AFMA

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By email: short.selling.cp@asic.gov.au

Dear Ms Wu

Short selling - Reliefs and Orders - Consultation Paper 299

The Australian Financial Markets Association (AFMA) welcomes the opportunity to respond to Consultation Paper 299 Short selling: Naked short selling relief, position reporting amendments and sunsetting class orders (CP).

In December 2008, the Government passed the Corporations Amendment (Short Selling) Act 2008 (Short Selling Amendment Act). This Act, together with Corporations Amendment Regulations 2009 (No.1), removed all but one of the exemptions to the naked short selling prohibition. The remaining exemption applied to prior purchase transactions (previous s1020B(4)(c)). The Short Selling Amendment Act and Corporations Amendment Regulations 2009 (No.8) (the short selling amendments) amended the Corporations Act and Corporations Regulations to provide for the current short selling reporting and disclosure framework in Australia. Under this regime ASIC is reviewing existing relief from the naked short selling prohibition provided to market makers of certain exchange traded products (ETPs); the granting of legislative relief from the naked short selling prohibition in the context of corporate actions and initial public offering (IPO) sell-downs; changing the relevant time short positions are calculated; and remaking a number of class orders on short selling which are due to sunset soon after 10 years. An important aspect of ASIC's review is to consolidate all short selling relief into a single instrument, including relief that is to be remade as a result of sunsetting as well as any new or modified relief raised by the proposals.

1. General observation

Across most of the proposals there is membership support for AFMA's proposals with some technical questions being raised. The move to a one off exemption to naked short selling prohibition provided to market makers of certain ETPs of general application is a

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welcome development.

However, there are two proposals that require further industry consultation in AFMA's view:

1.1. The proposal to change the time with respect to which a short position report is calculated under Reg 7.9.100(1)(d), as modified by Class Order [CO 10/29] Short selling position reporting regime in response requests to modify the Corporations Regulations so that short positions are calculated as at the end of the calendar date in the reporting entity's location has raised concerns. This change is intended to recognise that global firms have entities with trading desks that operate in a number of different time zones. This proposal raises operational issues for some of our membership and the option to retain the current 7 pm reporting time has continuing support. On the other hand other member firms are keen for this change to take place. There is also the need to base it on where the transaction is booked rather than where the trading desk is located. The preference would be for optionality on reporting to be allowed. This proposal therefore needs further discussion with the industry.

1.2. The proposed amendments to the market making exemption regarding the clarification of pre-emptive hedging could have a significant detrimental impact on the industry if the changes were to go through as currently drafted. The wording needs to be amended to ensure it does not inadvertently carve out activity that the market making relief was legitimately intended to cover, e.g. swap activity and structured options trades where the price is finalised based on the hedge execution price. It may be worth re-consulting the industry on the proposed drafting changes to ensure there are no unintended consequences, given the heavy reliance of the industry on this exemption.

2. ETP Market Making Relief

ASIC Proposal B1

We propose to grant legislative relief to ETP market makers, rather than continue to issue individual no-action letters. At this stage of the consultation process, we have limited the relief to ETFs and MFs only. We have not proposed relief for exchange traded structured products. The instrument would be subject to the same conditions as currently provided in the standard no-action letters, but some additional conditions are proposed: see proposals B2–B3.

AFMA supports the general proposal to grant legislative relief to Exchange Traded Product (ETP) market makers as a group to replace individual relief exemptions.

With regard to the scope of the relief there are three points we wish to make.

2.1. ***ETF Market Maker definition*** - It would be helpful if ASIC could provide clarity regarding the meaning of the ETF Market Maker definition in relation to these words:

> "*has entered into an agreement , or is registered with the relevant market operator, to make a market for those interest or securities*" [Draft CO 4D(a)(ii)]

The starting assumption would be that this covers a Market Participant who has registered with ASX or Chi-X to participate in a market maker rebate scheme, even in the event that they do not qualify for a rebate. The relief should also extend to a Participant who has entered into an Authorised Participant Agreement and Market Making Agreement with the Issuer of the securities.

2.2. ***Non Market Maker ETPs*** – Conceptually, it worth considering whether the basis for relief should focus on whether an ETP issuer has a mechanism for the creation of new units that is accessible by a Market Participant, rather than only whether a person is registered market maker. Consideration by ASIC is sought on whether relief should be made available to ETP products where the exchange does not offer a Market Maker scheme. In these cases the absence of the Market Maker framework should not prevent application of this relief, provided that the issuer has a mechanism that enable the Market Participant to create new units.

