. This was important for financial institutions because it allowed them to more easily access funding and conduct capital raisings; and

(d) mitigating systemic risk and limiting contagion into other elements of the financial system and economy.

94 However, as discussed earlier, the short selling ban may also have contributed to adverse market impacts, including widened bid–ask spreads of stocks and reduced liquidity. We also note that stock prices were subject to increased volatility during the short selling ban.

Implementation by Government of short selling measures

81 ASIC's short selling measures were subsequently confirmed by the Government. In December 2008, the Government passed the *Corporations Amendment (Short Selling) Act 2008*, which subsequently removed all but one exemption to the naked short selling prohibition.

82 In the explanatory memorandum to the Corporations Amendment (Short Selling) Bill 2008, the Government made the following statements in relation to the decision to ban naked short selling:

> Various concerns have been expressed in relation to naked short selling. Transactions of this nature may have a higher risk of settlement failure. They may also distort the operation of financial markets by causing increased price volatility and potentially facilitating market manipulation. In addition, the perceived activity of naked short sellers is likely to damage market confidence particularly among retail investors. For these reasons, naked short selling has the potential to damage the integrity of Australian financial market.
>
> In light of this, and given the limited evidence of any significant, market wide benefits from naked short sale transactions, it was considered appropriate to remove the general ability for people to enter into these transactions under the Corporations Act.

83 This explanatory memorandum also noted the role of ASIC in granting exemptions under s1020F of the Corporations Act.

84 The Government's decision to ban naked short selling was also supported by a number of industry organisations.[19]

Objective 2: Enhance confidence and integrity through greater transparency

85 Before the implementation of the short sale transaction disclosure regime, it was difficult to determine the amount of covered short sale activity taking place in the Australian market. It was noted that the degree of uncertainty surrounding the activity of covered short sellers in Australian securities at the time was having a significant impact on Australian capital markets.

86 Similarly, at the time, it was noted that when a security experienced a significant decline in price, it was unclear whether it was attributed to short selling activity or other factors. This resulted in considerable rumour and speculation regarding short selling activity, which potentially added to price volatility. Speculation about the level of short selling activity in Australian securities was also having broader market implications. As such, confidence in the market—particularly among retail investors at the time—was potentially being damaged.

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[19] Regulation Impact Statement *Short selling disclosure regime 2009*.

87 The interim disclosure regime for covered short sales achieved the objective and provided greater transparency to the market. For investors, access to transactional reporting provided an explanation of share price movements because they would be able to determine whether there had been an increased level of short selling in a particular security. This assisted in the removal of uncertainty in the market about short selling. For regulators, transactional reporting identified individual short sale transactions, which was useful as an audit trail when conducting investigations into market misconduct.

Implementation by Government of short selling disclosure measures

88 The *Corporations Amendment (Short Selling) Act 2008* also established the disclosure framework for covered short selling. Further, in December 2009, the Government passed the Corporations Amendment Regulations 2009 No. 8 to establish a formal framework for short sale transaction reporting and short position reporting.

89 In establishing a formal disclosure framework for short selling disclosure, the Government stated that the objective was to increase transparency about the activity of covered short sellers in Australian securities, provide useful information to investors and regulators, and also contribute to confidence and market integrity.

90 In particular, the Government noted that disclosure of covered short selling activity would:

(a) provide an early signal that individual securities may be overvalued;

(b) indicate that a proportion of the sales in an individual security would need to be reversed by new purchases (to cover the short seller's settlement obligations);

(c) enhance investors' willingness to participate in the market by removing uncertainty about the level of short selling; and

(d) potentially deter market abuse or reduce the opportunities for market abuse.

91 The Government stated that the short selling disclosure regime, complemented by the disclosure of securities lending to the Reserve Bank of Australia (RBA), was intended to provide greater transparency on short selling activity in Australia.

92 In response to the implementation of the disclosure regime, shareholder groups such as the Australian Shareholders Association, RiskMetrics and investor relations groups supported the continuation of the interim transactional reporting disclosure. They believed that this was necessary to ensure that the market was fully informed about the activities of short sellers.

93 However, industry feedback has been almost universally critical of the transactional reporting regime. Industry has submitted that transactional reporting does not provide clear information to the market about the actual level of short positions in a stock and that, as a result, the information may be misleading to investors.

Objective 3: Avoid extreme share price movements

94 Table 1 in Section B of this report shows that Canada, Switzerland, the United Kingdom and the United States took regulatory action against short selling on 19 September 2008—the same day that ASIC banned naked short selling.

95 As a result of the short selling bans in other jurisdictions, if ASIC had not implemented the short selling measures, it might have had the effect of intensifying the risks of speculative, panic-driven or abusive short selling activity occurring in the Australian financial market, given that global funds could move quickly. As we note elsewhere in this review, the effects of speculative, panic-driven or abusive short selling, in the context of market turmoil and economic uncertainty, could have been highly damaging to Australian financial markets and the wider economy. Therefore, on the following trading day—Monday, 22 September 2008—ASIC also banned covered short selling.

96 By aligning the regulatory response to short selling in Australia with other international jurisdictions, the possibility of international regulatory arbitrage in relation to short selling was avoided. The short selling measures prevented global funds from focusing on Australia as a potential destination to conduct short sales, which would have had the potential to increase market instability in Australia.

