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Business Law Section

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Dear Ms Wu

Submission in response to proposals in Consultation Paper 299

The Corporations Law Committee of the Business Law Section of the Law Council of Australia (**Committee**) welcomes the opportunity to provide this submission to the Australian Securities and Investments Commission (**ASIC**) on Consultation Paper 299, *Short selling: Naked short selling relief, position reporting amendments and sunsetting class orders*) (**CP 299**).

Summary

The Committee is generally supportive of the proposals in CP 299 and considers that they will assist in clarifying the legislative framework in relation to short selling in the Australian market, both as it relates to the granting of new legislative relief to permit certain types of naked short sales and the extension of existing relief.

While the Committee is also supportive of legislative relief in the area of Exchange Traded Products (**ETP**) market makers, a broader application the relief to cover market participants who facilitate trading in ETPs and Chess Depository Interests in foreign ETPs would provide a more meaningful impact to improve liquidity in ETPs and administrative costs for both market participants and ASIC (the latter in the context of reviewing applications for relief).

For corporate actions and Initial Public Offerings (**IPO**s), legislative relief for products trading on a deferred settlement basis is welcome. For products that are listed on a conditional and deferred settlement basis, it is similarly important to have a clear view on whether ASIC is willing to issue relief prior to the commencement of trading, otherwise the listed products are unable to trade until the end of the conditional period.

The continuation of Class Order [09/774] relating to market makers is supported, including the addition of the SPDR S&P/ASX 200 Fund (**STW ETF**). The proposed amendments relating to pre-emptive hedging are in principle a sensible clarification, subject to clarification of an unintended consequence flowing from the drafting of the legislative instrument which may leave binding orders unable to be hedged until the order has been filled. We have proposed an amendment to address this point.

Unless expressly defined in this letter, capitalized terms have the meaning given to them in CP 299.

We set out below the Committee's responses to certain questions posed by ASIC in CP 299. Even if ASIC is unable to accommodate the views expressed by the Committee in these specific responses, the Committee overall remains supportive of the revisions proposed by ASIC in CP 299.

Legislative relief for certain ETP market makers

1. ***B1Q1:*** **Should we grant legislative relief or continue to issue individual no-action letters on a case-by-case basis upon application? Please give detailed reasons in your response.**

1.1 The Committee is supportive of legislative relief in the area of ETP however it does not consider the current proposal to cover a sufficient proportion of the market for this to have a meaningful impact. At the time of writing, there are approximately seven (7) market participants who may benefit from this instrument[1]. While market makers play an important role, in the current trading state for ETPs, this is a very limited universe of market participants and unlikely to provide the benefit which legislative relief ought to be directed. The market for ETPs in its current state (absent the most liquid contracts such as STW – being the subject of its own relief under the market maker exemption) would not be able to support a large number of market makers, accordingly it is important to increase the universe of market participants making ETPs available to investors without the undue cost and time associated with individual relief instruments.

1.2 The time, cost and effort associated with preparing an application (and having ASIC review each application) in respect of each ETP for a market participant is extensive and lengthy and has acted as an impediment to the ETP market gathering momentum in the Australian market as compared to other developed markets (notably the US markets). Certain market participants have estimated that the cost for obtaining and maintaining relief per ETP exceeds $10,000 per annum.

1.3 As noted in CP 299, no-action letters do not provide certainty (in that ASIC reserves the right to take action) and do not preclude third parties from taking action – which creates uncertainty and impedes efficient market operation.

2. **B1Q2: The relief is currently only applicable to ETFs and MFs (see definition of 'exchange traded fund' and 'managed fund' in the draft instrument at Attachment 1). Should we extend the relief to other exchange traded products, such as structured products? Please give detailed reasons in your response.**

2.1 The proposal does not include Chess Depository Interests (**CDIs**) over interests in an offshore ETF. The Committee believes that the relief should similarly be extended to CDIs provided delivery of the underlying ETF securities (which might be held in inventory or borrowed) to the CDI nominee occurs on or before T+1 (on the relevant US market), and shunting messages are sent to the Australian CDI registrar, to facilitate creation of CDIs over the relevant ETF securities before Australian Securities Exchange (**ASX**) settlement time on T+2. Currently relief is sought on an individual no-action basis per RG 196.67.

[1] https://www.asx.com.au/products/etf/market-making.htm

B2Q1: What concerns (if any) do you have with the proposed circumstances and/or conditions imposed?

