



ASIC

Australian Securities & Investments Commission

REGULATION IMPACT STATEMENT

Short sale tagging

July 2012

About this Regulation Impact Statement

This Regulation Impact Statement (RIS) addresses ASIC's proposals to create a requirement for market participants to specify the quantity of a sell order that is short at the time the sale order is placed or at the time the trade is reported.

What this Regulation Impact Statement is about

- 1 This Regulation Impact Statement (RIS) addresses ASIC's proposal to introduce a new requirement for market participants to specify the quantity of a sell order that is short at the time the sale order is placed or at the time the trade is reported (otherwise known as 'real-time tagging').
- 2 This proposal applies to all market participants trading in section 1020B products, as defined in the *Corporations Act 2001* (Corporations Act), on a licensed market. These include securities, managed investment products and certain other financial products. The requirement applies to sales made on market and to off-market crossings.
- 3 In developing our final position, we have considered the regulatory and financial impact of our proposal. We are aiming to strike an appropriate balance between:
 - maintaining, facilitating and improving the performance of the financial system and the entities in it;
 - promoting confident and informed participation by investors and consumers in the financial system; and
 - administering the law effectively and with minimal procedural requirements.
- 4 This RIS sets out our assessment of the regulatory and financial impact of our proposed policy and our achievement of this balance.

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A Introduction

Background

5 Short selling is an activity where a person enters into an agreement to sell a security that the person does not currently own. Short sellers need to make arrangements to cover their delivery obligations to the buyer before they fall due (usually three trading days after the transaction is executed).

6 An investor may engage in short selling for a number of reasons. The most common reason is that they believe the security is overvalued and its price is likely to fall in the future. Short selling the security (a short sale transaction) will allow the investor to profit from this fall. However, not all short selling activity is linked to investors trying to profit from falling prices. For example, some investors (e.g. financial institutions) may engage in non-speculative short sale transactions to manage certain financial risks.

Current regulatory regime

7 Short selling is regulated by the *Corporations Act 2001* (Corporations Act) and the Corporations Regulations 2001 (Corporations Regulations). Division 5B of Part 7.9 of the Corporations Act and Division 15 of Part 7.9 of the Corporations Regulations set out the reporting and disclosure requirements for persons making short sales on a licensed market.

8 There are two separate short selling reporting requirements under the Corporations Act:

- (a) *short sale transaction reporting* is the reporting of daily volumes of section 1020B products that are short sold in the market; and
- (b) *short position reporting* is the reporting of instances where the quantity of a product that a person has is less than the quantity of the product that the person has an obligation to deliver.

These obligations apply to short sales of section 1020B products made on a licensed market, irrespective of whether the seller is in Australia.

9 This RIS relates only to short sale transaction reporting. It does not relate to short position reporting.

Short sale transaction reporting

10 Short sale transaction reporting is the reporting of daily volumes of section 1020B products that are short sold in the market. These volumes are aggregated for all short sale transactions in the market and made available to the public.

Figure 1: Example of a short sales report

ASX Code	Company Name	Product/ Class	Reported Short	% Short
AAH	ARANA THERAPEUTICS LIMITED	FPO	262,084	.01
AAX	AUSENCO LIMITED	FPO	4,258	.00
ABB	ABB GRAIN LIMITED	FPO B	316,595	.02
ABC	ADELAIDE BRIGHTON LIMITED	FPO	206,507	.00
ABP	ABACUS PROPERTY GROUP	STAPLED	50,978	.00
ABS	A.B.C. LEARNING CENTRES LIMITED	FPO	1,522,584	.03

Source: ASIC

- 11 The Corporations Act requires short sellers to advise their executing Australian financial services (AFS) licensee when the sale is a covered short sale.¹ In turn, the market participant² must report the disclosed covered short sale to the market operator. Market participants must also report principal covered short sales³ to the market operator.
- 12 The Corporations Regulations set the mechanics of disclosure for market participants, including the particulars of the information to be disclosed and the timing and manner of disclosure. Currently, the particulars required to be disclosed include:
- the number of products that are short sold;
 - the description of the product; and
 - the name of the entity that issued the product.
- 13 The market participant must provide these particulars by electronic transmission to the market operator at or before 9 am on the next trading day after it receives this information from the seller, or after it makes the sale on its own behalf.

¹ A covered short sale is a short sale supported by a securities lending arrangement.

² All AFS licensees that execute on a market are market participants.

³ Principal covered short sales are covered short sales made on the market participant's own behalf rather than on a client's behalf.