F Conclusion

The short selling measures and their regulatory objectives

97 At the time the short selling measures were implemented, ASIC, along with other global regulators, was concerned that prevailing market conditions, coupled with the extensive short selling of stocks (particularly financial stocks), were causing extreme stock price fluctuations, which might have affected the ability of Australian companies to raise capital in the market. ASIC's view was that these fluctuations, if unchecked, could threaten the operation of fair and orderly stock markets.

98 The purpose of implementing the short selling ban was:

(a) to maintain the orderly functioning of Australian financial markets in exceptional circumstances;

(b) to enhance confidence and integrity in financial markets by providing greater transparency for both investors and regulatory bodies;

(c) to avoid the extreme share price movements that might have occurred in the Australian market if Australia had maintained policies on short selling that were more permissive than its international peers.

99 It was not intended that the ban would achieve a particular level for stock prices.

100 In implementing the short selling measures, ASIC Chairman Mr Tony D'Aloisio said that the measures were necessary to maintain fair and orderly markets in the context of extreme, global crises of confidence in financial markets. Particularly given the economic climate in September 2008 and the actions taken by other regulators, ASIC formed the view that it was important to mirror these actions and put in place a circuit breaker to assist in maintaining and restoring confidence.

101 Broadly, the short selling measures achieved some of the objectives outlined in this report. By aligning the regulation of short selling in Australia with the approach taken by other regulators, and requiring permitted short sales to be disclosed, the short selling measures reduced the risks that might occur as a result of short selling of Australian financial sector entities or other systemically important entities. The reduction in settlement failure also assisted in maintaining the orderly functioning of Australian financial markets.

102 It should be noted, however, that the ban on short selling may have exacerbated market volatility. It also potentially inhibited price discovery in the market and may have reduced market liquidity. While these effects would normally run counter to ASIC's regulatory objectives, the particular, exceptional circumstances prevailing in the market at the time were such that they were justified in order to reduce the risk of greater market disorder. It is ASIC's view that the short selling measures must be assessed based on the market context in which they were taken—that is, a market that was under severe strain because of unprecedented global events.

Other impacts of the short selling measures

103 The short selling measures potentially contributed to a number of other outcomes, which had negative impacts on the efficient operation of the Australian market. These included higher bid–ask spreads, lower turnover and encumbered price discovery.

104 Therefore, any qualitative benefits to market confidence that arose from the imposition of the short selling measures need to be assessed in light of the measures' contribution to the reductions in market liquidity, increased spreads and heightened stock price volatility. These negative impacts may have been exacerbated by the length of the period of the Australian short selling ban compared with those in other highly developed markets.

105 As well as its impact on the financial market overall, the ban on short selling also imposed costs on certain participants in the market. The main costs incurred were the costs to implement reporting and other compliance arrangements and the loss of revenue and business opportunities because of the inability to short sell. Some fund managers using alternative investment strategies were significantly affected in this way.

106 While the short selling ban may have had the effect of assisting in the maintenance of an orderly market, stock prices inevitably continued to fall as economic fundamentals deteriorated. Of course, it is possible that even more adverse consequences could have resulted if the short selling ban had not been put in place.

107 The overall impact of the ban on covered short selling on the market is difficult, if not impossible, to isolate. This is because, at the time of the ban, volatility had increased substantially in global markets and confidence had declined to very low levels. The overall benefit of mitigating systemic risks, improving market confidence and ensuring the longer-term viability of the market is difficult to measure. However, in light of the particular environment in which the short selling measures were taken, these benefits outweigh the short-term costs associated with the short selling ban as well as the costs of compliance with the reporting regime.

Possibility of future short selling bans

108 It is difficult to predict whether a ban on covered short selling will need to be reintroduced in the future. This is because one of the reasons for introducing the ban in 2008 was to reduce the possibility of unwarranted short selling on the Australian market after similar bans were introduced in other jurisdictions. If a situation arises in the future that involves disorderly markets and action by regulators in other jurisdictions to limit short selling, it is likely that ASIC and the Australian Government would again contemplate a ban on short selling to bolster investor confidence and limit the potential for international regulatory arbitrage.

109 However, the market and regulators' understanding of short selling and its impact on trading conditions has deepened over the past three years and any future calls for taking measures similar to those of September 2008 would have the benefit of the lessons learned from the earlier short selling ban. In particular, the disclosure regime for covered short sales and short positions and the, now permanent, prohibition on naked short selling may limit the need for a total ban in future periods of market turmoil.

110 An example of this occurred around 12 August 2011, when some European jurisdictions—France, Italy, Spain and Belgium—implemented short selling bans on certain financial stocks in the context of very high market volatility and concerns about the global economy.[20] One of the reasons ASIC determined that a similar Australian ban was not required at that time was the higher amount of information now available about short selling, which enables ASIC to properly analyse the short selling taking place in the market.

111 None of this suggests, however, that ASIC would not implement a ban if it determined that the prevailing market conditions, in Australia and overseas, warranted it.

[20] Public statement *ESMA promotes harmonised regulatory action on short-selling in the* EU, European Securities and Markets Authority, 11 August 2011.