

FOCUS

SHORT SELLING



STOCK	BID	OFFER	LAST	VOL
AMCOR	5.82	5.83	5.83	611
AMP	8.96	8.97	8.98	311
ANZ BANK	7.10	7.11	7.10	1511
BHP BLT	18.23	18.23	18.22	311
COLES MYER	11.41	11.43	11.42	711
CWLTH BANK	28.31	28.36	28.33	211
FOSTERS	4.46	4.47	4.47	611
NAT BANK	30.97	31.00	30.89	411
NEWS CORP	12.44	12.45	12.45	511
RIO TINTO	35.08	35.12	35.12	211
ST. GEORGE	21.37	21.40	21.40	711
TELSTRA	4.88	4.89	4.89	411
MES. TRUST	3.48	3.49	3.49	311
NESFARMS				
SSH MEDIC	0.105	0.11	0.11	447
ST FRANCIS	0.021	0.022	0.022	511
ST SYNERGY	0.11	0.165	0.165	0
ST. BARBARA	0.085	0.086	0.085	411
STADIUM	0.205	0.22	0.203	411
STARGAMES	1.21	1.24	1.24	411
STARPHARMA	0.65	0.66	0.65	111
STARTRACK	0.027	0.028	0.028	211
STERNSHIP	1.90	2.10	1.94	0
STERICORP	0.17	0.175	0.175	0
STHN EQUIT				
STRT MINS	0.23			
STRT POOL	0.24			
STRATA	0.02			
STRATATEL	0.068			
STRATHFLD	0.13			
STRIKER	0.065			
STRUCTURAL	0.485			
STUART	0.72			

September 2008

IT WAS A LONG WEEK FOR SHORT SELLERS...

In the past 10 days, Australian market participants and fund managers have been subjected to an extraordinary series of announcements which, for the present, have significantly changed the regulation of short selling in Australia. At the same time, the Federal Government has also released the long-awaited exposure draft of its proposed legislative reforms in this area. Partner Warwick Painter and Senior Associate Justine Woodford outline the recent developments and provide a sense of the confusion that existed for market participants and fund managers during that time.

Late September saw a series of regulatory announcements which considerably restricted short selling in Australia

HOW DOES THIS AFFECT YOU?

- Fund managers and brokers have been in a state of some uncertainty while the Australian Securities & Investments Commission and the Australian Securities Exchange have, over the course of a week, worked through a series of clarifications and refinements to their initial announcements effectively banning both naked and covered short selling in the Australian market.
- Changes to the position on short selling in the Australian market have largely been in response to overseas developments.
- While the fundamental prohibition on short selling has not been changed and the existing exemptions are generally still in place, there are new reporting requirements for permitted short sales and a prohibition on covered short

sales using securities lending arrangements, as well as exemptions and 'no action relief' by the Australian Securities & Investments Commission in certain cases.

On 22 September 2008, we reported on the series of announcements by the Australian Securities Exchange (**ASX**) and the Australian Securities and Investments Commission (**ASIC**) that effectively resulted in a ban on both 'naked' and 'covered' short selling of securities on the Australian market from the commencement of trading on 22 September 2008. In the days that followed, both ASIC and the ASX issued further clarifications and announcements that redefined the prohibitions and provided further limited relief in some cases, while market participants and industry bodies continued to have urgent discussions with ASIC about the extent of the prohibitions and the impact on business. Below is a summary of what unfolded.



THE WEEK THAT WAS

FRIDAY, 19 SEPTEMBER

This was the starting point when, by a combination of announcements from the ASX and ASIC:

- all 'naked' short selling of 'approved' ASX securities under section 1020B(4)(e) of the Corporations Act 2001 (Cth) was prevented by removing all securities from the ASX list of approved short sale securities;
- ASIC confirmed that, from the opening of the market on 22 September, a permitted 'covered short sale' would require the person to have a binding commitment to obtain securities from another person before the short sale is entered into; and
- ASIC introduced a new legislative requirement¹ (applying to all 'covered' short sales where the stock is sourced under a securities lending agreement), that:
 - the client must report the sale to its broker and the broker must ask its client whether the sale is a short sale to which the new provisions apply; and
 - the broker must report its net covered short positions to the market by no later than 9am on the next trading day.

