



Securities lending activities add liquidity and efficiency to the market place, supporting the trading activities and strategies in all major markets



INDUSTRY NEWS

Member Newsletter – March 2010

Chairman's Statement

In 2009 the industry experienced unprecedented events in financial markets which had ramifications not just in Australia but across markets worldwide. The purpose of this newsletter is to provide a reference for industry participants of the events directly affecting the Australian market, the actions taken by the securities lending industry and in particular ASLA, and the outcomes we have witnessed as a result. Whilst contemplation of the events of last year is an important exercise, we also look forward to 2010 with an air of optimism around the Australian market. ASLA will continue to work for the benefit of the broader securities and investment industry, providing information and education on the liquidity and stability benefits that securities lending brings to financial markets.

Peter Martin, Chairman

ATO exemption for CGT in the event of counterparty default

Australia remains out on a limb compared to major developed markets regarding CGT application to securities lending transactions.

In February 2009 ASLA made a submission to the ATO seeking Capital Gains Tax exemption to the requirement that securities lent be returned by the borrower to the lender within 12 months, in the event of counterparty default or for suspended securities. This requires amendments to section 26BC of the Income Tax Assessment Act regarding securities lending. This request for exemption is still pending, leaving Australia with a potential exposure that has been addressed in overseas markets. When the first of these anomalies was drawn to the attention of the tax authorities in the US and UK, their corresponding securities lending laws were quickly changed to remove the issue. ASLA will keep members informed of any progress on this issue.

ASIC lifts ban on short selling financial securities

On 25 May 2009 ASIC lifted the short selling ban on financial stocks listed on the Australian Stock Exchange – putting Australia back on par with other major developed markets. The move was welcomed by ASLA as being in the best interests of all market participants – enhancing liquidity and ensuring a level playing field for investors.

ASLA continues to support the views of other industry bodies such as IFSA and ACSA in the promotion of discussion and actions that contribute to market liquidity, efficiency and fair market pricing without compromising the need for the highest levels of market integrity, competitiveness and investor confidence. ASLA issued a media release to the market on the day of the ASIC announcement - full details of ASLA's position can be found [here](#).

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Market maker exemption

On 4 June 2009 ASLA sent a submission to ASIC Consultation Paper 106: Short selling to hedge risk from market making activities, supporting the proposition that an exemption be made available for market makers. The submission noted that ASLA supports all measures to promote liquidity and efficiency in the equities market and, in turn, the securities lending market. In September 2009, ASIC issued **Report 167** Response to submissions on CP 106 Short selling to hedge risk from market making activities which granted relief allowing short sellers to hedge risk from market making activities, subject to conditions. Those conditions include: (a) having reasonable grounds to believe securities lending arrangements can be put in place to allow delivery; and (b) acquiring or borrowing sufficient securities by the end of each day to ensure that the securities will be able to be delivered on settlement. ASLA members can access the full ASLA submission via the Members Area on the **ASLA website**.

RBA/ASX disclosure of Equities Securities Lending consultation process

In February 2009 the Reserve Bank of Australia (RBA) released a document detailing a variation to a measure of the Financial Stability Standard for Securities Settlement Facilities to improve transparency via the disclosure of equities securities lending. ASLA has been working with both the RBA and ASX since late 2008 as part of an industry consultation process to provide a working solution to achieve their stated objectives, being:

- Manage the settlement process
- Identify potential settlement risks
- Analyse settlement fails
- Improve understanding of market functioning
- Improve the balance of information in the market
- Complement data on short selling

The RBA determined a two-part regime for disclosure – ie combining real-time tagging of settlement instructions with direct reporting of outstanding on-loan and borrowed positions – would best meet its objectives, without imposing unnecessary costs on industry participants. It would allow a simplified tagging arrangement to be put in place to meet the needs of the system operator in understanding and managing risks in the settlement process, while also providing an efficient means for public disclosure of aggregate on-loan positions. Below are the dates this became a requirement under the ASTC settlement rules:

2 November 2009 – Securities lending real time tagging in CHESS begins

14 December 2009 – Daily reporting to ASX by ASTC Settlement Participants who are Securities Lending Participants begins. Data reported includes aggregate securities on-loan and securities borrowed.