2.2 In relation to B2(a), the condition that the market maker needs to have entered into an agreement with the market operator (or registered with the market operator in relation to making a market for those ETP units) is unnecessarily restrictive. ASIC has acknowledged that client facilitation services are analogous to market making services.[2] This condition should be broadened accordingly to also provide relief to market participants that provide facilitation services, even where the broker may itself not be the "official" market maker of an ETP (as based on actual or anticipated client demand, it may not do so on a continuous or regular basis). The market participant should however still be required to be an "Authorised Participant" of the particular ETP in order to qualify.

2.3 In relation to B2(d), the condition contemplates that a record of each sale of an ETP be recorded as a short sale and retained for 5 years. The Committee believes that this approach is inconsistent with the previously maintained position for ETPs as well as other instruments for short sale relief (for example, the facilitation relief[3]) and as a result triggers a bespoke arrangement to short sale report and real time tag each transaction. This obligation will require a technology build for most organizations and reporting burden that is unlikely to provide any regulatory benefit.

2.4 In relation to B2(e), the condition that "as soon as possible after the short sale of the ETP units by the ETP market marker has occurred, the market maker must acquire or apply for a sufficient number of ETP units to settle the short sale" is problematic in that it sets a high bar for compliance. While this is a standard formulation and is reflected in ASIC's template relief conditions[4] it may be difficult to demonstrate that an acquisition of ETP units or application for creation of ETP units is undertaken as soon as possible after the short sale absent guidance on ASIC's expectations following the short sale. This difficulty applies not only to cross listing/shunting arrangements, but also in respect of standard Australian ETFs. The Committee understands that ASIC generally takes (and that industry participants generally take the view that ASIC will take) a sensible approach to determining "as soon as possible" in this context which should include taking necessary steps for creation of the ETP units on T before the relevant dealing deadline in order to facilitate settlement of the short sale on T+2. However, it would be helpful for this to be clarified – with an alternative formulation of "as soon as reasonably practicable" being suggested as more appropriate.

3. **B2Q2: How will this change affect your business? Please include any benefits or costs (in dollar terms) associated with the proposed change (as a one-off benefit or cost and on an annual basis).**

3.1 As currently drafted the relief is likely to only benefit a very small class of market makers, the overall benefit is unlikely to be material to the broader market. Should ASIC provide a broader application of this relief to cover facilitation services, then this is likely to provide for a one-off cost benefit in respect of new applications for relief on ETPs (noting that the ETP units are constantly evolving, so in the absence of

[2] See RG 196.70 and more particularly 196.72: "*[w]e consider that client facilitation services add to the efficient operation of the financial markets and are analogous to market making services*"
[3] *See RG 196.73*
[4] *As outlined in ASIC RG 196 (at paragraph 196.64(d))*

legislative relief an Authorised Participant is likely to seek further relief for additional ETP units). For all existing instruments, it is expected that market makers and if extended Authorised Participants would be permitted to migrate to any new framework within the transition period which would ensure that ASIC is provided with a consistent compliance and reporting framework regarding both market making and facilitation activities in ETPs.

4. **B3Q1: What concerns (if any) do you have with any of the proposed additional conditions imposed?**

4.1 Subject to the legislative instrument being broadened to cover Authorised Participants who are providing facilitation in respect of ETPs and the feedback in B3Q4 below, the proposed conditions are in principle fine, provided that there is sufficient time to implement the changes before the new framework comes into effect. In order to track the conditions and ensure that the trading desks draw a distinction between those ETPs where a notice of reliance has been given, against those where a notice has not been sent, a modification to systems is required to ensure this is tracked. Accordingly, it will be important for there to be a transition period with sufficient lead time to make changes before the existing instruments of relief expire.

5. **B3Q2: What concerns (if any) do you have with the proposed 28-day timeframe for providing the notifications? If you think the timeframe should be longer or shorter, please provide reasons.**

5.1 The obligation to notify of a suspension or termination, may in practical terms be difficult to track. For some ETPs a market participant may only be active intermittently and as a result will only be aware of a change in the status of the ETP at the time of making a price for an ETP. Where the ETP issuer de-lists, or suspends or terminates a class of an approved market participant, the market participant should not have an obligation to notify ASIC of that change within 28 days but rather the obligation should fall to the ETP issuer. Similarly, if the notice of reliance/cessation is specific to ETP units, there may be some delay in the market participant notifying ASIC that it no longer relies on the relief for particular ETP units where trading in those ETP units is sporadic (although the 28-day timeframe does not appear to be proposed in relation to that notice).