Purpose of current regime

- 14 The objective in regulating the disclosure of short selling is explained in the RIS to the *Short selling disclosure regime*,⁴ issued by the Treasury. Generally, it is to enhance market confidence and integrity by providing greater transparency to both investors and regulatory bodies about the short selling activity on Australian financial markets. In particular, the effective and timely disclosure of short selling activity:
- (a) indicates the level of short selling in particular stocks;
 - (b) explains certain share price movements;
 - (c) provides an early signal that individual securities may be overvalued;
 - (d) indicates that a proportion of the sales in an individual security will need to be reversed by new purchases (to cover the short seller's settlement obligations);
 - (e) enhances investors' willingness to participate in the market by removing uncertainty surrounding the level of short selling; and
 - (f) deters market abuse, or reduces the opportunities for market abuse, by enabling the market regulator to better identify instances of market manipulation.
- 15 Reporting of short selling activity is important in providing useful information to investors and regulators and also contributing to confidence and market integrity. At the time of the global financial crisis, the uncertainty surrounding the actual level of short selling activity in Australian securities compounded the direct impact of short selling because it was resulting in rumour and speculation in the marketplace. Especially in periods of market volatility and uncertainty, timely and accurate information to the regulator and the market is important.
- 16 The Government has described the reporting of short sale transactions ('transactional reporting') as providing 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 market 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, such as share price manipulation. This is because the information is likely to be more detailed than short positional information, as it identifies individual short

⁴*Short selling disclosure regime: Regulation Impact Statement*, Treasury
<http://www.comlaw.gov.au/Details/F2009L04316/72708018-7927-4d2a-9c99-63c7c8d3684b>

sale transactions. Regulators can use this information as an audit trail when conducting investigations.

- 17 For more information on the reporting and disclosure requirements relating to short selling, please see Regulatory Guide 196 *Short selling* (RG 196).

International developments

- 18 ASIC also recognises the need for a degree of international consensus in relation to regulating short selling. On 19 June 2009, the International Organization of Securities Commissions (IOSCO) taskforce released a final report on the regulation of short selling.⁵ The report identified four general principles for the effective regulation of short selling. IOSCO's four principles are:

- (a) short selling should be subject to appropriate controls to reduce or minimise the potential risks that could affect the orderly and efficient functioning and stability of markets;
- (b) short selling should be subject to a reporting regime that provides timely information to the market or to market authorities;
- (c) short selling should be subject to an effective compliance and enforcement system; and
- (d) short selling regulations should allow appropriate exceptions for certain types of transactions for efficient market functioning and development.

- 19 Jurisdictions such as Canada, Hong Kong, Japan and the United States require the tagging of short sales when orders are submitted to the exchange markets for execution. The European Commission indicated in September 2010 its intention to introduce real-time tagging of short sale transactions.

Scope of this RIS

- 20 This RIS assesses the regulatory impact of options to achieve ASIC's objectives of timely, efficient and more accurate collection and dissemination of short selling information.
- 21 It does not discuss in detail the impact of the short selling disclosure regime (an existing RIS addresses this⁶). Rather, this RIS focuses on the impact of proposals specifying the timing of reporting by market participants.

⁵ 'Regulation of short selling', IOSCO, June 2009, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD292.pdf>

⁶ Corporations Amendment (Short Selling) Bill 2008, Explanatory Memorandum, available at <http://www.comlaw.gov.au/Details/C2008B00261/Explanatory%20Memorandum/Text>: see Chapter 5, 'Regulation Impact Statement'.

Assessing the problem: The regulation of short selling in Australia

How are market participants currently complying with their disclosure obligations?

- 22 The regulations prescribe that disclosure must be made by electronic transmission to the market operator at or before 9 am on the next trading day. This represents the minimum requirement and allows market participants to report total short sales at the end of the trading day. Market participants manually record the number of products that they short sell for each transaction and aggregate this number at the end of each trading day. The daily volume of short sales by product is sent to the market operator.⁷ This process is time-consuming—market participants estimate that this process takes them one to two hours each day—and only provides ASIC with aggregate information, without any detail at the transactional level to provide an audit trail to assist in investigations.
- 23 Further, we estimate that approximately 60% of market participants have difficulties complying with their transactional reporting obligations because they utilise algorithms when trading (rather than the traditional manual method of a broker entering an order into the market). Algorithmic trading allows trade execution at higher speeds than through traditional methods. Consequently, a larger volume of trades may be executed within a period of time than is possible with traditional manual trading.
- 24 Compliance with the transactional reporting obligations necessarily requires a market participant to know at the time of making a sale (i.e. at the time of placing an order into the market) the number of products that are being short sold. For market participants that utilise algorithmic trading to be able to comply with the current transactional reporting obligations, they will need to build into their algorithms or systems a way of calculating the number of products for each trade that are short sold at the time of placing the order into the market. This must necessarily be on a real-time basis.
- 25 Industry has acknowledged this difficulty in complying with the transactional reporting obligations (i.e. by manually recording short sales) and using algorithmic trading simultaneously. It was decided, in accordance with industry, that ASIC would issue a no-action position for breaches of short sale transaction reporting obligations in specific circumstances for a period of time.

⁷ On receipt of reports by each market participant, the market operator aggregates this data and publishes a 'daily gross short sales' report that is intended to reveal the overall level of short selling that takes place on the market each day, as well as the proportion of trades in a particular security that are short sales.

26 ASIC has maintained this no-action position since 19 November 2008, stating its intention to minimise the disruption of market turnover while market participants that use algorithmic trading amend their systems to comply with any future requirements that enhance the reporting regime.⁸ The industry has been aware since 2008 that changes to the regime have been forthcoming and acknowledged that adjustments are necessary to provide a framework whereby the Australian market can achieve more accurate reporting of short selling activity. If these adjustments are not implemented by industry, ASIC will need to reconsider its no-action position.

What are the difficulties?