2.3. ***ETSP definition*** - It is noted that ASIC is not proposing relief for exchange traded structured products (ETSP). This raises the question of how to characterise ETSP that are intended to be excluded, in particular, CHESS Depositary Interests (CDIs) and related products. There is a need to consider extending legislative relief to CDIs and also to clarify whether a CDI would be considered an ETP or ETSP under the existing definitions given they are identical to shares in economic function. Accordingly, it would be helpful for ASIC to clarify what structured products are not intended to be included.

With regard to the conditions to accompany the relief we have the three following points to make.

2.4. ***Notice of reliance/cessation*** – The proposed requirement will create an additional administrative requirement. This is an unusual requirement based on our knowledge of other class orders. With regard to the notification requirement that reliance by a market maker is to be made on the class order. It is noted that ASX already maintains a list of those entities it has market making agreements with. Reference could be made to this ASX list[1].

2.5. ***Recording short sales -*** The proposed requirement in B2(b)(d) to record any short sales that rely on the relief for 5 years is an onerous record keeping burden for which a commensurate regulatory benefit cannot be identified.

The condition of having to keep a written record of whether an individual sale is a short sale is considered onerous. If the relief for intraday trading is covered based on the net position at end of day there is no value in the intraday record keeping. This goes to the core reason why end of day position reporting was adopted in the first place because it is onerous to determine whether one is in

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

fact short in real time and can involve a technical interpretation of when the units are created / settled versus the timing of the sell in the market.

2.6. ***Settlement fail notification*** - The proposed new condition to notify ASX of settlement failures above certain thresholds is queried. This concerns B3(c) which requires a Participant to notify ASIC if more than 1% of the volume of short sales fail over a 12 month period. ASIC is also requested to note that there is an existing mechanism within the ASX Settlement rules to handle late settlements, defaults from clearing participants and this added requirement seems to be redundant and unduly burdensome for participants. This risk is adequately addressed through the ASX Clearing rules which require a Participant to take action if batch settlement remains outstanding for more than 5 days.

The CP also does not make clear whether ASIC expects this to be across the whole range of securities of the Market Participant or just for individual ETFs.

3. Relief during IPO sell-downs

ASIC Proposal C1   *We propose to grant legislative relief to permit persons to make naked short sales of unissued section 1020B products to buyers on a licensed market during a deferred settlement trading period.*   *We also seek views on whether to grant legislative relief in relation to naked short sales during a conditional and deferred settlement trading period.*   *We propose to grant legislative relief from s1020B(2) for IPO sell-downs where a sale co offers shares to IPO investors but does not have an unconditional right to those shares until ASX grants quotation.*

This proposal is supported.

It is unclear from the CP what policy reason exists for making a distinction between deferred settlement markets and conditional deferred settlement markets. It makes equal sense if the market operator has determined to enable the commencement of conditional and deferred settlement trading to permit naked short selling by provisional shareholders.

If the relief were not to be extended to conditional deferred settlement markets, the market operator at the point of creating the conditional deferred settlement market would need to apply for the relief otherwise no one can sell on market. This separate step of ad hoc relief detracts from market efficiency and would add regulatory cost with no benefit to investors.

There are no specific benefits for having deferred settlement other than if ECM desks have concerns about issuance settling.

4. Timing for short position calculation

ASIC Proposal D1

We propose to modify the definition of 'short position' so that the obligation applies to short positions held as at the end of the calendar date (Global Calendar End Time) in the location of the reporting entity that created the short position. For example, for a UK-based entity, short positions on Australian shares would be calculated based on UK time. We propose that this would be the case even if the entity operates globally using trading desks in multiple jurisdictions. Accordingly, the Global Calendar End Time for the UK entity would be based on UK time even where the relevant trading desk is located elsewhere. We propose modifying this by amending the relief currently granted in [CO 10/29] (discussed in Section E as one of the proposed 'sunsetting' instruments to be remade).

The overall suggestion is for the Global Calendar End Time to be an option and to be based on where the relevant trade is booked. While some firms identify clear benefits to them of going to a global calendar end time to suit international clients, this is not the case for other firms.

Accordingly, some members wish to maintain the current status quo to provide reports by 7 pm, given this is how the current reporting process has been set up. From a cost benefit analysis it would not be beneficial to amend existing reporting infrastructures that have been in place since 2010 to accommodate the new time for reporting.