From this data, the ASX is now able to produce a series of useful market reports which aim to provide disclosure of securities lending activity to improve understanding of the settlement risks, thereby strengthening the overall functioning and stability of the market. Greater transparency will also assist the settlement facility operator, ASX Settlement and Transfer Corporation Pty Ltd (ASTC) in identifying potential settlement risks in managing the settlement process. The reports are available to download from the **ASX website**.

As well as the reports themselves there are explanatory notes advising what the information actually represents. There is also a Q&A section “What is Securities Lending?” which can be accessed from the ASX homepage. ASLA assisted in the production of these documents to help both investors and market participants improve their general understanding around securities lending practices.

ASLA makes joint Relevant Interest submission

On 7 August 2009 ASLA made a joint submission with its global association partners, the UK-based International Securities Lending Association (ISLA), the Pan Asia Securities Lending Association (PASLA) and US-based Risk Management Association (RMA) to the ASIC Consultation **Paper 107**

Securities Lending and Substantial Holding Disclosure.

The main joint submission points were:

- Including only net positions in calculations for Substantial Shareholder Notices (SSNs).
- Allowing lenders to only include either their on-loan position or their collateral position but not both.

- Not requiring Prime Brokers to include in their own calculations for SSNs client securities that are “available” for loan albeit they have not yet been received by them from their client, granting relief from disclosure of the commercial terms of securities lending arrangements in SSNs.

This consultation process is still ongoing and ASLA will keep members informed of any updates.

ISLA/PASLA/ASLA establish Operations Groups conference calls

ASLA has joined forces with fellow associations ISLA and PASLA to establish quarterly conference calls which aim to help the associations better understand each other's structure and activities, as well as explore opportunities to liaise and share information going forward.

The first call took place on 10 December 2009. ASLA is pleased to be working closely with its international peers and believes the cooperation will also facilitate the sharing of "best practises" within the industry.

Super system review

On 14 December 2009 the Australian Government released its Phase One - Preliminary Report on its Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System (Cooper Review). A copy of the report can be found [here](#).

Like many industry organisations, ASLA made a submission to the Review on behalf of its member base. One of the main points made in the ASLA submission was that as the trustees of a fund have responsibility for the investment strategy of the fund, it follows that the trustees should also be responsible for deciding whether the fund enrolls in a securities lending program. We are pleased that this view has been supported in the Preliminary Report.

ASLA engages with the media

As well as the direct engagement of local regulators, ASLA has this year moved to provide more comment and content to journalists writing about securities lending practices and related issues. Correcting some of the misconceptions that existed in Australia around the function of securities lending, particularly the mis-association with margin lending, was a key goal for 2009.

Providing education to the broader market is an ongoing commitment by the Association. Below is a series of links to press releases and articles of interest to the industry.

- 8 February 2010 Investment & Technology: Lean times for sec lenders after the shorting ban
- 25 February 2009 The Herald Sun: Focus on open book
- 25 May 2009 ASLA press release: ASLA welcomes lifting of short selling ban in Australia
- 23 September 2009 The Australian: Securities lending still in vogue: survey
- February 2010 Global Investor: PASLA market profile: Australia

For co-ordination of media enquiries please contact ASLA's PR consultants Philippa Honner or Suk Hee Lee at Honner Media on +612 8248 3745.

Updates to the ASLA website

In addition to including information about the Australian securities lending market the ASLA website has been updated to include a section for global articles relevant to the industry, and another for sharing academic research. There is also an archive section to search historical downloads to the website - for example, a discussion paper written by ISLA on **Securities Lending and Short Selling** from July 2009.

Reports from offshore regulators on short selling

In June 2009 the Technical Committee of the International Organisation of Securities Commissions (IOSCO) released its Final Report on Regulation of Short Selling.

The main recommendations of the Report are that effective regulation of short selling comprises the following four principles:

- 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 financial 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.
- d) Short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development.

A copy of the full report can be found [here](#).

In October 2009 The FSA published its feedback statement on its short selling discussion paper. It confirms that it intends to pursue enhanced transparency of short selling through disclosure of significant short positions in all equities. However, it will work towards agreement on future requirements at an international level rather than introducing a separate domestic regime. In the meantime it has no plans for immediate changes to its current short selling requirements. A copy of the statement can be found [here](#).

