



**Australian Government**

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**The Treasury**

# **Short Selling Disclosure Regime**

**Consultation Paper**

**The Treasury**

**March 2009**

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### **Consultation**

Comments are sought on this discussion paper by no later than 3 April 2009. Submissions should be sent by mail, fax or email to:

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# 1. INTRODUCTION

In December 2008, the Government passed the *Corporations Amendment (Short Selling) Act 2008*. This Act established the framework for a permanent short selling disclosure regime that is intended to replace the interim disclosure requirements put in place by ASIC in September 2008. Under the Act, the detailed aspects of the disclosure framework are to be prescribed by regulations. The objective of this consultation paper is to seek feedback from stakeholders on the content of the regulations.

The objective of the disclosure regime is to enhance market confidence and integrity by providing greater transparency to both investors and regulatory bodies about short selling activity on Australian financial markets.

For investors, the information will be of assistance in helping to explain share price movements as well as giving an understanding of the market sentiment towards the stock. This should help investors to make informed decisions and assist in pricing efficiency. In addition, it will improve confidence by reducing the potential for rumour and speculation surrounding the activities of short sellers.

For regulators, greater transparency will assist in the investigation of market misconduct cases. There is a general concern that short selling has been used in the past to facilitate market manipulation (for example, by way of so called “distort and short” and “rumourtrage” trading strategies). A comprehensive disclosure regime will provide regulators with greater ability to identify short sellers who may be involved in market manipulation.

There are two principal methods of reporting short sales: positional and transactional. The two methods of reporting can be seen as complementary if each achieves different aspects of the objectives outlined above. The interim disclosure requirements imposed by ASIC are based around transactional reporting. The paper primarily focuses on issues associated with positional reporting, since many of the questions about transactional reporting have been answered by the experience of ASIC’s interim disclosure regime, but it also seeks feedback on outstanding issues associated with transactional reporting.

Treasury also recognises the need for a degree of international consensus in relation to regulating short selling. Decisions relating to the final make-up of the disclosure regime will also take into account the views expressed by the International Organization of Securities Commissions (IOSCO) taskforce on short selling.

Feedback from stakeholders on the issues raised in this paper will be used to advise Government on the optimal disclosure regime for short selling.

## 2. POSITIONAL REPORTING

### 2.1 Policy rationale for positional reporting

Positional reporting involves investors reporting their overall short position (as a proportion of issued capital) in relation to a particular stock. It differs from transactional reporting because it takes into account transactions that close out short positions. For this reason, positional reporting may provide a more accurate indication of the bearish sentiment within a particular stock at any point in time and also the amount of overhang in the stock that will need to be covered at some point by short sellers purchasing shares. In addition, for investors, this information may provide an indication of the level of risk involved in shorting the stock, particularly if total aggregate short positions are made available. For example, it may be risky for an investor to take a short position in a particular stock if a significant proportion of that stock has already been shorted. This is because there is a greater chance of being subject to a 'short squeeze' if market sentiment changes and the investor is required to close out its position in a short period of time. A number of countries (including the US, UK and many European countries) have adopted reporting requirements for short positions.

However, it is important to note that positional reporting has some inherent limitations, which are likely to impact on the usefulness of the information provided. The extent of the limitations will be influenced by the approach used to implement the reporting regime (discussed below). For example, for pragmatic reasons, the positional reporting regime may only require positions above a certain threshold to report (see issue 2.3). In addition, there are likely to be significant compliance issues associated with enforcing the reporting obligation, particularly when the investor is located in another jurisdiction (see issue 2.2). For these reasons, positional reports may materially understate the amount of short selling in a particular stock.

Investors may have the ability to obtain the information derived from positional reporting through alternative sources. The Reserve Bank of Australia (RBA) announced on 24 February 2009 that it would amend the *Financial Stability Standards* to mandate the disclosure of stock lending information. In particular, the regime requires settlement participants to report directly to the ASX the net amount of a particular stock that the participant either has lent or has borrowed. This information will be published by the ASX following a short lag (still to be determined). An investor may be able to use this information as a proxy for the net short position in the stock and also the risk associated with short squeezes. It is accepted that stock lending information is an imperfect proxy for net short positions because of the potential for stock to be lent for reasons other than short selling. However, the shortcomings of stock lending information need to be weighed up against the potential limitations of any positional reporting regime (outlined above) in deciding whether to require positional reporting in addition to stock lending information.

