



AIMA AUSTRALIA

**POSITION PAPER
ON
SHORT SELLING**

April 2008

**A paper prepared by the Regulatory Committee
of the Australian Network of the
Alternative Investment Management Association**

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The Alternative Investment Management Association Limited (**AIMA**) was established in 1990 as a direct result of the growing importance of alternative investments in global investment management. It is a not-for-profit educational and research body that specifically represents practitioners in hedge funds, futures funds and currency fund management - whether managing money or providing a service such as prime brokerage, administration, legal or accounting advice. AIMA's global membership is in excess of 1000 members, comprising 3000 individuals in 46 countries.

The Australian network of AIMA (AIMA Australia) represents participants in alternative investments in Australia. AIMA Australia has over 60 members, including fund of funds managers, institutional investors, hedge fund managers, prime brokers, lawyers, auditors and other service providers.

Why is AIMA Australia producing this Position Paper?

This Position Paper has been produced by AIMA Australia in response to the current publicity, media coverage and discussion surrounding the practice of short selling on Australia's financial markets. In particular, AIMA Australia wished to state its current position on the relevant issues raised in:

- the Information Release and Media Release from the Australian Securities and Investments Commission (**ASIC**) headed "ASIC reminds market participants about stock lending disclosure obligations" and "false or misleading rumours".
- AIMA Australia's subsequent discussions with ASIC and with the Australian Securities Exchange Limited (**ASX**); and
- ASX's Public Consultation Paper on short selling dated 28 March 2008. (However, AIMA Australia intends to respond separately, directly to ASX, on the specific issues raised in that Public Consultation Paper).

Executive summary of AIMA's position

- Hedge fund activity on Australia's financial markets is an important and productive component of activity on those markets and adds considerable depth to trading in those markets. However, only a small proportion of hedge fund trading relies on short selling. A large amount of short selling in the Australia market relates to the risk management and hedging activities of non-hedge funds and superannuation funds.
- Australia has one of the most detailed and onerous regimes for regulation of short selling in the world. The Australian regime, uniquely, is based on a prohibition of short selling subject to exemptions. The scope of these exemptions and their relevance to current market conditions is in need of review and reform. AIMA Australia has suggestions for change which will improve transparency and price-discovery in relation to short selling.

- Australian law, and in particular the provisions of Part 7.10 of the Corporations Act, provide adequate protection from the sort of risks referred to in ASIC's media release "False or Misleading Rumours" dated 6 March 2008. AIMA agrees with the conclusions of the Financial Services Authority (**FSA**) of the United Kingdom in its 2002 paper on short selling, to the effect that although short selling, like any other form trading, may be manipulative when misused, short selling is not in itself manipulative¹.
- Most importantly, unwarranted or unreasonable restrictions on, or prohibition of short selling, is likely to significantly reduce the ability of investors (such as superannuation funds) being able to adequately manage risk and hedge their investment positions and will permanently damage Australia's hard-won reputation as a regional financial centre. Regional and international investors will "vote with their feet" and leave Australian markets. Why? Because, as demonstrated in this Position Paper, short selling is an accepted and important risk management tool. It has been recognised as such by academics and market commentators, and by regulators, worldwide.
- The key to regulatory reform in this area is enhanced transparency of short selling through disclosure. AIMA Australia makes a specific proposal for a workable disclosure regime on pages 7 and 8 of this Position Paper.

What is short selling?

Some 74 years ago a US Senate Committee observed that:

"Few subjects relating to exchange practices have been characterised by greater differences of opinion than that of short selling."²

Briefly stated, short selling is the sale of a security or other property that the seller does not own. A person who short sells financial products such as securities usually does so with the hope or expectation that the price of those products will fall. The seller will then borrow or purchase (i.e. "buy-in") the number of securities, or other items of financial product, necessary to cover the short sale commitment.³ It is usual for the required securities or other items of financial product to be "borrowed" so that the short seller does not default on the obligation to make delivery of the relevant securities at the settlement time. For ASX transactions under the current T+3 settlement procedures this is 3 days after the sale.

Short selling is primarily a professional activity. It is used by hedge fund managers to establish principal positions as part of their investment strategies. It is also used by market makers and intermediaries to facilitate or hedge customer business and by investment banks, funds or individual market players wishing to take a view on the direction of a particular security or market. Significantly, a short sale can be a complex and costly transaction as it involves the borrowing of securities in order to meet delivery obligations. In volatile market conditions in particular it can also involve considerable risk to the seller if the market moves the wrong way.⁴

¹ Financial Services Authority: Discussion Paper 17: Short Selling: October 2002, paragraph 4.15.