Upcoming events



3 March 2010 – Trevor Amoils, ASLA Director, speaking on the Global/Developed Markets Update panel

4 March 2010 – Peter Martin, ASLA Chair, speaking on the Industry Leaders panel

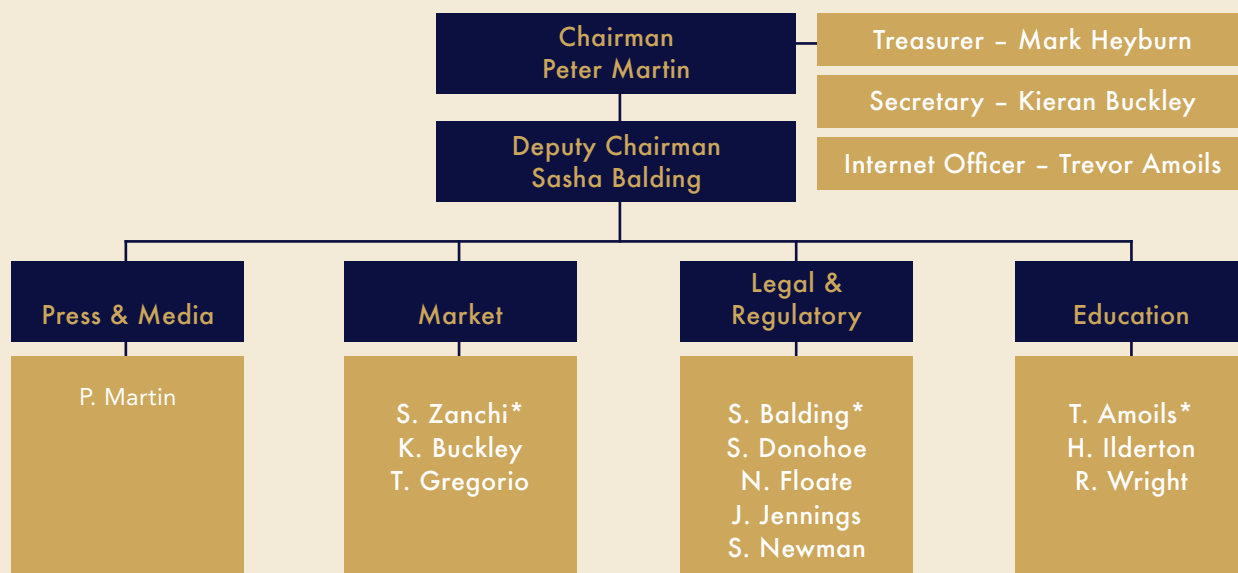
10 March 2010 – ISLA/PASLA/ASLA Operations working group conference call

ASLA AGM – date to be advised.

About ASLA

The Australian Securities Lending Association was formed in 1991 to give securities lending industry participants a unified representation in regulatory and other issues relevant to its members. In addition to ASLA's role of assisting regulatory development, the Association also promotes standardisation through the industry in terms of documentation and market practice. ASLA currently represents 33 organisations across the spectrum of investment banks, custodian and commercial banks, brokers, legal firms and information technology providers. Further information can be found at www.asla.com.au

ASLA COMMITTEE STRUCTURE



* Sub Committee Chair



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REGULATORY CHANGE: AN OVERVIEW

Introduction

This section of the newsletter provides a high level overview of the evolution of regulatory changes impacting securities lending and short selling in the Australian market since September 2008.

There are 4 major changes impacting the market. These include:

- Short selling regulations
- Daily reporting of short selling activity (transactional and positional)
- Disclosure of equities securities lending regime (on-loan, borrowed, stock committed to lending)
- Settlement failures and penalties

Time Line of Change

2008

<p>19 Sept 08</p> <p>ASIC announces that naked short selling will not be permitted from 22 Sept 08.</p> <p>ASIC issues Regulatory Guide 196 to explain how the legislation on short selling will be interpreted.</p>	<p>22 Sept 08</p> <p>ASIC implements the ban on all naked short selling, a ban on covered short selling transactions, and reporting and disclosure requirements. The trading participant (executing broker) must make positive enquiry with the person placing the order about whether their sell order is a covered short sale.</p>	<p>24 Sept 08</p> <p>ASIC issues 'no action' position for owners selling positions which are in securities lending programs.</p>	<p>21 Oct 08</p> <p>ASIC extends ban on short selling.</p>	<p>20 Nov 08</p> <p>The ASX aggregates the market gross covered short sale data and publishes this information to the market on a daily basis.</p>	<p>11 Dec 08</p> <p>The Government passes the Corporations Amendment (Short Selling) Act 2008.</p>
<p>21 Sept 08</p> <p>ASIC announces that covered short selling will also not be permitted from 22 Sept 08.</p>	<p>23 Sept 08</p> <p>ASIC provides clarification regarding the short selling prohibitions and permitted exemptions including hedging for existing positions, dual listed entities, all exchange-traded options, index arbitrage transactions, market makers.</p>	<p>19 Nov 08</p> <p>ASIC lifts ban on covered short sales of Non Financial securities but continues with ban on financial securities. The executing broker must record the client sales as either a "Long Sale", "Short Sale", or "Exempt Short" sale, and must report the aggregate total of the covered short sales.</p>			