#### Issue for comment:

- A. Do you support the disclosure of positional information in relation to short sales? If you support disclosure of positional information, do you believe the disclosure should be in addition to or in place of transactional information? Please explain why.
- B. Does the disclosure regime for stock lending established by the RBA reduce or remove the need for reporting of short positions? Please explain why.

## 2.2 How positional data would be collected

The existing transactional reporting regime is based around brokers receiving information from investors and reporting the information to the ASX, which then collates and releases the information. This is a cost effective method of reporting because it utilises existing infrastructure and communication channels. However, there is no existing infrastructure or communications channel that can be utilised for the reporting of positional information. This gives rise to a number of issues:

- ***Who should be required to report positional information:*** The ultimate legal responsibility for the reporting of short positions should rest with the holder of the position (the investor). Investors are in the best position to calculate their overall short positions and are likely to already have internal systems in place to calculate this information. The investor may use multiple brokers making it difficult for individual brokers to obtain accurate information about an investor's short positions.

For pragmatic reasons, an investor may authorise an agent (for example, a custodian or prime broker) to report this information on their behalf. The investor would be responsible for managing this relationship and ensuring that the agent is reporting correct information on their behalf. If the agent failed to lodge correct information on behalf of the investor, it is the investor that would be held accountable.

Imposing legal responsibility upon the investor might present some enforcement difficulties both for domestic investors and investors located in another jurisdiction. For foreign investors, the regulator (ASIC) might be required to rely on cross-border information sharing arrangements to investigate possible breaches of the requirements. While these arrangements may be effective, they can delay proceedings and make the regime more costly to enforce.

- ***Who should positional information be reported to:*** There are two entities that are potentially in a position to collect this information: ASIC or the relevant market operator (generally, the ASX). While investors will generally have systems to report this information internally, there is currently no infrastructure in place that allows for this form of reporting to external entities (for example, ASIC or the ASX). This means that either infrastructure would need to be built or reporting would need to be done manually. ASIC or the ASX would then be obliged to release the information to the market in the format specified by the regulations (see issue 2.5 below). This would impose costs on either the ASX or ASIC. The extent of these costs would be a function of the number of individuals reporting, the form of reporting and the frequency of reporting. Under the transactional reporting regime, the ASX is ultimately responsible for collecting and publicly releasing (via its website) the information. In the UK, investors report positional information to a regulatory information service. In the US, there is reporting to both the SEC and to market operators.

**Issues for comment:**

- C. Do you agree that investors should hold ultimate responsibility for the reporting of short positions? If not, please explain why and where you think this responsibility should lie.
- D. Do custodians/prime brokers have sufficient access to information about their clients' short positions to enable them to accurately report this information? If so, what proportion of investors are likely to use custodians/prime brokers to report positional information? Do you think there are potential issues with reporting of short positions through custodians/prime brokers? If so, what are they?
- E. Do you have any views on ways to make enforcing the disclosure requirements (particularly against foreign investors) more effective?
- F. Who should collect and disseminate the information: market operators or ASIC? Please explain why.

## 2.3 Threshold for disclosure

A threshold would operate to exclude investors with only small short positions from the obligation to disclose the information. It would be intended to make the system more cost effective by reducing the number of investors with reporting obligations. However, if some positions were excluded from reporting, this would reduce the completeness of the data and lead to an understatement of actual short positions. These costs need to be taken into account when deciding whether there should be a threshold and, if so, the level of the threshold.

The UK has adopted a reporting threshold of 0.25 per cent of issued capital. This means that short positions of less than 0.25 per cent of issued capital are not required to be reported. Data available in relation to short positions in financial stocks in the UK indicates that the average short position is 1.05 per cent of issued capital (the median short position is 0.51 per cent of issued capital). The FSA is currently consulting on a proposal to increase this threshold to 0.5 per cent of issued capital. This would further reduce the number of short positions that are required to be reported. The US has also adopted a 0.25 per cent threshold for reporting of short positions to the SEC. There is no threshold for reporting to market operators in the US (this is because the data is aggregated by brokers prior to it being passed on to the market operator).

**Issues for comment:**

- G. Do you support the introduction of a threshold to exclude the reporting of small short positions? If so, what level do you consider to be the appropriate threshold for reporting of short positions? Please explain why.
- H. What percentage of your total short positions would be excluded from reporting if the threshold was set at 0.25, 0.5, 0.75 and 1 per cent? Please explain why.