27 We estimate that more than 60% of market participants on ASX utilise algorithms for trading.⁹ Approximately 60–70% of orders entered into the market are generated by algorithms. This means that for 60–70% of orders entered into the market, market participants are not identifying whether they are short sales and these are not currently being reported to the market operator.

28 The current regulations are not adequately achieving the objectives of the disclosure framework to provide an accurate 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 market each day. The current regulations provide a sub-optimal result:

- (a) they are not conducive towards timely reporting of 60–70% of orders entered into the market (those generated using algorithmic trading), which means that not all market participants are complying with the law; and
- (b) current short sale transaction reports do not accurately reveal the level of short selling in the market—they only reflect approximately 30–40% of orders entered into the market as algorithmic trading is not captured.

Therefore, the overarching purpose of the short selling disclosure regime is considerably undermined by the fact that some 60–70% of transactions go unreported to ASIC.

29 The lower levels of reporting do not provide meaningful reports to assist ASIC in its market surveillance activities, or to investors that use these reports to assist in making their investment decisions. Investors receive short sale transaction information that is only representative of 30–40% of orders entered into the market, and ASIC receives aggregate short sale transaction

⁸ For more information, see ASIC Media Release 08-211 *Requirements for disclosure and reporting of short sales from 19 November 2008*.

⁹ This figure is based on the automated order processing (AOP) certifications that ASIC receives from market participants. Under Rule 5.6.6 of the ASIC Market Integrity Rules (ASX Market) 2010, before using a system for AOP (i.e. the system through which algorithms are used to process orders), market participants must give a written certification to ASIC that their system complies with certain requirements.

information that is only 30–40% complete, on a next-day basis. As the data is produced in aggregate form, ASIC is required to trace through and complete complex data-mining exercises to isolate short selling activities of interest. As the current short sale reporting framework does not achieve the objectives of the regulations, it requires refinement.

- 30 Enhancing short sale disclosure is in line with the principles of short selling recommended by IOSCO. It specifically enhances Australia’s short selling regime in relation to the second principle—that ‘short selling should be subject to a reporting regime that provides timely information to the market or to market authorities’.¹⁰

Objectives of government action

- 31 The objective of government action is:
- (a) the efficient collection of short selling information from market participants; and
 - (b) the accurate and timely dissemination of short selling information to the market regulator and the market.
- 32 Because the current regulations are not conducive to the reporting of algorithmic trading (which constitutes some 60–70% of orders generated on the market), the overall objective of government action is to create a framework that facilitates the reporting of these trades to ASIC.
- 33 The creation of the reporting framework will allow market participants to comply with the regulations, and therefore give effect to the underlying purpose of the short selling disclosure regime.

¹⁰ ‘Regulation of short selling’, IOSCO, June 2009, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD292.pdf>

B Options and impact analysis

Implementation options

Option 1: ASIC requires market participants to disclose information about a short sale at the time of making the transaction (preferred option)

- 34 This involves placing an obligation on market participants, through a new market integrity rule, to disclose short sale information at the time of making the transaction (otherwise known as ‘real-time tagging’). This would enable more efficient collection of short selling information from sellers and market participants and result in transactional (not aggregated) reporting to ASIC. ASIC would be able to use this information as an audit trail to ascertain which parties are making short sales in the market. ASIC, or a third party, would produce a single report of aggregated short selling activity by product, which would continue to be made public the following day.
- 35 The proposed market integrity rule would not change the existing short sale transaction reporting obligations in the Corporations Act in terms of:
- (a) the types of transaction to be disclosed;
 - (b) the particulars that are to be disclosed;
 - (c) the scope of the obligations; or
 - (d) the persons responsible for making disclosures.
- 36 The proposed market integrity rule would specify the *timing* of reporting required by market participants to improve the efficiency of the reporting process and the accuracy of information that is available to the market.
- 37 Compliance with the requirement would rely on information technology (IT) systems to manage short sale orders in a particular manner. However, we do not propose to prescribe specific IT systems that market participants use to comply. Implementation of these systems is key to improving the efficiency of the information collection process, and the accuracy and completeness of the resulting information.

Option 2: ASIC removes the no-action position and market participants must comply with the regulations (market participants continue to disclose information about short sale transactions on an aggregated basis at the end of the day)

38 Under Option 2, the disclosure framework would continue to rely on manual aggregation and reporting of short selling activity in the market at the end of each trading day.

39 ASIC would receive the same information as the public—an aggregated report on the following trading day: see the example in Figure 1.

40 However, ASIC would remove the no-action position in relation to algorithmic trading, and market participants would need to comply with the regulations. To avoid breaching their obligations under the regulations, market participants that engage in a high proportion of algorithmic trading may need to change their systems to enable them to make short sale transaction disclosures for algorithmic trading. This would increase the accuracy of short selling information to the market compared with the status quo.

Option 3: ASIC grants permanent relief under the current no-action position

41 Under Option 3, ASIC would extend its current no-action position on short selling transaction disclosure. This may require providing relevant market participants with class order relief from complying with the regulations in relation to algorithmic trading. This would extend the current position indefinitely.

42 Option 3 would provide for a minimum framework in which there is some short selling information available to the market on a next-day basis.

