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11 June 2009

Mr. Andrew Templer
Investment Banks
Australian Securities & Investments Commission
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SYDNEY NSW 2001

By email: policy.submissions@asic.gov.au ; andrew.templer@asic.gov.au

Dear Mr. Templer

SUBMISSION ON CONSULTATION PAPER CP 106 - SHORT SELLING TO HEDGE RISK FROM MARKET MAKING ACTIVITIES

SDIA welcomes the release of CP 106 and the relief proposals outlined in it, and appreciates the opportunity to provide comment to ASIC including in relation to the specific questions set out in the Paper as well as general comments.

We refer to SDIA's submission to ASIC dated 23 December 2008 requesting that ASIC consider granting relief on an industry-wide basis to permit certain limited forms of naked short selling to be undertaken by brokers in connection with a number of categories of common and accepted broking activities. This included among other activities market making by brokers.

We note that ASIC has issued Consultation Paper CP 106 following on from SDIA's submission ("December Submission") and perhaps from other similar approaches. SDIA reiterates the arguments in its December Submission. The matters in that Submission remain relevant to the issues in CP 106 and should be considered in relation to the questions asked in CP 106.

SDIA also notes that IOSCO subsequently released its Consultation Report on Regulation of Short Selling on 20 March 2009. In particular, we note Principle Four in that Report, that "Short Selling Regulation should allow appropriate exemptions for certain types of transactions for efficient market functioning and development". In particular, we note that market making is specifically referred to in parag. [3.38] of the IOSCO Report as a potential candidate for exemption.

Preliminary matter – Client facilitation

As a preliminary matter, we note that ASIC does not define market making to including client facilitation, and that ASIC proposes to continue to deal with relief applications in this area by way of individual case by case applications from brokers.

We submit that there is no logical reason to deal with client facilitation in a different fashion to market making, and that CP 106 should be extended to also deal with relief for client facilitation. When a client approaches a broker for facilitation services, it would be common for the client to request the broker to quote a buy/sell price for the stocks in question. The client will in many cases prefer not to divulge whether they are a buyer or seller at that point, and will frequently seek competing quotes from different brokers in order to obtain the best price.

The characteristics of the provision of facilitation services therefore are not materially different from the making of a market, and therefore the same policy considerations ought to apply to any relief that is extended to both types of activity. There should be no need for parties to be put to the expense of separate case by case relief applications for client facilitation relief, and similarly no need for ASIC to expend resources in having to consider individual applications.

Preliminary Matter – Arbitrage

In SDIA's December Submission, industry-wide relief was urged in respect of arbitrage activity, including index arbitrage and DLC arbitrage. Whilst we are pleased at the proposed relief in CP 106, we are disappointed that arbitrage activity has not received similar attention.

We note that the IOSCO March 2009 Report at parag. [3.38] also refers to arbitrage as being a potential candidate for exemption. In our view, the picture that is emerging is that absence of arbitrage has impacted on the level of liquidity and price efficiency in the Australian market. The absence of arbitrage which would normally operate as a factor in taking advantage of price discrepancies and thereby tending to close them, providing liquidity in the process of doing so, has been noticeable in recent times. Spreads remain wider than usual.

Whilst there may be a number of factors limiting the ability to undertake arbitrage at the present, the inability to naked short sell to instantly capture arbitrage opportunities as soon as they appear is a major factor leading to the absence of this activity.

To the extent that the key areas of regulatory concern are the risk of settlement failure and the potential for market manipulation, there is little evidence that either of these has resulted from arbitrage activity in the past.

We note that under the previous legislation, notwithstanding the strictness of the statutory framework, including the up-tick rule, arbitrage activities enjoyed a carve-out, due we believe to the economic benefits arising from the activity, the impracticality of requiring the pre-borrowing of stock in the time frames involved, and the low level of risk that is inherent in that activity. This status was removed when the legislation was amended, however SDIA submits that the overwhelming argument is for the status to be reinstated.

Comments on Questions in CP 106

C2Q1 Do you agree with our proposal to permit market makers to make naked short sales of section 1020B products to hedge risk arising in their market making businesses? Why/why not?

We refer to the December submission. Members have continued to advise us that the existing requirements to pre-borrow securities in order to be in a position to short sale in connection with market making is detrimental to market efficiency and is tending to discourage market making.

It is impossible for market makers to know beforehand what business will be done by them on any given day, and whether and how much stock will be needed in order to cover sales. At present, all market makers are having to pre-borrow a sufficient amount of stock in the event that it will be needed, which is leading to economic inefficiency. Brokers may be borrowing more stock than is actually required. This is leading to increased competition for available loan stock and demand for loan stock at higher volumes levels than may actually be needed. This has the tendency to inflate the demand for stock available for loan, erode the available supply and drive up the price of borrowing for all parties, not just market makers. The cost of borrowing stock that ultimately is not required is wasted cost. Unnecessary borrowings can deprive other parties who have a real need to obtain the same stock for borrowings for other reasons, e.g. to meet settlement shortfalls. If the supply of stock is tight for certain issuers, then market making is reduced or not available for those names. The prices quoted by market makers are adversely impacted by the cost of borrowing.

