

## ASIC CLASS ORDER [CO 09/774]

### EXPLANATORY STATEMENT

Prepared by the Australian Securities and Investments Commission

*Corporations Act 2001*

The Australian Securities and Investments Commission (*ASIC*) makes ASIC Class Order [CO 09/774] under s1020F(1) of the *Corporations Act 2001* (the *Act*).

Subsection 1020F(1) of the Act relevantly provides that ASIC may exempt a person from specified provisions of Part 7.9 or declare that Part 7.9 applies in relation to a person as if specified provisions were omitted, modified or varied.

#### **1. Background**

A market maker regularly states prices at which it proposes to buy or sell financial products on its own behalf.

If a market maker enters a transaction with a counterparty that creates a ‘long’ exposure to an underlying product, the market maker may want to hedge the risk of this long exposure by short selling the underlying product to achieve a ‘delta neutral’ position in the product. Market makers often use automated systems to immediately hedge positions established in the course of making a market.

Section 1020B regulates the short selling of certain financial products. ‘Naked’ short selling is prohibited in Australia—that is, a person selling section 1020B products must, at the time of sale, have ‘a presently exercisable and unconditional right to vest’ the products in the buyer.

Exceptions to the prohibition previously relied upon by some market makers to ‘naked’ short sell to hedge their long exposures were repealed on 8 January 2009 by the *Corporations Amendment (Short Selling) Act 2008*.

A market maker is generally permitted to engage in ‘covered’ short selling of section 1020B products to hedge risk. A covered short sale is a sale where the person selling products has, at the time of sale, a presently exercisable and unconditional right to vest the products in the buyer because of a securities lending arrangement entered into before that time.

## **2. Purpose of the class order**

The purpose of the class order is to:

- promote liquidity in the Australian markets by facilitating efficient hedging by market makers; and
- maintain confidence in the Australian markets by adequately addressing risks associated with naked short selling.

Under the current law, to make a covered short sale of section 1020B products to hedge its risk, a market maker must before the time of sale have an agreement to borrow the products under a securities lending arrangement.

To comply with s1020B, market makers are effectively required to maintain an inventory of long or borrowed products. There are practical difficulties for a market maker to borrow an inventory of section 1020B products needed to cover its market making activities at the start of each trading day because:

- the market maker is unable to anticipate the volume of products it will require to cover possible future positions; and
- the market maker will incur borrowing and administrative costs, regardless of whether the borrowed products are actually used.

Maintaining such an inventory may affect the spreads (cost) at which market makers can price bids and offers in the derivatives markets.

Naked short sales tend to have a higher risk of settlement failure because at the time of sale the seller does not have a presently exercisable and unconditional right to vest the product in the buyer. To mitigate the risk of settlement failure from naked short selling by market makers, the class order relief is subject to strict eligibility criteria and conditions.

In addition to these safeguards, market makers will continue to be subject to the ASX Market Rules relating to failure to deliver products at settlement, including the imposition of fees in the event of a failure to settle: see ASX Circular 244/08.

## **3. Operation of the class order**

### **Eligibility**

The class order provides relief for a market maker from s1020B(2) where all of the following apply:

- (a) the market maker makes a market for a financial product;
- (b) the market maker holds, or is exempt from holding an Australian financial services licence for making a market;

- (c) the naked short sale is a bona fide transaction to hedge the risks arising from the market maker's market making activities;
- (d) at the time of the sale, the financial product sold is a constituent of the S&P/ASX 200 index;
- (e) at the time of sale, the market maker believes on reasonable grounds that a securities lending arrangement can be put in place before delivery of the financial product sold so that a financial product of the same class as the financial product sold can be delivered to the purchaser.

### **Conditions**

The relief under [CO 09/774] is subject to conditions that, by the end of the day, the market maker must:

- acquire a financial product of the same class as the financial product short sold; or
- enter into a contract to acquire a financial product of the same class as the financial product short sold; or
- have entered into a securities lending arrangement in relation to a financial product of the same class as the financial product short sold

so that the financial product can be unconditionally vested in the purchaser at the time of delivery.

If the market maker is unable to do so, it must notify ASIC in writing by 9:00am the following day.

### **4. Documents incorporated by reference**

No documents are incorporated by reference.

### **5. Consultation**

The exemption in [CO 09/774] was the subject of public consultation in Consultation Paper 106: *Short selling to hedge risk from market making activities* (CP 106) (released for comment on 30 April 2009, which foreshadowed this relief). In addition to publishing CP 106 on our website (at [www.asic.gov.au](http://www.asic.gov.au)), we sought comments from market makers, the Australian Financial Markets Association, the Securities & Derivatives Industry Association and the ASX. The submitting parties were generally supportive of the proposal for class order relief. The relief has been refined from that proposed to address the concerns of the submitting parties. Further details of the submissions are contained in REP 167 *Response to submissions on CP 106 Short selling to hedge risk from market making activities* which is also available on our website.