Impact analysis

Option 1: ASIC requires market participants to disclose information about a short sale at the time of making the transaction (preferred option)

Impact on industry

43 We expect that the new market integrity rule proposed under this option would affect market participants because the proposals apply to them directly. There would also be some impact on market operators.

- 44 ASX is currently the main operator of the market in section 1020B products.¹¹ This is likely to change following the introduction of competition and the commencement of Chi-X Australia operating a market in certain products quoted on ASX since 31 October 2011.
- 45 At present, there are approximately 100 market participants, and around 150 indirect market participants, that use market participants' authority to trade on behalf of their clients as a substantial part of their business model.¹² The market is relatively concentrated. The largest 12 ASX market participants accounted for 81% of the value of equities traded in 2009–10. The five largest market participants currently account for around half of the total volume of trades. The concentration of trading in the equity exchange market has changed very little over the past decade, with the majority of the top 12 market participants servicing institutional clients.
- 46 We estimate that more than 60% of market participants of ASX utilise algorithms for trading. Approximately 60–70% of orders entered into the market are generated by algorithms. The use of algorithms has increased in past years and is likely to continue to increase, based on experiences overseas and the trends in the domestic market to date.
- 47 Changes to market participants' technical systems would be likely as a result of the implementation of Option 1. The extent of technical systems changes required for each market participant would depend on their existing systems, and the availability of vendor systems that are compatible with their existing systems and that meet their needs:
- (a) The industry consultation found that market participants without existing capabilities in place to comply with Option 1 would need to implement substantial modifications to their order management systems. They anticipate these would incur a cost. Most of the 12 larger market participants running an automated trading platform (utilising algorithmic trading) estimate that it is likely they would incur costs of between \$80,000 and \$2 million to implement real-time tagging. This would be a one-off cost and could be offset against the ongoing cost of manual reporting. The costs would be lower for the remaining approximately 80 smaller market participants. It is likely that most of these smaller market participants would rely on a vendor to provide a systems solution. The cost of this is not known at this stage. One market participant provided an estimate that this would take four months depending on other IT changes being implemented at the same time.

¹¹ There are also a small number of exchanges that cater for small and micro capitalisation companies.

¹² Of the population of indirect market participants, identified at 1400, 150 have more than \$50 million in trading volume or more than 100 clients.

- (b) Some market participants stated that they began developing modifications to their systems in or around 2008, when ASIC first indicated its intention to introduce such a proposal. These participants would require further development and resource allocation to comply with the proposal.
- (c) One market participant indicated that it would be possible to utilise existing systems available to the market (subject to market operators accepting information in compatible formats).
- (d) One market participant indicated that it was already able to comply with the proposal and would not require any systems changes.

While questions were asked during consultation about specific costs to industry, responses received were not conducive to precise quantification of the costs other than what is stated above.

- 48 Market participants may incur other costs in complying with the proposed obligation. These primarily involve explaining to clients the changes to the electronic order systems (for those who interact with these systems), and educating traders on the change to process.
- 49 ASIC estimates that market participants would incur not more than \$10,000 each to make these changes.¹³ Costs would depend on the nature of the market participant, including the number of advisers and number of clients, and also the method of education and training (e.g. workshops, external training providers, online modules). For some, costs would be negligible as the market participant may be easily able to incorporate these requirements within existing procedures.
- 50 We expect that the main costs would arise from:
- (a) client education, which would likely be provided via a mailed-out newsletter or email. At a rate of \$50 per hour, we estimate this would take a maximum of 10 full-time equivalent (FTE) hours to draft and publish the newsletter, and one to 10 FTE hours to distribute. Costs would also depend on whether the newsletter is sent via postal mail or email, and the number of clients: \$200–\$5,000;
 - (b) training traders about the change in process. Because traders already record the number of sales that are short for each transaction, training would mainly consist of explaining to traders the differences in procedure when entering the order. We estimate that it would take up to five FTE hours to prepare a training session, consisting of a half-hour presentation. The number of presentations would depend on the number of traders and the form of training (e.g. face to face, online module): \$300–\$5,000; and

¹³ Industry did not provide any accurate figures on these costs, and, as such, these numbers are estimated by ASIC.

- (c) documentation to reflect the change in process, which would be made available to relevant people in the organisation. We estimate that this would require up to 20 FTE hours to create new or change existing documentation: up to \$1,000. This may be considerably less for smaller firms.

51 Market operators may need to develop or modify their systems for collection of this information from market participants. Because aggregation and publication of the daily volume of short sales in each product by market operators is already required by the Corporations Act, there would be minimal significant changes to systems for these purposes. Market operators (existing and prospective) have indicated that they either would be able to facilitate the collection of this information through changes to their trading system, or were already capable of doing so.

Benefits

52 Option 1 aims to enhance the accuracy and efficiency of the current short sale transaction reporting regime. The proposal automates the process of:

- (a) recording the volume of short sales in each short sale transaction;
- (b) aggregating the information to produce daily data for each security; and
- (c) sending the information to the market operator (see paragraph 22).

53 All market participants that are AFS licensees are required to comply with transactional reporting obligations on a daily basis. Automating this process would reduce the time and costs associated with reporting short sale information to the market operator. It would remove the need for market participants to spend one to two hours each day to record, aggregate and send the reports. However, industry did not indicate specific dollar amounts that this would equate to.