On the other hand some members that are globally based are strongly supportive of the proposal to move to a global calendar date reporting. They operate in a global business with Australian trades/positions being booked into various locations 24 hours a day. Therefore, net short reporting should preferably occur at end of day for differing time-zones around the world for the various entities within an organisation.

The benefits are:

- Legal entities consolidate their ledger positions and exposures on a daily basis.
- There are potentially late bookings, allocations and give-ups from other brokers which do not get actioned by 7:00pm AEST.
- Global systems generally run-on an end of calendar day basis.

For legal entities offshore the reports are run generally in the local time zone morning to align with a 7:00 pm AEST reporting time which puts pressure on the IT system which are running out of cycle. Members have suggested that they would look to align with their regional and global processes for similar reports which would put them into a central team. The proposal aligns more generally with how legal entities calculate their holdings for monitoring substantial shareholder notifications and allows for a single database to be used.

In addition, there is a caveat to go with the Global Calendar End Time. There is concern with the proposal being based on the location of the reporting entity that created the short position and not where the relevant trading desk is located. Rather it should be where the relevant trade is booked as it is the processing cycle of where the trade is booked that is relevant.

This proposal therefore needs further discussion with the industry.

5. Remaking current relief permitting specified short-selling

ASIC Proposal E1   *We propose to continue the relief provided in [CO 08/764] beyond the expiry of that instrument on 1 October 2018. See the current instrument: [CO 08/764]. We propose to incorporate the relief currently given by [CO 08/764] into a new consolidated legislative instrument: see section 9 of the draft instrument at Attachment 1.*

This proposal is supported.

It makes eminent sense to consolidate all the existing class orders in Proposals E1 to E4 in order to aid accessibility, transparency and understanding of the law.

We suggest that this may be a timely opportunity for ASIC to clarify its position with respect to OTC options, which also play a role in maintaining an efficient derivatives market in Australia given the limited flexibility of ETOs. Specifically, we suggest that ASIC extend the two existing ETO reliefs to cover the OTC market as the risks they are trying to manage are the same for ETOs as they are for OTC in terms of the potential naked short selling issues.

ASIC Proposal E2   *We propose to continue the relief provided in [CO 09/1051] beyond the expiry of that instrument on 1 April 2019. See the current instrument: [CO 09/1051]. We propose to incorporate the relief currently given by [CO 09/1051] into a new consolidated legislative instrument: see sections 10 and 11 of the draft instrument at Attachment 1.*

This proposal is supported.

It would be helpful if ASIC were to use this opportunity to clarify the treatment of the semi government bond entities under this exemption, i.e. if the intention is that semi government entities are intended to be covered by the 'government bond' definition or if they are currently considered to be an 'eligible debenture'. If the semi government bond entities are not currently captured by the 'government bond' definition in the exemption, suggest this be changed so that they have the same relief as government bonds given how liquid these products are in the Australian market. We also suggest it may be worth ASIC providing clarification on the jurisdictional scope of the prohibition under s 1020B for sales of offshore bonds that may be undertaken by Australian based staff, including clarification on whether the domicile of the client (onshore or offshore) in this circumstance is a relevant consideration.

ASIC Proposal E3   *We propose to continue the relief provided in [CO 09/774] beyond the expiry of that instrument on 1 October 2019. See the current instrument: [CO 09/774]. We propose*

to incorporate the relief currently given by [CO 09/774] into a new consolidated legislative instrument: see section 8 of the draft instrument at Attachment 1.

We further propose to amend the relief currently provided in [CO 09/774] to:
(a) clarify that relief does not extend to pre-emptive hedging; and
(b) extend relief to short sales in the STW ETF to hedge the risks arising from making a market in listed options over the STW ETF.

The proposal to continue the relief provided by [CO 09/774] beyond the expiry of that instrument on 1 October 2019 is supported.

There is a problem with the proposed amendment carve out of 'pre-emptive hedging'. This is concerning because the proposed legislative instrument wording requires the financial instrument to have been issued before the relief can be relied upon. This is problematic for the following reasons:

- Structured options transactions where the price will be determined by reference to the hedge that is executed wouldn't be able to be covered.
- Reliance on the market making relief in the synthetic equity swap space would not be possible as it requires the swap to have been entered into before one can cover the risk through short selling, when market convention is for the hedge to generally be executed first and the price of the swap based on the execution price of the hedge.