Time Line of Change

2009



2010

1. Short selling regulations

On 19 September 2008 ASIC issued Regulatory Guide 196 to clarify how it interprets the Corporations Act 2001 (Cwth) ("Corporations Act") on short selling. A person may only sell securities to a buyer if they have a presently exercisable and unconditional right to vest the products in the buyer. In order to do this the seller must have the absolute ability to give the buyer title to the securities.

If relying on a securities lending agreement, the lender must give the borrower a firm commitment (legally binding commitment) to deliver the securities. The best evidence of a firm commitment would be a written confirmation for delivery into settlement. A "best endeavours" undertaking by the lender to deliver the securities would not fall within the definition of a "firm commitment".

Summary of the current rules:

- All sales must be long sales or covered short sales (there must be a firm legally binding agreement in place to borrow the securities prior to the sale);
- No naked short selling in Australia (there are a couple of very limited exceptions eg hedging by market makers, but conditions apply);
- The client must disclose to the broker whether the sale is a long sale or a covered short sale at the time the order is placed;
- If the disclosure at point 3 is not made at the time the order is placed, the broker must ask the client if the sale is a long sale or a covered short sale prior to taking the order. The broker must record that they asked the client for this information and the broker must also record the client's response;
- Brokers have an obligation to report gross short sales to ASX prior to 9am on T+1 for all short sales on T (house + client);
- The ASX publishes a report to the market each morning of the aggregated gross short sales that were reported to it the previous day.

Exemptions:

ASIC has provided certain Class Order and other relief from the obligation to comply with the short selling requirements. Examples include the following:

- Client Facilitation – for bona fide short sales to clients in the ordinary course of the broker's facilitation business, subject to certain conditions.
- Market Makers – allows short sellers to hedge risk from market making activities, subject to conditions. Those conditions include: (a) having reasonable grounds to believe securities lending arrangements can be put in place to allow delivery; and (b) acquiring or borrowing sufficient securities by the end of each day to ensure that the securities will be able to be delivered on settlement.

2. Daily reporting of short selling activity

On 25 November the Australian Federal Government made Corporations Amendment Regulations 2009 (No 8) to supplement the short selling disclosure in Div 5B of Part 7.9 of the Corporations Act 2001 (Corporations Act). ASIC is looking for two streams of short selling disclosure: transactional and positional. Transactional reporting requires gross covered short selling to be reported to ASX the following day. Positional requires reporting by short sellers to ASIC which, in turn, will then publish the data after four days from when the positions were taken.

Transactional Reporting

Gross Short Sale Report

ASX trading participants must report their daily gross short sales to the ASX. The ASX aggregates the data and publishes a Daily Gross Short Sale Report. The report provides an aggregate gross number of shares that were short sold in each stock on the previous day.

The daily report will simply include details of all short sales executed in the 24 hours up until 7:00pm on the relevant day.

Reporting to ASX will be coupled with disclosure to the market. ASX will produce and disseminate a report to the market that will be released after 9:00am each trading day. The report will show, by security, the total volume of short sales executed on the previous trading day.

The requirement to report to the ASX on a daily basis will continue until real time trade tagging is implemented.

Real Time Trade Tagging

Real time tagging was originally intended to replace the gross short sale reporting, but it is unclear at this stage whether or not this will proceed.

ASX has initiated system changes to automate the receipt of short sale information. When these changes are complete, trading participants will be able to dispense with the end of day reports to ASX. Once real time tagging is implemented, the ASX will aggregate data received from the real time tagging of orders to produce a report which will be released after 9:00am on the next trading day.

ASX has been working towards implementing the software capability to support real time tagging of short sales in the Integrated Trading System. The aim of tagging is to make reporting by market participants more efficient by automating the reporting of short sales to the ASX. The software was available from Monday 18 May 2009. However, manual reporting of total daily gross short sales will continue until tagging becomes mandatory under ASX's Market Rules.