² *Stock Exchange Practices*, Report of Committee on Banking and Currency. Sen. Rep. No 1455, 73rd Cong. 2d Sess (1934); cited in R Deutsch "Short Selling" (1983) C & SLJ 142 at 150.

³ Lexis Nexis Australian Corporation Law Principles and Practice: <https://www.lexisnexis.com/au/legal/delivery>.

⁴ FSA Discussion Paper 17 op cit Paragraph 1.4.

Market benefits of short selling

There has been substantial regulatory, academic and market commentary on the benefits which short selling can bring to a financial market. These can be summarised as follows:

- A principal argument for short selling is the benefit it can bring to a market in accelerating price corrections in over valued securities or to accommodate abnormal buying pressure which would otherwise over inflate a security's price. (AIMA Australia notes that this was recognised by the FSA as a valid argument, and one that has even greater importance in a market which is dominated increasingly by large longer term investors and index funds⁵).
- Short selling may add volume to trading, increasing the liquidity, and potentially the price discovery benefits of a market. A short seller engages in that practice because it believes that the market will decline. Whether that prediction is correct or incorrect the short seller must repurchase the security to cover the short.⁶
- Short selling may also benefit a market as a support for trading that corrects pricing anomalies. Without the opportunity for participants who are engaging in arbitrage to lock in a profit by going short of the over valued instrument the efficiency of price correcting processes may be reduced.⁷
- Any effective restriction on cash market hedging through short sales would potentially increase the costs of risk management, and would seriously constrain the use of derivatives, thus impeding the efficient working of the market in "down side protection".⁸
- It has also been contended that in a down turn or crisis short sellers can assist in maintaining an orderly market, in that activities of short sellers serve as a cushion to break the force of a decline in the price of stocks, and that short selling can have the effect of establishing a ceiling on a rising market.⁹

The US Securities Exchange Commission in its report "SEC Concept Release: Short Sales"¹⁰. The SEC said that:

"Short selling provides the market with two important benefits: market liquidity and pricing efficiency. Substantial market liquidity is provided through short selling by market professionals... such short sale activities, in effect, add to the trading supply of stock available to purchasers and reduce the risk that the price paid by investors is artificially high because of the temporary contraction of supply. Short selling can also contribute to the pricing efficiency of the equities markets. Efficient markets require the prices fully reflect all buy and sell interest. When a short seller speculates on a downward movement in a security, his transaction is a mirror image of the person who purchases the security based upon speculation that the security's price will rise."

⁵ FSA Discussion Paper 17 op cit Paragraph 4.3; and the Goldwasser "*Short Selling Revisited*" (1994) 12 C & SLJ page 277 at 286.

⁶ Goldwasser op cit at page 287, citing JA Walker "*Selling Short - Risks Rewards and Strategies*" (John Wiley and Sons, 1991) page 6.

⁷ FSA Discussion Paper 17 op cit Paragraph 4.4.

⁸ FSA Discussion Paper 17 op cit Paragraph 4.6.

⁹ Deutsch "*Short Selling*" op cit at page 50, citing report by Brisbane Stock Exchange (1971).

¹⁰ <http://www.sec.gov/rules/concept/34-42037.htm>; discussed in New Zealand Ministry of Economic Development discussion document "*Reform of Securities Trading Law Volume 2*" (May 2002) at paragraph 173.

Potential risks of short selling

AIMA Australia recognises that short selling practices bring with them some degree of market risk. Due recognition of these market risks is essential but needs to be balanced against the market benefits of short selling outlined above. It is only through striking this sensible balance that a realistic, and competitive structure for regulation of short selling can be achieved.

It has been recognised that the market risks of short selling include the following:

- Short sales can add weight to the supply of long sale orders in the market. That does not automatically lead to disorderly or manipulative trading, but in some circumstances it may increase the potential for both of these.
- Short selling may also increase short-term volatility in share prices.
- There is some risk of disorderly market trading practices. These may arise for example from the incremental weight of sell orders generated by short sales overwhelming current buy-side interest, and thereby causing an accelerated fall in the share's price and an increase in price volatility in the short term.¹¹
- There is also, at least potentially, a disequilibrium of risk between long and short positions: a long holder of stock can only lose the current value to zero, while a short holder in a "bear squeeze" has an unlimited loss profile. It follows that disclosure of the proprietary information by investors as to their short positions cannot be treated on the same basis as information as to their long positions.¹²
- It is important however that these risks be assessed in light of the existing protections available from market manipulation activity by way of the prohibition in Part 7.10 of the Corporations Act. AIMA supports the existing regime under Part 7.10 but we repeat that short selling practices do not of themselves amount to market manipulation.