SUNDAY, 21 SEPTEMBER

Within a short time after the Friday announcements, ASIC further revised its position and announced a ban on 'covered' short selling of all ASX-listed securities where the cover was provided by a securities lending arrangement. ASIC issued class order (CO 08/752)², which added a further notional s1020BD to the Corporations Act, to give effect to this announcement. This new section provided a limited carve-out for hedging by ASX-registered market makers and warrant market makers.³

1. ASIC issued Class Order (CO 08/751), which added a notional s1020BC to the Corporations Act.
2. This new class order amended CO 08/751.
3. It is worth noting that both s1020BC and s1020BD only apply to selling on an Australian licensed market and s1020BD only applies to 'securities', thereby excluding government debt instruments and, before it was modified, managed investment products. Neither section applies to sales of derivatives, (eg CFDs), but could apply to a sale of securities upon exercise of a derivative.

MONDAY, 22 SEPTEMBER TO WEDNESDAY, 24 SEPTEMBER

As market participants and fund managers attempted to come to terms with the new arrangements, ASIC announced further modifications and exemptions over the course of several days as follows:

- ASIC announced (Advisory Release AD 08-20) that it would provide a no-action letter in relation to covered short sales by market makers for the purpose of hedging positions taken prior to 22 September 2008.
- ASIC issued a further Class Order (CO 08/753),⁴ which had the effect of varying notional s1020BD so that it also prohibited covered short selling of managed investment products and stapled securities.
- ASIC issued a further announcement (Advisory Release AD08-22), indicating its decision to exempt some further market operations from the short selling prohibition 'in line with overseas developments' and indicating:
 - its view on the requirement for market participants to report net short sales involving securities lending transactions;
 - that existing limited exemptions under s1020B for certain naked short sales and certain covered short selling were unaffected by the ASIC Class Orders;
 - that ASIC would consider individual applications for 'no-action' relief for Direct Market Access (**DMA**) service providers that use automated trading facilities, relieving the provider from a positive obligation of enquiry in relation to sell orders;
 - that the prohibition on covered short selling applies to trading in corporate debt securities, but does not apply to trading in government debt securities;
 - that ASIC would monitor the use of existing exemptions for market makers and also monitor the use of exemptions in the derivatives and options markets to ensure there is no misuse of the exemptions 'to reinstate objectionable short selling behaviour'; and
 - that the exemptions may change further as ASIC continues to coordinate its response 'in line with international developments'.

4. This new class order again amended CO 08/751.

- In accordance with ASIC's update announcement (AD08-22), ASIC issued Class Order 08/763⁵:
 - substantially reworking the exemption for hedging by market makers (and introducing a new requirement that the market maker does not know that the issue or sale of a financial product by it in the course of making a market 'will result in the client establishing or increasing an economic net short position in relation to the shorted product');
 - modifying the previously announced no action relief for hedging exposures arising prior to 22 September 2008 and replacing the previously announced 'no action letter' with a more formal exemption under the notional s1020BD;
 - adding an exemption for sales of securities or financial products 'as part of' a dual-listed arbitrage or an index arbitrage transaction; and
 - adding an exemption for sales of securities or financial products for the purpose of hedging in relation to: (a) the underwriting of dividend reinvestment plans and security purchase plans; and (b) the conversion of convertible securities (although this exemption did not cover all underwriting or conversion situations).
- The Treasurer announced the release of the long-awaited exposure draft of the Corporations Amendment (Short Selling) Bill 2008, inviting submissions from interested parties by 21 October 2008.⁶
- ASIC issued a further Class Order (CO 08/764), providing an exemption from s1020B(2) (the primary short selling prohibition) in relation to the 'naked' short sale of a security or managed investment product as a result of the exercise of an option (**ETO**) registered with Australian Clearing House Pty Limited, subject to the conditions set out in the class order.
- Finally, ASIC announced (Advisory Release AD 08-23) that it will not take any action for a breach of short selling requirements in relation to the bona fide sale of securities from a portfolio by a fund manager where the seller has made securities of the same type available (whether or not through a custodian) to a securities lender for use in a securities lending program, subject to

certain conditions. ASIC further indicated that it will monitor the market to ensure there is no misuse of this no action position 'to ensure that shares are not loaned out so as to facilitate objectionable short selling'.

