

FOCUS

CAPITAL MARKETS



April 2008

FEDERAL GOVERNMENT AND ASX INVESTIGATE FURTHER REGULATION ON SHORT SELLING

Much has been written lately about short selling and associated activities in the current period of turbulence in securities markets. Partner Warwick Painter and Law Graduate Cameron Wilson examine the background to the current debate.

The ASX has released a public consultation paper outlining initiatives to improve market transparency

HOW DOES IT AFFECT YOU?

- Both the Commonwealth Government and the Australian Securities Exchange (the **ASX**) have proposed changes to the way short selling is regulated and short sales are disclosed. This could also indirectly affect stock lending arrangements.
- For ASX participants, it could mean increased reporting obligations in relation to short sales.
- For fund managers, it could mean less flexibility in the trading strategies that can be employed and a reduction in fee income from stock loans.
- For stock lenders and borrowers, it could mean reduced volumes of business or increased reporting.
- For other investors, it could mean a reduction in liquidity for smaller capitalised stocks.

INTRODUCTION

Much has been written recently about the new triple demons of the financial markets: short selling, stock lending and margin lending.

The following themes emerge from recent media reports:

- **Margin lending** is bad (particularly for directors and executives) because the borrower might have to sell shares to meet a margin call on the loan and that will put downward pressure on share prices.
- The situation is made worse because speculators (such as hedge funds) can sell stock that they do not own (known as **short selling**) and deliberately drive the price of particular shares down, leading to further margin calls and forced sales by margin borrowers.



- Speculators can only do this because of the ability to cover their short sales by unregulated **stock lending**, which allows them to avoid the legitimate controls on short selling under the *Corporations Act 2001* (Cth) and the ASX Rules.

Recent market turbulence has uncovered a whole raft of practices associated with short selling, stock lending and margin lending. Some think that disclosure is the solution so that investors know how much money has been borrowed on margin loans, how much stock has been borrowed and how many short sales have been made using borrowed stock. Others think that increased regulation is the solution, preventing directors and executives taking out margin loans on their company's own shares, restricting short sales using borrowed stock and regulating those who offer stock borrowing. Others again think that the current rules are sufficient and simply need clarification and consistency in their application.

The average investor is probably not too concerned which view prevails, provided the Federal Government re establishes order in the universe and sets his or her share portfolio back on its proper path of increasing in value year by year.

BACKGROUND: WHAT IS SHORT SELLING?

Despite being the target of criticism, the practice of short selling is a significant trading strategy employed by Australian and international securities professionals. A short sale is essentially the sale of a security that the seller does not own and involves selling securities at the current market price in the expectation of being able to purchase later at a lower price. Settlement of sales must generally occur three ASX trading days after the sale (T+ 3), which means that a short seller needs to purchase shares to cover the sales on the same trading day unless an exception applies or the stock can be 'borrowed' from another investor. Contrary to the popular notion that short sellers inevitably profit by driving down share prices, the technique is not risk free and a short seller can lose a potentially unlimited amount on the sale if the price of the particular share rises unexpectedly.

EXISTING REGULATION OF SHORT SELLING

What is missed in the current criticism of short selling is that there is already a significant body of regulation around the conduct of short sales. However, there has for many years been uncertainty around whether a 'short sale' occurs at all in circumstances where the seller has either borrowed or arranged to borrow securities before placing the order on market.

The reason why this matters is that a short seller who borrows stock is not subject to the risk of having to go into the market to cover a sale and can borrow a potentially unlimited amount of securities from persons who would not otherwise be sellers in that market (eg 'buy and hold' fund managers).

Section 1020B(2) of the Corporations Act sets out the general prohibition against short selling in Australia. A short sale is one where the seller does not have 'a presently exercisable and unconditional right to vest the products in the buyer'. This is subject to five main exemptions:

1. Securities traded by a financial services licensee who is a participant in a licensed market and who specialises in dealing in odd lots (the 'odd lot sales' exemption).
2. Securities sold as part of a bona fide arbitrage transaction (the 'arbitrage transaction' exemption).
3. Securities sold by a person who has entered into a contract to buy the securities, but has not completed the purchase at the time of the short sale (the 'contract to buy' exemption).
4. Securities sold where arrangements are made before the sale to enable the delivery of the securities of the class sold to be made to the buyer within three business days after the sale (the 'covered short sale' exemption). At the time of the sale, the seller must not be an associate of the body corporate that issued the securities. Pricing restrictions apply to these sales so that the short sale price is at or above the price of the last sale (the so called 'uptick rule'). The short sale must also be reported to the ASX.

5. Short sales of approved securities, as designated by the ASX, sold in accordance with the operating rules of the market (the 'approved short sale' exemption). At the time of the sale, the seller must not be an associate of the body corporate that issued the securities and the short sale must be reported to the ASX. The uptick rule also applies to this exemption.