How is short selling undertaken by hedge funds: current market practice

Of course, not all short selling is done purely as a speculation on a market decline. It is used by professionals such as hedge fund managers as a means of facilitating other transactions.¹³

It is central to the business of most Australian hedge funds to take short positions, but this is usually done in combination with a long position in another stock where the hedge fund seeks to profit from the relative move in prices between the long and short positions. When the short position is taken through the hedge fund managers prime broker (normally an investment bank), the hedge fund may then also borrow the stock from the same source to satisfy delivery to the buyer (that is, the other party to the short transaction). In turn, the prime broker may either borrow the stock from the market or it may have the stock in its own inventory, either from its in-house principal trading desk or from its fund management arm.

¹¹ See generally FSA Discussion Paper 17 op cit Paragraphs 4.9 and 4.10. See also R Deutsch op cit at page 150.

¹² AIMA Response to FSA Discussion Paper No 17, November 2002: <http://www.aima.org/aima.asp?id=4>.

¹³ JA Walker op cit Cited in Goldwasser "Short Selling Revisited" op cit Page 287.

Long/short strategies of this type are fundamental to most hedge funds operating in Australia.¹⁴

Additionally, hedge funds in Australia employ short selling as an adjunct to arbitrage. There are many ways in which arbitrage can be carried out, some of which are relatively risk-free and in most cases a short sale is part of that strategy.¹⁵ "Arbitrage" (from the French meaning "to judge") is the near simultaneous purchase and sale of the same or exchangeable security or other financial product, in the hope of showing a profit arising from different pricing between 2 or more markets. Put simply the arbitrageur tries to find a situation in which he can buy at one price and sell at a higher price at virtually the same time.¹⁶

Indeed, without short selling being readily available as part of its overall strategy, any hedge fund manager in Australia would be severely limited in its trading strategies and in a real sense would be "uncompetitive" both internationally and regionally.

Benefits for Investors

Australian investors in managed funds (including hedge funds) benefit from the successful application of any investment strategy which manages the risk of loss by prudent use of short selling.

The great benefit which hedge fund strategies bring to an individual investor's portfolio is the protection of overall capital and the aim of making a relative gain in a falling market. In that sense, it is in a falling market, incorporating strategies such as short selling, that hedge funds fulfil most markedly this prime objective of protection of investor capital.

How is short selling regulated in Australia?

For convenience of reference we have attached a schedule summarising the relevant provisions of the Corporations Act relating to short selling.

There are of course further very substantial and detailed regulatory provisions in the ASX Market Rules.

It is well recognised that Australia has one of the most detailed and onerous regimes for regulation of short selling in the world.

The "regulatory gap" under current Australian law and regulation

In order to understand the regulatory gap which has arisen under Australian law it is necessary to appreciate the difference between a "naked" and a "covered" short sale.

- A "naked" short sale occurs where the seller does not own and has not borrowed or made any other arrangements to borrow securities at the time of the sale, but intends to purchase or borrow securities in order to meet the T+3 settlement obligation.

¹⁴ FSA Discussion Paper 17 op cit Paragraph 3.15.

¹⁵ Goldwasser op cit Page 287.

¹⁶ Goldwasser op cit Page 288 citing Walker "Selling Short - Risks, Rewards and Strategies", Note 6 op cit

- In very general terms a "covered" short sale is one in which the seller has made some form of arrangement for borrowing securities or otherwise meeting its delivery obligations.
- As described in the ASX short selling public consultation paper¹⁷ the regulatory gap arises because of uncertainty as to exactly what activity constitutes a covered short sale.
- On a narrow interpretation a covered short sale arises where the seller has arranged to borrow securities but will only take delivery of the securities after the sale has been executed but in such a way as to meet its T+3 settlement obligation. (The ASX notes that the taking of delivery may simply involve a custodian transferring securities from one account holder to another under the terms of a lending agreement).
- A broader approach would involve ignoring whether or not any borrowing takes place before or after entering sale order but focusing instead on whether a borrowing and or purchase takes place in order to meet the delivery obligations.
- The critical point is that the statutory definition of the transactions which need to be reported as short sale should capture both sell orders submitted when the seller does not own the amount of securities being offered, as well as sell orders submitted when the seller only owns the securities through a borrowing agreement and is subject to a contractual obligation to return the securities to the lender.
- AIMA Australia agrees with the ASX's contention, in its public consultation paper to the effect that the loop hole or regulatory gap is that the prohibition under s1020B is widely considered not to extend to sales of securities at the time when the seller owns such securities, even if the seller only owns them by virtue of having entered into a stock borrowing arrangement, whereby the borrower actually purchases the securities from the lending and contracts to resell the same number of securities to the lender at a specified time or on demand. (Buy/sell arrangements).
- We agree with the ASX's conclusion that because the buy/sell arrangement is typical in the industry, the s1020B prohibition on short selling has no application to many covered short sales because the prohibition does not apply to transactions in which the seller has, at the time of the sale, "a presently exercisable and unconditional right to vest the products in the buyer."