54 Real-time tagging allows for more effective and accurate disclosure of short selling activity. It:

- (a) increases the transparency of short selling activity to the market;
- (b) enhances the market analysis and surveillance efficiencies of the market supervisor; and
- (c) builds confidence in the integrity of Australia's capital markets.

55 It does this by reducing the margin for error in manual reporting, and providing a sustainable solution to under-reporting as a result of the practical difficulties posed by algorithmic trading. It would enable market participants to use algorithmic trading and comply with short sale transaction reporting obligations under the law at the same time: see paragraphs 23–26. Both market participants and market operators would benefit from the increased efficiencies in process as a result of this proposal.

56 Investors, which may include market participants (e.g. those engaging in proprietary trading), would benefit from receiving more accurate reports of short selling activity, which may assist them in their buying and selling decisions.

57 Real-time tagging would help to build investor (and potential investor) confidence in the integrity of Australia's financial markets because it would assist ASIC's market surveillance activities. This would improve the performance of the financial system and the overall efficiency and development of the Australian investment landscape, and facilitate international capital flows. It would bring the Australian market into line with other markets internationally.

Impact on consumers

58 For the purposes of this RIS, retail investors are categorised as consumers. Retail investors consistently represent between 15% and 20% of equity market turnover.

59 We expect that retail investors would see minimal change to their trading experience as a result of Option 1. Short selling is relatively rare among retail investors. Those who do partake in short selling may be informed by their market participant of the changes taking place. Market participants should already be asking sellers about short sales under section 1020AE of the Corporations Act, so there should be no significant change to investors' interactions with market participants.

60 Some retail investors who interact with market participants' systems when placing orders (e.g. online trading or trading through an automated trading platform) should already be familiar with disclosing the required particulars under the law.¹⁴ This would not change if Option 1 is implemented. There may, however, be some changes to the interfaces offered by some market participants, which may result in a slight change to process by retail investors (for those who place orders through an automated trading platform, rather than through a broker). Ordinarily, when placing an order, these investors may need to input specific information, including the product they wish to transact in, whether they wish to buy or sell the product, and the price and volume at which they wish to transact. Under this option, investors may also need to state whether any of the products are being short sold, and the number of products that are intended to be short sold.

61 It is unlikely that consumers would be affected by any material cost changes, because (apart from the initial one-off costs) there would be no long-term increased marginal costs to industry that would be passed on to consumers.

¹⁴ Online brokers generally require their clients to hold the positions prior to selling unless previous arrangements have been made so these retail investors who trade through online brokers are less likely to be affected.

In fact, market participants may even pass on cost savings under an automated real-time tagging system.

Benefits

62 Option 1 aims to enhance the accuracy of reports of short selling activity to the market. Retail investors would benefit from receiving more accurate reports of short selling activity, which may assist them in their buying and selling decisions.

63 The proposed market integrity rule would also help to build investor (and potential investor) confidence in the integrity of Australia's financial markets as real-time tagging would enhance ASIC's market surveillance efficiencies and functions.

Impact on Government

64 As a result of additional intelligence, the proposed market integrity rule may impose some additional costs on ASIC in the form of supervisory and surveillance costs. ASIC already has infrastructure in place to capture trading information through data feeds. The additional transactional short sale information would be included in these feeds from market operators so the regulatory impact of transactional reporting would not be expected to be significant from ASIC's perspective.

Benefits

65 ASIC currently has access to information about short selling activity in the market on a post-trade basis. This proposal would give ASIC a well-informed view of short selling as it occurs, and equip ASIC to quickly analyse the market for supervision and surveillance purposes as the information would be collected and stored in a database automatically. ASIC would expect to gain synergies from receiving the information in an appropriate format so that the data can be stored and searched through rationally (at present, to collate short sale transaction information, it must be entered manually into ASIC's database).

66 Real-time tagging would help ASIC to:

- (a) indicate the level of short selling in particular stocks and the parties that are partaking in this short selling—this is important when analysing market manipulation matters;
- (b) explain certain share price movements—this is important when analysing the market for compliance with continuous disclosure obligations and market manipulation; and

- (c) generally deter market abuse, or reduce the opportunities for market abuse, by enabling the market regulator to better identify instances of market manipulation.

Option 2: ASIC removes the no-action position and market participants must comply with the regulations (market participants continue to disclose information about short sale transactions on an aggregated basis at the end of the day)

Impact on industry

- 67 If Option 2 is adopted and market participants can no longer rely on a no-action position from ASIC, they may require systems changes to comply with the regulations. Market participants that utilise algorithmic trading may need to implement systems to be able to calculate which of their algorithm-generated orders are short sales and how much of each product is short sold at the time of making the sale: see paragraph 24. This could mean that market participants would need to amend their technical systems at a cost that is similar, if not the same, as that required for real-time tagging—estimated at between \$80,000 and \$2 million. This is because the systems changes that are required to ascertain how many products are being short sold at the time of the sale make up the core of the costs in implementing real-time tagging (Option 1).
- 68 Option 2 would not be conducive to the use of algorithmic trading because it would pose difficulties for market participants that utilise algorithmic trading to fully comply with their transactional reporting obligations: see paragraphs 23–26. ASIC would need to reconsider its no-action position if real-time tagging is not implemented. If a sustainable solution is not introduced, market participants may not be able to continue to use algorithmic trading. This represents about 60–70% of orders submitted to the market and could result in a significant disruption to market turnover: see paragraph 27.
- 69 Industry confidence in the integrity of the market may also be compromised because ASIC would have access to less real-time information about market activity to enable it to efficiently carry out its market supervision functions. If markets enter a period of volatility similar to that experienced in the global financial crisis, ASIC would not have timely access to the necessary intelligence to allow it to respond quickly and appropriately.