C2Q2 If so, do you agree with our proposed conditions to the relief? Are these conditions too restrictive? Are there other conditions you consider appropriate?

SDIA refers to our December Submission and to C2Q1 above. The requirement for a prior-borrowing to be in place is detrimental to market making for the reasons there given, hence the reason for that submission.

SDIA does not agree with the condition proposed in CP 106 which would require instead that a conditional hold be obtained prior to a short sale. In our view, this would result in the relief being of little benefit compared to the existing situation which necessitates a prior borrowing. Firstly, we understand that the practice surrounding conditional is not necessarily consistent between lenders. The condition would therefore not be certain without further clarification.

Of greater significance is that the difficulties presented by the need to pre-borrow stock would essentially remain, with the difference only being a matter of slight degree. Market makers would be required to obtain conditional holds over stock at the start of the day without knowing how much they are likely to require and in which stocks, and hence will be obtaining conditional holds over stock that they are likely not to need.

The reliance on the need for conditional holds is likely to lead to lenders being in a position to charge a premium for providing such a service, and that the differential between the cost of obtaining a hold attaining levels is likely to be only marginally less than the cost of a borrowing. Market makers could be vulnerable to lenders potentially forcing the conversion of a conditional hold into a full borrowing, on the basis that a later party has contacted the lender seeking to borrow the stock. The first broker must then elect to “fill” the hold or lose it. It may therefore be that many conditional holds could end up as a full borrowing in any event.

As with borrowings, the expense incurred in obtaining a conditional hold over stock that is not ultimately needed is a wasted cost.

C2Q3 Do you consider that the proposed relief will be of benefit to the Australian markets? Why/why not?

See answer to C2Q1 and C2Q2 above. The relief will provide considerable benefit by removing adverse economic impacts on market making and will assist in ensuring the continued availability of those services to the market at a more efficient price, so long as the requirement for the "conditional hold" or for a prior borrowing to be in place are imposed as a condition. Otherwise, the relief will not provide a significant contribution to addressing present difficulties presented to market makers.

C2Q4 Do you agree that the risk of settlement failure associated with short selling by market makers is negligible? Why/why not?

and

C2Q5 Do you agree that the risk of settlement failure would be adequately mitigated if the proposed relief were granted? Why/why not?

In response to C2Q4 and C2Q5, we refer to our December Submission. We submit that there has been little evidence to date of any significant incidence of settlement failure arising from market making activities. The major cases where settlement failure has been an issue in recent times have all stepped from other causes, and generally speaking, settlement failure is more likely to result from unrelated issues such as poor communication between parties responsible for delivery, including between clients and custodians. It is not evident that settlement failure has resulted from the activities of short sellers, in particular from short sales by market makers.

In our view, it should be sufficient for the proposed relief to require that the market maker must either secure a borrowing of or buy back the short-sold stock by the deadline specified in the relief. This should be sufficient to adequately guard against the risk of settlement failure. In generally, market makers are subject to a very tight risk management discipline in order to prevent economic loss, and will rarely want to hold positions which are subject to directional market risk. In addition, the measures adopted by ASX recently to minimise the risk of settlement failure, including the increase in failed settlement fees and the obligation to close out trades which have failed to settle in T +5, are particularly stringent and have proven to be quite effective. Hence, the prospect of a market maker not either covering a naked short sale with either a later stock borrow or by buying back in the market would have to be regarded as very low.

For these reasons, we believe that the risk of settlement failure has been adequately adressed by changes to market regulation, and the activities by market makers will not pose any significantly greater risk.

C2Q6 Would limiting the relief to securities on the S&P/ASX 200 index be problematic? If so, why?

SDIA submits that, provided a market maker is required to cover a naked short sale either by a later borrowing or by buying back the stock by the relevant time, then there is nothing to be gained by limiting the relief to stocks within the ASX 200.

Relief in respect of ASX 200 stocks will certainly assist in relation to market making in standardized listed derivatives. However, it will not assist in relation to more customized OTC derivative instruments, which may include stocks outside the ASX 200.

It may well be that market makers will limit market making activity in stocks outside the ASX 200 on the grounds that liquidity may be less, or that stocks may be harder to borrow. However, the latter is not true of all such stocks. There are many stocks outside the ASX 200 which enjoy sufficient liquidity to support market making activities, and therefore we submit that this proposed condition would be unnecessarily restrictive. There is no reason why the market should be deprived of market making services in stocks where this would be entirely feasible. In fact, limiting market making in stocks outside the ASX 200 would have the negative impact of further removing liquidity from those stocks tending also to widen price spreads.

As mentioned earlier, the new rules dealing with settlement failure, together with the economic risks inherent in holding a naked directional position, should be sufficient to enforce a discipline of market makers either borrowing stock to cover a naked short or closing the position by a later purchase. It is unlikely that market makers will incur the risk of providing these services where there is a real risk that borrowing or repurchase are questionable, but alternatively, there is no reason to restrict the provision of these services in stocks where these are not an issue. The underlying tenet of market making involves the avoidance of risk by means of hedging, not exposure to risk by way of dealing in stocks where risk cannot be managed in this way.