## 2.4 Frequency of disclosure

This will determine how frequently an investor is required to report the information and when it is released to the public. The timeliness of reporting will determine how informed the market is in relation to short positions. However, this needs to be weighed against the higher costs associated with

more frequent reporting. In addition, early release of the information may raise concerns by some stakeholders about potential front-running whereby investors can seek to copy trading strategies of other market participants or use other strategies that could disadvantage the disclosing investor.

In the UK, investors are required to report their short positions at the end of the day if their short position has changed during the day outside of a prescribed band (plus or minus 0.1 per cent of issued capital). No reporting is required if the position has remained the same or has changed but within the prescribed band. In the US, there is reporting on a weekly basis to the SEC for some investors (this information is not made public) and fortnightly reporting to market operators (this information is then made publicly available after a short delay).

### Issues for comment:

- I. How frequently should positional information be provided to ASIC or the market operator:
- \* on a daily basis (with an exclusion from reporting if your positions have not changed)?
  - \* on a weekly basis?
  - \* on a fortnightly basis?
- Please explain why.
- J. Do you support banded disclosure requirements so that changes to positions within a prescribed band are not required to be reported? If so, what do you consider the range of the band should be? Please explain why.
- K. Once the information is reported to ASIC or the market operator, should there be a delay before the information is then released to the public? Please explain why and how long you consider any delay should be.

## 2.5 Format for releasing the information

Different formats of reporting information about short positions have been adopted in different jurisdictions. In the US and Canada, short positions are disclosed publicly on an aggregated basis by market operators. Under this approach, the entity responsible for collecting the information aggregates all the short positions in relation to a particular security before releasing it to the public. This ensures the confidentiality of individual positions is preserved. This approach has merit in the US and Canada because all short positions (regardless of size) are reported (there is no threshold for excluding small short positions). As a result, the aggregated short position reported publicly should be an accurate reflection of the total short interest in the stock.

In contrast, other jurisdictions, particularly in the UK and Europe, have implemented positional reporting regimes under which information is released to the market in a similar format to the substantial shareholder notices in Australia. This means that individual short positions are not aggregated before release and the identity of the holder is also disclosed to the market. These jurisdictions generally have a threshold to exclude reporting obligations for small short positions. As a result, aggregating the information could be misleading because not all short positions have been reported. In these circumstances, if the information was aggregated, the figure could materially understate the actual level of short positions in the stock. This will also become an issue in Australia if a similar threshold is adopted here (see issue 2.3).

Disclosing the holder of the short position would provide more transparency about short selling activity. However, it may act to create a disincentive for investors to engage in short selling because of the possibility that confidential trading information is released to the market or that the investor

may be unfairly targeted by other traders in the market. The intention of the disclosure regime is not to inhibit short selling activity, which is recognised as playing a legitimate role in ensuring market efficiency and liquidity during normal market conditions.

It should be noted that, unlike investors with substantial long positions in a company, investors with substantial short positions have no ability to exercise control by way of voting rights. This means that while there is a sound rationale for disclosing holders of substantial long positions, this same rationale cannot be used to justify disclosure of investors with substantial short positions. However, short sellers do redistribute voting rights in a company by shifting voting rights away from the person lending the stock to the person buying the stock in the short sale. In addition, the short seller may be under an obligation to return equivalent stock to the lender in the event that the lender wishes to participate in a company vote. Some stakeholders have identified this as a reason for requiring the public disclosure of the identity of short sellers.

**Issues for comment:**

- L. Do you support the disclosure of the information on an aggregated or disaggregated basis? Please explain why.
- M. If you support aggregated disclosure, are you concerned that aggregated disclosure could be misleading if a reporting threshold is also adopted? Please explain your reasons.
- N. Should the identity of holders of short positions be publicly disclosed? Please explain why. If you support the identity of the short sellers being publicly disclosed, do you believe this should apply to all short positions or only 'substantial' short positions? Please explain why and what you consider to be a substantial short position.

## 3. TRANSACTIONAL REPORTING

### 3.1 Policy rationale for transactional reporting

Transactional reporting involves the reporting of the aggregate value of all short sale transactions in a particular stock during the day. As outlined above, the interim ASIC disclosure requirements are based around transactional reporting. They provide an indication of the proportion of trades in a particular security that are short sales and the overall level of short selling that takes place on the ASX each day. This assists investors and companies in explaining share price movements. For example, if a company's share price is particularly volatile, interested parties are able to refer to the transactional short selling information to gain an understanding of whether there has been an increased level of short selling activity in the stock. This information is also useful for regulators in carrying out market surveillance and investigating alleged cases of market misconduct. This is because the information is likely to be more detailed than positional information, as it identifies individual short sale transactions. Regulators can use this information as an audit trail when conducting investigations.