Benefits

- 70 If Option 2 is adopted, the industry would have a more accurate gauge on the level of short sale transactions that occur on a daily basis. This may result from an increased level of reporting due to systems changes by market participants to make short sale transaction disclosures for algorithmic trading, or alternatively may result from a substantial reduction in the level

of algorithmic trading because of difficulties in complying with the disclosure obligations.

Impact on consumers

- 71 If industry incurs additional costs in complying with the regulations, it is likely that these costs would be passed on to consumers. Therefore, consumers may face increased transaction costs when engaging brokers or increased costs in obtaining reports.
- 72 It is likely that, if market participants are unable to comply with the regulations for algorithmic trading, these services would be removed from the market. As a result, consumers would have a smaller amount of choice in their investment options with one method of trading effectively withdrawn.

Benefits

- 73 Although they do not capture all short selling activity in the market, the current reports still provide some indication of short selling activity, which may be of use to some consumers.

Impact on Government

- 74 If market participants must comply with the existing regulations, access to real-time information on short selling activity would not be available to ASIC to enable it to identify changes in short selling behaviour at the time it occurs, or the parties behind short selling activity of interest. This currently hampers ASIC's ability to supervise the market because it requires additional time and resources to determine whether short selling activity is taking place in a particular stock and the parties behind this activity.
- 75 Confidence in the integrity of the market may be compromised as a result, and the Australian markets may become less attractive for international capital flows.

Benefits

- 76 ASIC would continue to have access to the levels of short selling activity in the market on an aggregated and delayed next-day basis. This could provide ASIC with an initial source of investigation to discover the parties behind the short selling activity.
- 77 If many market participants withdraw from algorithmic trading, this may mean that ASIC does not have to monitor as many trades and, therefore, supervision may be less resource intensive.

Option 3: ASIC grants permanent relief under the current no-action position

Impact on industry

- 78 If ASIC extends its current no-action position indefinitely, market participants would not have to comply with the transactional disclosure requirements in relation to algorithmic trading. This would extend the current position indefinitely.
- 79 For all trading other than algorithmic trading, the status quo is a time-consuming and inefficient process for market participants to comply with their transactional reporting obligations under the law. Manual recording, aggregation and reporting is required on a daily basis and affects all market participants that are AFS licensees: see paragraph 22. Market participants would continue to spend one to two hours each day to comply with the transactional reporting obligations. This cost would remain ongoing. Market participants did not state the specific dollar amount costs as a result of complying with this transaction reporting obligation.
- 80 As mentioned in paragraph 27, we estimate that 60% of market participants use algorithmic trading, and 60–70% of orders entered into the market are generated by algorithms, which would be excluded from disclosure under the current no-action position. International developments have demonstrated that these figures are likely to grow over the near term. If ASIC continues its no-action position indefinitely, these transactions would continue to be exempt from the reporting requirements under the regulations.
- 81 This would minimise costs for industry in relation to algorithmic trading as market participants would essentially not have to comply with the regime for these transactions. This would mean that industry would have no additional costs from its current position.
- 82 However, as noted in paragraph 47, many market participants have already commenced developing infrastructure to comply with the proposed requirements under Option 1 in anticipation of a requirement for real-time tagging. If ASIC reverses its position, these market participants would have expended a large degree of costs unnecessarily.

Benefits

- 83 The main benefit of ASIC continuing its no-action position is that industry would not have to incur any additional costs to comply with the disclosure regime for its algorithmic trading activities.
- 84 However, this would mean that the purpose of the short selling regime would continue to be undermined by the use of algorithmic trading.

Impact on consumers

85 Retail investors would continue to receive reports of short selling activity that are not as accurate as they could be—not least because there is a larger margin for error in manual reporting and current reports do not capture short selling transactions arising out of algorithmic trading. This may compromise the usefulness of the reports in assisting investors' buying and selling decisions because they would not be fully informed about the activities of short sellers, and thus may not be able to fully explain share price movements and may make investing decisions based on incomplete information. For example, if a company's share price is particularly volatile, interested parties may 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. Since current reports only reflect approximately 30–40% of orders submitted to the market, investors may not be able to see the short selling activity that has actually occurred in the stock, leading investors to apportion other factors to the share price volatility.

86 Investor confidence in the integrity of the market may also be compromised because ASIC would have access to less real-time information about market activity to enable it to carry out its market supervision functions efficiently. After the global financial crisis, for example, the availability of short selling information was critical. Without a permanent and effective disclosure regime in place, investors may be inhibited from participating in the market.