The "up-tick" rule has ceased to apply.

Positional Reporting

Commencing 1 April 2010, short sellers will be required to report their net short positions to ASIC. ASIC will publish the aggregated data four days after the positions are taken. Reporting to ASIC can be effected by way of FIX Protocol 'Position Report' messages. ASIC will publish the market aggregated short positions on its website.

Time line example as follows:

- Position as at Monday 29th March 2010.
- Reported to ASIC by 9am on Thursday 1st April 2010.
- Reported in aggregated form by ASIC on Friday 2nd April.

The seller must continue to disclose that short position on each subsequent business day even if that short position has not changed from the previous day. ASIC will apply a threshold (still to be determined) that will exclude small short positions from being reported.

3. Disclosure of equities securities lending regime

In February 2009 the Reserve Bank of Australia released a document detailing a variation to a measure of the Financial Stability Standard for Securities Settlement Facilities to improve transparency via the disclosure of equities securities lending.

There is a two-pronged approach to the disclosure of securities lending, being real time tagging of CHES messages, as well as securities lending positional reporting.

Real Time Trade Tagging in CHES

There is now an obligation to tag securities lending transactions in CHES on a real time basis. Both parties to a securities lending transaction, regardless of domicile, will

be required to ensure their CHES instruction contains the "L" tag, which is one of the criteria for matching. If either of the parties do not tag the transaction with "L" then the trade will not match and will not settle. ...continued page 8

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Securities Lending Positional Reporting

On-Loan Positions

This is the outstanding loan position in a given security, aggregated across reporting participants. Each reporting participant reports the number of securities that have been lent and not yet returned. Inter-company transactions to related bodies corporate are excluded.

Borrowed Positions

This is the outstanding borrowed position in a given security, aggregated across reporting participants. Inter-company transactions to related bodies corporate are excluded.

Committed Positions

This is the number of securities committed to lending arrangements as at the previous quarter end, aggregated across the market. It is defined as the number of securities that are either on loan or available for loan to other parties

whether or not subject to any conditions. It excludes positions held for the purpose of trading by the entity on its own behalf.

From this data, the ASX is able to produce the below market reports which are available to download from the **ASX website**:

- Daily Market Report of Outstanding Borrowed Positions, by Security
- Daily Market Report of Outstanding Loaned Positions, by Security
- Settlement & Securities Lending Comparison Report
- Daily Gross Securities Lending Transaction Report
- Monthly and Daily Market Equity Fail Report (Volume)
- Securities Lending Participation Report
- Daily Market Reports of Outstanding Borrowed and Loaned Positions

4. Settlement failures and penalties

Over the past 18 months we have seen a series of changes to enhance the equity settlement processes designed to either:

- Reduce the possibility of a CHESSE batch payment failure or delay; or
- Minimise the impact should such an event occur.

These changes can be summarised as follows:

1. Settlement shortfall fees

From 1 September 2008 - Daily trade value fee remained constant at 0.1% of the settlement shortfall, while the minimum fee increased from \$50 to \$100 and the maximum fee from \$2,000 to \$5,000 per security per day.

2. CHESSE processing schedule changes

From 1 December 2008 - Pre-Settlement Activity in CHESSE opens two hours earlier, Chess Online Processing moved from 8am to 6am, to enable a greater timeframe to highlight and manage settlement issues.

3. Automatic "close out" requirement

From 30 March 2009 – ASTC introduced a close out obligation on participants with a net short position where a resulting settlement shortfall remains after T+5. The position must be closed by no later than 10:30am on T+6.

4. Increased transparency of settlement performance

Enables comparison of settlement performance, including failure rates and fees, between Settlement Participants.

5. CHESSE RTGS Service

Increased awareness of the availability and benefits of Delivery Vs Payment (DVP) settlement via Real Time Gross Settlement (RTGS) for equity settlement. The CHESSE RTGS service allows Participants the option of DvP settlement of equity transactions on a line-by-line basis within CHESSE, instead of having to settle non-DvP with payments made outside of CHESSE, or be constrained by the timing requirements of once-daily net batch settlement processing.

Reference: **ASX Consultation Paper: Enhancing Australia's Equity Settlement System**

Sources

- ASIC
- ASX
- ASX Online
- RBA
- Australian Treasury