The existing transactional reporting regime has been in place for a number of months and appears to be operating effectively (subject to issues associated with public disclosure – see issue 2.2). For this reason, if a decision was made to mandate the disclosure of transaction information in the regulations, it is likely that the regulations would largely seek to mirror the existing interim requirements.

#### Issues for comment:

- O. Do you support the disclosure of transactional information in relation to short sales? If you support disclosure of transactional information, do you believe the disclosure should be in addition to or in place of positional information? Please explain why.
- P. Do you have any suggestions to improve the operation of the transactional reporting regime currently in place (excluding the public disclosure of reports discussed below)?

### 3.2 Public disclosure of reports

Under the existing ASIC disclosure regime, the ASX publishes information relating to the total volume of shares in a security that has been sold by way of short sales. This information is published on the day following the execution of the sale. This ensures the market has timely information about the total level of short selling taking place both across the market and in individual securities. However, industry (in particular, fund managers) has expressed a number of concerns about the publication of this information on a daily basis:

- **Misleading information:** People may draw misleading conclusions from transactional information because it does not take into account transactions that close out short positions (in the same way as positional data).
- **Front-running:** Fund managers generally accumulate short positions over a number of days. There are concerns that making transactional information publicly available on a daily basis may result in trading strategies becoming publicly known before the fund manager can finalise their position. This would reduce the returns available to fund managers from executing a particular strategy and may potentially make them vulnerable to short squeezes if market sentiment changes.

**Issues for comment:**

- Q. If positional reporting is made mandatory, would you support the continued public disclosure of transactional information? Please explain why.
- R. What do you consider to be the appropriate lag period before the information is made available to the public (for example, 1 day, 5 days)? Please explain why.
- S. Are you aware of any instances where the daily publication of transactional information has resulted in front-running or any other damaging consequences to the short seller? If so, please provide details.
- T. Are you aware of any instances where the daily publication of transactional information relating to short selling as misled anyone or been of benefit to anyone? If so, please provide details.

## 4. COST INFORMATION

The compliance costs associated with the various methods of reporting is an important consideration that will be taken into account when determining the optimal disclosure regime. Treasury is seeking quantitative input from stakeholders on each of the issues outlined below.

If some of the outstanding issues identified in this paper will influence your costs, please provide an indicative range of costs (from the most to the least expensive) and identify which issues will influence your compliance costs. At least initially, any reporting of positional information is likely to be done manually (for example, by email). In the longer-term, systems may be developed to facilitate more efficient means of reporting this information. Please provide an indication of your costs to comply with this regime both initially and over the long term (including any system development costs).

### For fund managers and other investors:

- U. How much would it cost you to comply with the current ASIC interim disclosure regime if it was made permanent (both in terms of initial costs and ongoing costs)? Please reply without including any costs already incurred.
- V. How much would it cost you to report positional information directly to the ASX or ASIC:
  - \* on a daily basis (with an exclusion from reporting if a position has not changed)?
  - \* on a weekly basis?
  - \* on a fortnightly basis?

### For brokers:

- W. How much would it cost you to comply with the current ASIC interim disclosure regime if it is made permanent (both in terms of initial costs and ongoing costs)? Please reply without including any costs already incurred.

### For custodians and prime brokers:

- X. How much would it cost you to report positional information directly to the ASX or ASIC on behalf of investors:
  - \* on a daily basis (with an exclusion from reporting if a position has not changed)?
  - \* on a weekly basis?
  - \* on a fortnightly basis?

### For market operators:

- Y. How much would it cost you to comply with the current ASIC interim disclosure regime if it is made permanent (both in terms of initial costs and ongoing costs)? Please reply without including any costs already incurred.
- Z. How much would it cost you to collate, aggregate and release positional short selling information received directly from investors if the information is reported to you:
  - \* on a daily basis (with an exclusion from reporting if a position has not changed)?
  - \* on a weekly basis?
  - \* on a fortnightly basis?

### All stakeholders:

- AA. Given that this measure will impose some compliance costs, are there any other regulations in this area that you would like to see improved or removed to reduce your compliance costs? If so, please explain what they are and why they need to be improved or removed.