C2Q7 Are there any other matters you consider we should take into account when deciding on the proposed relief?

Other than as mentioned in elsewhere in this submission and in SDIA's December submission, no.

C2Q8 Should we modify our existing client facilitation relief (see Table 1) by adding a condition in the form of proposal C1(f)? Are there any other conditions we should include?

We refer to the December Submission and to the Preliminary Comment above in relation to Client Facilitation. We also refer to our answers to C2Q1 and C2Q2 above. For the reasons there given, we also do not support the imposition of the condition in C1(f) in relation to relief with respect to client facilitation.

C3Q1 Do you agree that if naked short selling relief is granted, market makers should be required to actually borrow sufficient section 1020B products at the end of each sale day to ensure delivery of the products on the date delivery is due? Why/why not?

There is an issue surrounding what is meant by the "end of each sale day", that is, whether the term means the end of the calendar day or the close of trading on ASX. In either case, this requirement could potentially affect the provision of market making services in the latter part of trading on any trading day.

For instance, if a market maker makes a market after, say, 3.30pm, then there is limited time remaining to arrange a borrowing to cover the short sale before the market shuts. If for some reason there borrowing cannot be arranged before the market shuts and it transpires that the supply of loan stock is unavailable, then the market maker may also not be able to cover the sale by buying back the stock given that the market has shut. There is the potential for late trading after-market, however there are limitations on the ability to freely trade after market compared to whilst the market is open.

For these reasons, we would submit that the condition applicable to market making relief should be that the market maker be required to either borrow equivalent stock or buy it back by the “relevant time”, which would be an appropriate time after the end of the trading day.This would enable stock to be bought back should the market maker be unable to borrow sufficient stock by the end of the day on which the market making has occurred, and the opportunity to buy the stock is also no longer available. Without this change, it is likely that market making services will be curtailed well before the close of trading on any given day so that the market maker can ensure that they do not run out of time to borrow or buy back stock before the end of day.

We believe that there should be further opportunity for wider market consultation as to what the relevant time should be i.e. whether it should be a time on the following trading day or even later. Whilst this might be viewed as increasing the potential risk of settlement failure, we would again argue that this risk is low in relation to market making. There remain strong reasons for a market maker to do whatever is within their power to not wait until the following day to buy back the stock, given the overnight market risk and the imposition of fail fees for failure to settle the intial sale by T+ 3. Hence, we believe the risk arising from such a condition, including risk of abuse, would not be great.

C3Q2 Do you agree that the risk of settlement failure would be adequately mitigated if market makers were required to borrow section 1020B products to cover net short positions in products at the end of the sale day? Why/why not?

See answer to C3Q1 above.

C3Q3 Should we modify our existing client facilitation relief (see Table 1) by adding a condition in the form of proposal C3? Are there any other conditions we should include?

See answer to C3Q1 above.

C3Q4 What are your daily average costs of making covered short sales of section 1020B products to hedge risk arising from your market making business? Please include an explanation of the cost of borrowing products, your human resource costs and technology costs.

These costs will vary from Participant to Participant, depending on a range of factors such as the volume of business, relationships with lenders, and so on. SDIA understands that market makers may be providing some of this information to ASIC direct, given the commercially sensitive nature of some of this data.

C3Q5 What do you anticipate your daily average costs would be if the proposed naked short selling relief were granted? Please include an explanation of your anticipated cost of obtaining conditional holds over section 1020B products, your human resource costs and technology costs.

See answer to C3Q4 above.

C3Q6 How do your costs affect the spreads at which you are able to price the bids and offers you make in your market making business?

See answer to C3Q4 above.

C3Q7 How many settlement failures have you been responsible for during the period 1 March 2008 to 21 September 2008 and the period since 21 September 2008?

See answer to C3Q4 above.

C3Q8 Of these settlement failures, how many were associated with your market making activities? Please describe the circumstances of each such settlement failure.

See answer to C3Q4 above. We understand that this particular information is not the sort of statistic that is likely to be tracked by many market makers.

C3Q9 For each week during February and March 2009, what is the total volume of section 1020B products you sold (both long sales and short sales) to hedge risk arising from your market making business?

See answer to C3Q4 above.

C3Q10 For each week during February and March 2009, what is the total volume of section 1020B products you sold short to hedge risk arising from your market making business?

See answer to C3Q4 above.

C3Q11 For each week during February and March 2009, what is the total volume of section 1020B products you reported that you sold short?

See answer to C3Q4 above.

C3Q12 For each week during February and March 2009, what percentage of your reported short sales were short sales made in the course of your client facilitation business?

See answer to C3Q4 above.

We would be happy to discuss any issues relating to this matter at your convenience. Should you require any further information, please contact Peter Stepek, Policy Executive, on (02) 8080 3200 or email pstepek@sdia.org.au.

Yours sincerely,

David W Horsfield
Managing Director/CEO