Benefits

87 There would be very limited benefits to consumers in maintaining the no-action position in preference to Option 1.

88 The primary effect is that consumers would continue to receive the same limited information in their reports.

Impact on Government

89 Access to real-time information on short selling activity would not be available to ASIC to enable it to identify changes in short selling behaviour at the time it occurs, or the parties behind short selling activity of interest. This currently hampers ASIC's ability to supervise the market because it requires additional time and resources to determine whether short selling activity is taking place in a particular stock and the parties behind this activity. Especially in periods of market volatility and uncertainty, such as during the global financial crisis, ASIC requires accurate and timely information to respond quickly to market disruptions and wider market-moving events. With the current reports only reflecting about 30–40% of orders entered into the market, ASIC—and the wider market—does not receive the complete picture on short selling activity. Maintaining the status

quo would severely hamper ASIC's ability to effectively supervise the market and take proper action when required because it would not be able to observe the behaviour for 60–70% of transactions.

- 90 Furthermore, by allowing a long-term exemption from the short selling disclosure requirements, ASIC would effectively be undermining the Government's intention to have a short selling disclosure regime to the extent that the no-action position applies to short selling activity through algorithmic trading.

Benefits

- 91 The primary benefit of extending the no-action position is that ASIC would not have to incur any additional costs in expanding systems and the number of staff to monitor short selling activity deriving from algorithmic trading.

C Consultation

- 92 ASIC has engaged in targeted consultation with stakeholder groups in relation to short sale disclosure since 2008. Initially, this was in the context of wider discussions with industry about the general short selling disclosure regime. These discussions focused on identifying current market practice, the scope for additional disclosure of covered short sales and the likely impact on industry of any regulatory change. The real-time tagging proposal (Option 1) became unworkable at the time of the short selling ban for technical reasons and resulted in the deferment of the introduction of the proposal.
- 93 Despite the deferment of the proposal, ASIC continued to engage in targeted consultation with stakeholder groups. This included a range of market participants, industry associations (such as the Australian Financial Markets Association and the then Securities and Derivatives Industry Association (now the Stockbrokers Association of Australia)) and ASX. Taking into account industry comments, it was decided during 2009 to further delay implementation of the proposal to enable the industry to manage other changes in the market (e.g. the transfer of market supervision from domestic financial markets to ASIC on 1 August 2010) and to align the system changes with those required for the introduction of competition in exchange markets.
- 94 An industry advisory group to the Commission has been in place since before the transfer of supervision in 2010 and throughout the entirety of the project to introduce competition in exchange markets. The industry advisory group has helped to inform the policy development and now advises on implementation and practical issues. We have discussed with the advisory group, since 2010, our intentions to introduce a real-time tagging requirement.

CP 145 consultation

- 95 We formally consulted publicly on the real-time tagging proposal as part of the consultation package on enhancing the regulation of Australia's equity markets, including the introduction of competition in exchange markets. The consultation package was released publicly on 4 November 2010 and included:
- (a) a detailed consultation paper—Consultation Paper 145 *Australian equity market structure: Proposals* (CP 145);
 - (b) draft market integrity rules; and
 - (c) a supporting economic report on Australian equity market structure—*Australian equity market structure* (REP 215).

Consultation for CP 145 closed on 21 January 2011.

- 96 We have held meetings on real-time tagging with at least 10 stakeholders since CP 145 was published to discuss further issues that industry faces. Industry associations—the Australian Financial Markets Association and the Stockbrokers Association of Australia—have also been engaged.

Overview of responses to CP 145

- 97 We received 16 written responses about the real-time tagging proposal in CP 145 from a broad range of stakeholders, including market operators, industry associations, market participants, high-frequency trading firms and others from the data vendor and technology sectors.
- 98 There was mixed feedback, as shown below, on the proposal, generally corresponding to the capability of the respondents' systems to implement such a proposal:¹⁵
- (a) Several respondents were supportive of our proposal to eliminate manual reporting.
 - (b) Concerns were raised by some respondents around implementation difficulties and costs. Several respondents recognised that the obligation to disclose short sales already existed and that the capability for real-time tagging was already available to the market. Generally, respondents stated that implementation was achievable if sufficient time was provided.
 - (c) One association submitted that the existing short sale requirements were in line with IOSCO principles on short sale reporting, and that any change should be made through amendments to existing regulations, rather than through new market integrity rules.
 - (d) Some clarification was sought around the application of the rule.
- 99 We have taken into account feedback from consultation on whether transitional arrangements are necessary and have tailored our proposal to take into account this feedback.
- 100 We found that parts of the industry require some guidance on their existing obligations under the Corporations Act, and clarification on how the proposed market integrity rule would work in practice. We propose to release guidance to assist industry in complying with the rule.
- 101 The other main concern raised in the feedback was the timing of implementation and the use of finite resources for a number of other impending changes required by industry. In response, we propose to allow market participants a transitional period, until 10 March 2014, to allow for systems and process changes and the education of traders and clients.

¹⁵ See paragraph 47.