6. **B3Q4: What concerns (if any) do you have with the proposed settlement failure reporting threshold? Should this be higher or lower? Please provide reasons**.

6.1 While the 1% by volume or value provides for a low trigger given the current liquidity in ETPs generally, it may be prudent to limit the categories of the settlement failure which are in-scope such that it only captures the failures of the market maker or Authorised Participant and not other extraneous factors outside of the control of those entities. As currently drafted, a single settlement failure could easily result in a trigger and although this only gives rise to a report, it will be important to understand what factors will be considered by ASIC when reviewing such a report. The categories of event which might result in settlement failure which are outside of the control of the market maker or Authorised Participant, include:

(a) Cash or brokerage mismatch with counterparty;

(b) Quantity mismatch with counterparty;

(c) No instruction from counterparty;

(d) Counterparty short to deliver;

(e) Counterparty alleging different basis of quote e.g. ex-dividend/ cum dividend;

(f) Market maker short to deliver;

(g) Mismatch direction with counterparty (buy/sell);

(h) Counterparty facing different broker;

(i) Settlement date mismatch with counterparty;

(j) Counterparty instructing to match sell trades after stock borrowed (after 9.45am); and

(k) Counterparty failing to deliver to market maker causing market maker to fail another counterparty.

Legislative relief for short selling relating to corporate actions and IPO sell-downs

7. **C1Q1: What are your views on deferred settlement trading periods and conditional and deferred settlement trading periods in general? In particular:**

(a) should deferred settlement trading periods and/or conditional and deferred settlement trading periods be permitted? Please give reasons for your view;

(b) do you think that deferred settlement trading periods and/or conditional and deferred settlement trading periods provide benefits to the market? If so, what are those benefits?

(c) should any changes be made to deferred settlement trading periods and/or conditional and deferred settlement trading periods (e.g. to the duration of the periods, or to the types of corporate actions that may include a period of deferred settlement trading or a period of conditional and deferred settlement trading)? If so, what changes should be made?

7.1 Yes, we think there is a benefit in continuing to permit both deferred settlement and conditional and deferred settlement trading periods. They provide an opportunity for investors to capture liquidity in the relevant financial product and assist with price discovery.

7.2 In an IPO context, conditional and deferred settlement trading is an important mechanism to provide investors with near-term price transparency and liquidity to manage their risk position. If conditional and deferred settlement trading was not permitted, listing would occur approximately five business days later (on commencement of deferred settlement trading). Earlier liquidity can be a driver of investor participation and pricing in an IPO, particularly in an environment of elevated volatility. To illustrate this, a front-end bookbuild structure (where there is approximately a three-week risk period between investor allocations and trading) is traditionally reserved for smaller IPOs while a back-end bookbuild (approximately two business days between investor allocations and trading, assuming conditional and

deferred settlement trading) is preferred for larger IPOs where investors are more acutely focused on immediate liquidity.

8. **C1Q2: Do you agree with our proposal to grant legislative relief to permit naked short sales of unissued section 1020B products during a deferred settlement trading period? Please give reasons for your view.**

8.1 The Committee agrees with the legislative relief and considers this provides the benefit of certainty and greater efficiency rather than relying on the current ASIC no-action position. Where a product commences trading on an Approved Market, the security must be able to be traded in order to ensure orderly markets in those products. While the approach adopted by ASIC under its December 2017 no-action relief is a sensible approach and provides a proportionate response to ensuring that no sale occurs unless the seller has reasonable grounds of its unconditional entitlement to the product in the fullness of time, as noted by ASIC in the Consultation Paper, a no-action position is not as clear or as certain as a legislative amendment. Accordingly, the Committee considers this a positive and welcome move.

9. **C1Q3: Do you agree with the proposed drafting of the draft instrument at Attachment 1? Please give reasons for your view.**

9.1 The instrument should be amended to clarify that not only should transactions "*on a licensed market*" be permitted, but also transactions that are required to be reported to the operator of the listing market. In addition, the instrument should apply to section 1020B products that may yet to be transferred (as opposed to only unissued). The Committee believes that products subject to conditional trading also be included provided that ASIC outlines further conditions for this class of products that is in line with the considerations they would normally undertake when reviewing an application for relief.

10. **C1Q4: How will this proposal to grant legislative relief affect your business? Please include any benefits or costs (in dollar terms) associated with the proposal (as a one-off benefit or cost and on an annual basis).**

10.1 If the legislative relief is not extended to products issued on a deferred settlement basis, then then the existing position which provides some comfort will presumably continue to apply. We do not believe that no-action relief provides the market with legal certainty and support the deployment of permanent instrument.