It is AFMA's policy presumption in relation to 'pre-emptive hedging' that the intention is to carve out 'proactive facilitation'. If this is the case the drafting should make clear the policy intention in order to assist understanding and compliance with the law. If the intention was just to carve out 'active facilitation' the drafting needs to be updated to better reflect this. For example, the wording in the relief could be amended to "*the market maker has issued, acquired or disposed of, or agreed the terms to issue, acquire or dispose of a financial product…*".

In relation to extending relief to short sales in the STW ETF to hedge the risks arising from making a market in listed options over the STW ETF, AFMA suggests that this should not be drafted to be specific to just one ETF issued by that issuer, but rather it should be drafted to apply to ETFs that meet the criteria that ASIC deem appropriate to be met for coverage by the class order. This will help future proof the class order. Generally, it is considered appropriate to provide relief for any security where there is sufficient liquidity and the sales are undertaken by a defined Market Participant.

ASIC Proposal E4

We propose to continue the relief provided in [CO 10/111] beyond the expiry of that instrument on 1 April 2020. See the current instrument: [CO 10/111]. We propose to incorporate the relief currently given by [CO 10/111] into a new consolidated legislative instrument: see section 12 of the draft instrument at Attachment 1.

This proposal is supported subject to our following comments on the deferred purchase agreement (DPA) restriction.

5.1. ***DPAs*** - With regard to the current restrictions under CO 10/111 applying to deferred purchase agreement (DPA) AFMA makes the following comments.

AFMA suggests three changes to the extent of the current CO 10/111:

1) the minimum length of the term of the DPA to be changed from 12 months to 1 month

2) the range of permissible reference assets expanded so that the reference asset may be the delivery product).

3) the range of permissible delivery products expanded from the requirement to be a constituent of the S&P/ASX 200 to include any financial product that is quoted on ASX.

The reasons for theses suggestion are:

1) The current condition which extends to 12 months should be brought back to 1 month, as there is no discernible rationale for it to extend out to a full 12 months. In the Explanatory Statement to the original Class Order, ASIC noted that DPA issuers submitted that the cost of holding inventory of delivery products in long anticipation of the delivery date of the DPA would be prohibitive. These same cost considerations arise for DPAs that mature within 12 months from the date of issue, as it is expensive for the issuer to warehouse the delivery product. Furthermore, we note that DPAs with a maturity of less than 12 months are commonly traded instruments in the Australian market.

2) If the DPA is a product that is not a delta one at all times, then the conditions of the relief should be updated to the effect that the reference asset and delivery asset can be the same.

3) Non AUD stocks should be covered in the new drafting, rather than just being limited to ASX listed product as in the proposed drafting.

   Structured notes or securitised products that require, under certain defined circumstances, the delivery of shares that are in scope of the section 1020B products (or has a settlement election method which can include physically settling the shares) should also benefit from relief. If the obligation to deliver is subject to conditions which are outside of the product issuer's control (e.g. subject to price performance of a reference asset), or the quantity to be delivered is not known upfront (e.g. because it can only be calculated at expiry), there is a case to be made that the product issuer does not need to borrow stock until it knows how much it has to deliver (if at all). The underlying policy rationale is similar to that for ETOs and OTCs.

6. Remaking instruments providing short sale reporting relief

ASIC Proposal F1 *We propose to continue, in its current form, the relief provided in [CO 10/29] beyond the expiry of that instrument on 1 April 2020 with the exception of:* *(a) the transitional arrangements set out in paragraph 157(a) above which are no longer required; and* *(b) the clarification of the timing of short position reporting set out in paragraph157(d) which we have proposed to amend in proposal D1 above.*

This proposal is supported.

ASIC Proposal F2 *We propose to continue the relief provided in [CO 10/135] beyond the expiry of that instrument on 1 October 2020. See the current instrument: [CO 10/135]. We propose to incorporate the relief currently given by [CO 10/135] into a new consolidated legislative instrument: see sections 17 and 18 of the draft instrument at Attachment 1.*

This proposal is supported.

ASIC Proposal F3 *We propose to continue the relief provided in [CO 10/288] beyond the expiry of that instrument on 1 October 2020. See the current instrument: [CO 10/288]. We propose to incorporate the relief currently given by [CO 10/288] into a new consolidated legislative instrument: see sections 15 and 16 of the draft instrument at Attachment 1.* *We propose to extend the relief in [CO 10/288] so that it is also applicable to ETP market makers who make a covered short sale of units of a quoted ASX-managed fund, in the course of making a market in those units.*

This proposal is supported.

Please contact David Love either on 02 9776 7995 or by email dlove@afma.com.au if further clarification or elaboration is desired.

Yours sincerely

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