D Conclusion and recommended option

- 102 We recommend Option 1 because the benefits are significant at potentially similar costs to Option 2. We do not recommend Option 3, because substantially less information is disclosed, which would undermine the Government's intent under the short selling disclosure regime. In introducing a real-time tagging requirement for market participants, the daily reporting process that market participants are required to undertake would become more efficient. Transparency of short selling activity would also be increased as the daily reports published to the market would be more accurate than under the current regime because of the difficulty of capturing short sale transactions executed using algorithmic trading strategies.
- 103 This option would give ASIC a well-informed, disaggregated view of short selling in real time and equip ASIC to quickly analyse the market for supervision and surveillance purposes. The importance of this ability for a regulator has been highlighted during the experience of the global financial crisis.
- 104 Option 1 has been discussed with industry since 2008, when ASIC and ASX first began working with industry to develop arrangements for disclosure and reporting of short sales when the ban on covered short selling was lifted. Industry has envisaged the implementation of Option 1 since 2008 as it has been, and continues to be, foreshadowed in ASIC's interim no-action position for algorithmic trading.
- 105 Our proposal to introduce real-time tagging is in line with the principles of short selling recommended by IOSCO. It specifically enhances Australia's short selling regime in relation to the second principle—that 'short selling should be subject to a reporting regime that provides timely information to the market or to market authorities'.¹⁶
- 106 Jurisdictions such as Canada, Hong Kong, Japan and the United States require the tagging of short sales when orders are submitted to exchange markets for execution. The European Commission indicated in September 2010 its intention to introduce real-time tagging of short sale transactions. When investors choose from international markets to invest their capital, one consideration is the integrity of the markets and the efficacy of the markets regulator. If ASIC is better equipped to perform its market supervision functions, the Australian market would stand as an attractive location for international capital flows.

¹⁶ 'Regulation of short selling', IOSCO, June 2009, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD292.pdf>

- 107 We believe that Option 2 is not supportable because it does not address the problem of inaccurate and incomplete reporting due to the practical problems faced by market participants when using algorithmic trading. If Option 2 is adopted, and industry can no longer rely on ASIC's no-action position, industry may nevertheless require systems changes and costs of a similar magnitude to those incurred if Option 1 were to be adopted.
- 108 Option 2 also represents an inefficient method for the information to be collated and disseminated to the market regulator and investors. It does not provide a sustainable solution to the difficulties that algorithmic trading poses for market participants in complying with their short selling disclosure obligations under the law, and does not address the information inaccuracies arising from this issue.
- 109 Under Option 2, access to real-time information on short selling activity would not be available to ASIC. This would continue to hamper our ability to supervise the market, especially in periods of market volatility and uncertainty (such as those experienced in the global financial crisis) that require timely actions and a proactive approach.
- 110 We consider that Option 3 is also not feasible because industry would still incur significant ongoing costs associated with manual aggregated reporting. Furthermore, the current no-action position means that ASIC does not receive short selling information for some 60–70% of transactions. This means that ASIC is not able to determine whether these transactions are short, and is therefore unable to monitor and supervise these transactions.
- 111 Furthermore, Option 3 goes against the Government's intent that the short selling disclosure regime should apply to a large proportion of transactions. Given that algorithmic trading accounts for some 60–70% of all transactions, providing permanent relief would mean that these transactions would not be complying with the short selling disclosure regime.
- 112 Option 1 enhances the quality of reports to the market, and also provides significantly more useful and timely information to ASIC for market surveillance purposes in comparison with Option 2. Considering that the costs for industry of complying with the requirements under Option 2 may be of a similar magnitude to those incurred under Option 1, and that Option 1 greatly enhances the disclosure of short selling information, Option 1 is preferred.

E Implementation and review

Mechanisms for implementing the proposals

- 113 The proposed market integrity rule would supplement the Corporations Act and Corporations Regulations. Prior to ASIC's adoption of its markets supervisory function in August 2010, it was considered best to determine the enhancements to short sale transaction reporting via the ASX Market Rules because they applied to market participants only—that is, those who need to report to the market operator—and the reporting mechanisms related directly to the interaction between market participants and ASX.
- 114 As many of the ASX Market Rules have been adopted and become ASIC market integrity rules, we intend to implement our proposal through the market integrity rules. This is a rule-making power that ASIC received as a result of its new supervisory function under the *Corporations Amendment (Financial Market Supervision) Act 2010*.
- 115 Market integrity rules are legislative instruments. ASIC requires Ministerial consent before making any rules, and any rules are subject to Parliamentary disallowance.¹⁷
- 116 The proposed market integrity rule would supplement existing ASIC Market Integrity Rules (ASX Market) 2010 and ASIC Market Integrity Rules (Chi-X Australia Market) 2011. The proposed market integrity rule would also supplement market integrity rules that are implemented to address issues arising from competition in exchange markets—the ASIC Market Integrity Rules (Competition in Exchange Markets) 2011.

Implementation and transitional arrangements

- 117 We expect that the proposal would take time and investment to implement. We propose to allow market participants a transitional period, until 10 March 2014, to allow for systems and process changes and the education of traders and clients. We also intend to release guidance to assist industry in complying with the rule.

¹⁷ A House of Parliament may disallow a market integrity rule within 15 sitting days after it is tabled in the House if a motion to disallow has been given and, within the 15 days, a resolution to disallow is passed, the motion is not withdrawn or the motion is not acted on.

Review of regulatory framework

- 118 ASIC is conscious of the need to effectively engage with industry to ensure the preferred approach is implemented in a way that minimises regulatory costs. ASIC would engage with industry periodically throughout the transitional period, and once the market integrity rule is in operation, to ensure that it is operating effectively.