THE SCORECARD

Stepping back from the many changes outlined above, it is important to consider where this actually leaves market participants and fund managers who are involved in both securities lending and hedging activities that require them to maintain or enter into short positions in relation to Australian securities and financial products. In our view, the current position is as follows:

- The primary criteria for assessing whether a sale is a short sale in the first place has not changed. That is, a sale will not be a short sale if a person has a presently exercisable and unconditional right to vest the sold financial products in the buyer at the time the sale is made in accordance with s1020B(2) of the Corporations Act.
- The existing exemptions in s1020B(4) have not been materially changed by the ASIC Class Orders, although they no longer apply where a covered short sale involves a securities lending arrangement, because notional s1020BD overrides s1020B. As a result there are still exemptions for:
 - short sales 'as part of' an arbitrage transaction (eg naked short sales or covered short sales not involving securities lending);
 - short sales where a contract to buy the securities has been concluded but not yet settled; and
 - covered short sales by way of agreements to acquire securities that can be settled within three business days after the date of the short sale (provided it is not a securities lending arrangement).
- In addition, the existing Corporations Regulations exemptions for sales of certain debt securities and the writing or exercise of ETOs in certain circumstances have not been affected.⁷
- Transactions in derivatives that do not involve the selling of underlying securities or managed investment products (other than exchange traded warrants &– see regulation 7.9.80B) are permitted, as they were never covered by s1020B and are not covered by the ASIC class orders.

5. This was a further modification to CO 08/751.

6. It is the commencement of this legislation which signals the potential removal of the temporary prohibitions on covered short selling announced by ASIC on Sunday, 21 September 2008.

7. See Corporations Regulations 7.9.79 and 7.9.80A.

However, what the ASIC class orders, Regulatory Guide 196⁸ and ASIC Advisory Releases give effect to is:

- a new reporting requirement where a covered short sale by a market maker or other permitted person involves a securities lending arrangement (notional s1020BC); and
- a prohibition in relation to covered short sales using securities lending arrangements (notional s1020BD), with various exemptions for hedging by ASX-registered market makers and warrant market makers; and
- clarification of ASIC's policy that a securities lending arrangement will not be sufficient for a permitted covered short sale unless the securities have actually been committed under a binding arrangement to deliver the securities to the seller; and
- certain exemptions and 'no action relief' for:
 - covered short sales for hedging purposes by market makers;
 - covered short sales by underwriters and persons receiving securities on conversion of convertible instruments in certain circumstances;
- covered short sales as part of certain arbitrage transactions;
- certain short sales by market makers that relate to hedging of pre-22 September 2008 transactions or client orders;
- short sales for the purpose of settling ETOs;
- monitoring client transactions by providers of DMA services; and
- short sales by fund managers and institutional investors selling portfolio securities that have previously been provided to a securities lender.

We will keep you updated on further developments in this area, particularly in relation to the progress of the Corporations Amendment (Short Selling) Bill 2008.

THE LAST WORD

Today's financial press has speculated that ASIC may consider lifting its ban on short selling as early as this week. At present there is no formal announcement by ASIC of any such proposal.

8. ASIC released RG 196 *Short Selling: An Overview of section 1020B* on 19 September 2008.



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

Andrew Pascoe

Partner, Perth
Ph: +61 8 9488 3741
Andrew.Pascoe@aar.com.au

Robert Clarke

Partner, Allens Arthur Robinson
TSMP, Singapore
Ph: +65 6535 6622
Robert.Clarke@aar.com.au

Matthew Barnard

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

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

Bangkok
Beijing
Brisbane
Hanoi
Ho Chi Minh City
Hong Kong
Jakarta
Melbourne
Perth
Phnom Penh
Port Moresby
Shanghai
Singapore
Sydney
11697

www.aar.com.au