The ASX Market Rules also impose short selling restrictions directly on brokers, adopting the same definition of short selling as in the Corporations Act. The ASX Market Rules also support the exemption in point 5 above in providing the framework for 'approved short sales'.

Exemptions 1 and 2 are highly specialised activities and Exemption 3 is fairly uninteresting. Most of the interest lies in Exemption 4 (covered short sales) and Exemption 5 (approved short sales), and a further unwritten exemption that turns on the question of whether the short seller has a 'presently exercisable and unconditional right' to vest the securities in the buyer.

Recent commentary has simply divided short selling into two distinct categories – 'naked' and 'covered' short selling. A 'naked short sale' is said to occur when a market participant enters an order in the market and does not have in place arrangements for delivery of the traded securities. This is contrasted against a 'covered short sale', which is said to occur when a market participant has in place an arrangement for the delivery of the securities at or before the time when the sale is entered into on the market. This is usually achieved by the participant borrowing the relevant securities.

THE ISSUES

Stock lending arrangements usually give the stock borrower the right to issue a borrowing request and have shares vested in the borrower, or in accordance with the borrower's directions. Professional investors and some market participants argue that this provides the short seller who has entered into a stock borrowing agreement with a presently exercisable and unconditional right to vest the shares in the buyer and, as a result, the prohibition on short selling simply does not apply. That is, the sale is not a 'short sale' as defined in the Corporations Act and ASX Market Rules, so there is no further need to consider the application of any

of the exemptions outlined above. As a result, the trading activity also avoids the disclosure obligations imposed by the Corporations Act and the ASX Market Rules, and is not subject to the 'uptick' rule, thereby leaving market participants uninformed about the amount of short selling taking place and at risk of trading strategies that have the effect of driving prices downwards.

Recent commentary has also suggested that this allows short sellers to 'target' particular stocks, with the intention of driving prices down, thereby ensuring a risk-free short selling strategy.

ASX CONSULTATION PAPER

The ASX acknowledges that legislative amendments are necessary to remove the ambiguity in the Corporations Act around the disclosure of covered short sales. In its media release of 28 March 2008, the ASX noted the comment by Federal Treasurer Wayne Swan that the Federal Government would pursue legislative change to remove the ambiguity in the Corporations Act around the disclosure of 'covered' short sales. Legislative amendments, of course, take time to enact.

The ASX also released a public consultation paper on 28 March 2008 outlining a number of initiatives that the ASX can pursue to improve market transparency. In particular, the paper identifies two alternative short-term solutions to overcome the current ambiguity in the Corporations Act. The first solution would impose new reporting obligations on custodians, requiring them to provide stock lending data. This information would be aggregated and disseminated to the market to increase transparency as to the level of stock lending/borrowing. The second solution would involve amending the ASX Market Rules to broaden the definition of 'short sale' to replace the current definition (which refers to a short sale under section 1020B of the Corporations Act). The ASX has invited comments on these alternative short-term approaches by Thursday, 24 April 2008.

In the meantime, the ASX has confirmed that market participants engaging in covered short selling are not exempt from fundamental disclosure obligations. The ASX Market Rules put the onus on brokers that have a contractual relationship with the ASX to ensure that clients report the types of short sales that other market users would expect to see reported.

CONCLUSION

Until a firm proposal for change comes from either the Federal Government or the ASX, it is difficult to predict with any certainty what the impact of those changes will be on securities professionals and the market. In formulating any changes, it is to be hoped that there is a close examination by the Federal Government and the ASX of why the current rules are seen to have failed (or, in fact, whether they have failed at all) before an additional raft of regulation is imposed on the market. It may, at the end of the day, be as simple as ensuring that the existing exemptions are applied in the way they were originally intended.

As to whether any of this will set the universe to order and make share prices rise again, that is a story for another day.



CONTACTS

Warwick Painter
Partner, Sydney
Ph: +61 2 9230 4174
Warwick.Painter@aar.com.au

Robert Pick
Partner, Melbourne
Ph: +61 3 9613 8721
Robert.Pick@aar.com.au

Andrew Knox
Partner, Brisbane
Ph: +61 7 3334 3356
Andrew.Knox@aar.com.au

Tim Lester
Partner, Perth
Ph: +61 8 9488 3841
Tim.Lester@aar.com.au

Matthew Barnard
Partner, Hong Kong
Ph: +852 2903 6212
Matthew.Barnard@aar.com.au

Bangkok
Beijing
Brisbane
Hanoi
Ho Chi Minh City
Hong Kong
Jakarta
Melbourne
Perth
Phnom Penh
Port Moresby
Shanghai
Singapore
Sydney
11263

Have your details changed?

If your details have changed or you would like to subscribe or unsubscribe to this publication or others, please go to www.aar.com.au/general/subscribe.htm or email Publications@aar.com.au

© 2008 Allens Arthur Robinson, Australia

www.aar.com.au