11. **C1Q5**: **Should we also grant legislative relief to permit naked short sales of unissued section 1020B products during a conditional and deferred settlement trading period, and if so:**

    (a) in what circumstances should the relief apply (e.g. what are the conditions, as declared by the operator of the listing market, which would need to be satisfied)?

    (b) should that relief be subject to conditions and, if so, what conditions should apply? Please give reasons for your view.

11.1 It is the Committee's view that legislative relief should also be extended to products issued and/ or transferred on a conditional and deferred settlement basis. Without legislative relief or in the absence legislative relief, individual relief is required to be obtained prior to listing the product. If ASIC were unwilling to grant short sale relief for

the relevant product, it would not be possible for a holder of such product to sell (nor would a purchase be technically possibly) during that conditional and deferred settlement period.

(a) Legislative relief should apply to any product where conditional trading is declared provided that those conditions as outlined by the operator of the listing market provide reasonable certainty that the product will in fact capable of being divested to the legal owner at the end of the conditional trading period, including, without limitation, conditions such as the payment of consideration and receipt of a proper instrument of transfer.

(b) The legislative relief should be subject to the operator of the listing market only permitting such products to proceed to listing where the conditions to be met are a question of process and are not conditional on factors which are not within the control of the issuer (or its shareholders).

12. **C1Q6: How would it affect your business if we did/did not grant the legislative relief referred to in C1Q5? Please include any benefits or costs (in dollar terms) associated with ASIC granting, or not granting, legislative relief (as a one-off benefit or cost and on an annual basis).**

12.1 Refer to our response to C1Q4 (above).

Remaking instruments which permit naked short selling in specific circumstances

13. **E3Q1: Do you agree that the relief under [CO 09/774] should continue? Please give detailed reasons for your view.**

13.1 It is the Committee's strongly held view that market makers are important for providing liquidity, price efficiency and transparency in financial markets. This is of greater importance with the bifurcation of liquidity between lit venues and other trading venues. The framework under the existing class order instrument, ensures that the market maker has taken appropriate steps to manage its settlement obligations and given the liquidity in the permitted products the settlement risk is and remains low. The mechanism by which a market maker is required to notify ASIC of any issues prior to open of market on the day following trade date ensures that the ASIC has early notice of any risks to settlement and whether the conditions to making a market in these products has been satisfied.

14. **E3Q2: Do you consider that the relief should apply to pre-emptive hedging by market makers? What are the reasons for your view?**

14.1 It is our view that pre-emptive hedging could cover a broad range of activities however the notion that it would cover a mere "expectation" of a future long position would not in the view of the Committee be sufficient to satisfy the test as outlined in the existing class order instrument. There are however, circumstances where it is necessary to manage, avoid or limit a risk in respect of a long position which is a binding order subject to certain conditions. Accordingly, a hedged product may not technically arise (under the proposed legislative relief) at the time of sale of the shorted product.

14.2 Examples where a binding order has been taken but a "hedged product" has not yet arisen might be an order providing for completion at the end of day (i.e. market on

close or Volume Weighted Average Price (**VWAP**) orders), fill or kill orders (i.e. fill 100,000 shares at a price or there is no order) and any other binding order that has a condition to complete prior to the financial product being issued, acquired or disposed. In that regard a more appropriate limitation would be that the test for what constitutes a "hedged product" may need to be clarified that it can only be undertaken off the back of making a market in the "hedged product" and in respect of pre-hedging only where there is a corresponding binding order which needs to be hedged. This seeks to ensure the regulatory intent regarding pre-hedging and its availability would continue to apply, but it would not exclude orders that need to be hedged at the time they are accepted. A proposed revision to the legislative instrument could be drafted as follows (addition in highlighted text):

> "*(5A) Subsection (2) does not apply to a market maker in relation to a sale of a security (the **shorted product**) or managed investment product (the **shorted product**) by the market maker where all of the following apply:*
>
> *(a) the market maker has issued, acquired or disposed of a financial product or has agreed to issue acquire or dispose of a financial product (the **hedged product**) in the course of making a market for the hedged product;*"

The Committee would be pleased to discuss this submission if that would be helpful. Please contact Shannon Finch, Chair of the Corporations Committee at shannon.finch@au.kwm.com or 02 9296 2497, Jeremy Williams at jeremy.williams@gs.com, 02 9320 1407 or Anne Murphy Cruise at anne.murphycruise@macquarie.com or 03 9635 8559, if you require further information or clarification.

Yours sincerely

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