Possible solutions to the regulatory gap

AIMA Australia intends to make a response, containing detailed suggestions, to the ASX Public Consultation Paper.

However, in summary, AIMA Australia's position is that the regulatory gap should be resolved by a combination of the following steps:

- transformation of the present section 1020B prohibition so that the provision is facilitative rather than prohibitory. This could be achieved by a broader definition of short selling, and a provision specifically allowing short selling in the situations presently covered by the existing section 1020B exemptions and where otherwise permissible under the rules of a licensed financial market; and

¹⁷ ASX Public Consultation Paper Short Selling 28 March 2008, page 4.

- by a combination of the legislative definition of "short sale" and provisions in the ASX Market Rules, both forms of covered short sale (i.e. a covered short sale under both the broad and narrow constructions referred to under the previous heading) should be permitted; and
- again under a suitable combination of legislative amendment and ASX Market Rules the disclosure and reporting requirements in relation to short provisions should extend to both categories of covered short sales.

Disclosure and transparency issues: why is proper disclosure essential

AIMA Australia agrees with the case made by the United Kingdom FSA¹⁸ that greater transparency in relation to the volume of short selling on any market is an important element of any reform.

AIMA Australia recognises that market transparency requires there to be more publicly available information as to the volume and proportion of short selling in any market.

However, it is critical to the position of hedge funds, and to their continued effective use of short selling (and perhaps the extent of their use of the Australian markets) that any arrangements for increasing the transparency of short selling through additional disclosure measures should not breach commercial confidentiality.

AIMA Australia's Proposed Solution: Disclosure and transparency

AIMA Australia fully endorses any proposal for enhanced reporting of short selling as the key to sensible regulatory reform in this area.

What is needed is a compulsory disclosure regime which enhances market transparency by requiring regular reporting (at sensible and internationally consistent intervals) of short sold securities as a percentage of issued capital, per security.

The reportable information needs to be obtained from a source that does not impede the efficient and confidential flow of information which is vital to portfolio management.

Is there a practical way of achieving this? AIMA Australia believes that there is.

AIMA Australia has made initial approaches to several custodian institutions and in-house custody facilities and there is considerable support in principle for developing a framework whereby:

- the amount of short sold securities as a percentage of issued capital, per security, could be reported by these custodial institutions and in-house facilities;
- reporting would be done by existing trade notification mechanisms from investor to custodians;
- confidentiality could be preserved; and
- a reasonably frequent cycle of reporting could be introduced; possibly monthly (although consideration could be given to introducing rules similar to those in the USA where prescribed stocks could be reported more frequently, say bi-monthly).

¹⁸ FSA Discussion Paper 17 op cit Paragraphs 4.24 to 4.27.

Such a reporting system appears attractive, and the feasibility of the early introduction of such a system should certainly be pursued.

Such a system of reporting would enhance transparency of short selling. AIMA believes that is the key to the solution. Transparency is absolutely vital to the development of efficient markets, and to enhancing (rather than diminishing) Australia's attractiveness as a regional market centre.

Concluding remarks

- Hedge funds are substantial users of short selling practices which are consistent with current Australian law and ASX regulation.
- Hedge fund activity on Australia's financial markets is an important and productive component of activity on those markets and adds considerable depth to trading in those markets. However, only a small proportion of hedge fund trading relies on short selling.
- Australia has one of the most detailed and onerous regimes for regulation of short selling in the world. The Australian regime, uniquely, is based on a prohibition of short selling subject to exemptions. The scope of these exemptions and their relevance to current market conditions is in need of review and reform. AIMA Australia has suggestions for change which will improve transparency and price-discovery in relation to short selling. These changes are set out under the heading above "possible solutions to the regulatory gap" and involved both statutory change and a recognition in the legislation of the binding nature of the ASX Market Rules.
- Australian law, and in particular the provisions of Part 7.10 of the Corporations Act, provide adequate protection from the sort of risks referred to in ASIC's media release "False or Misleading Rumours" dated 6 March 2008. AIMA agrees with the conclusions of the Financial Services Authority (FSA) of the United Kingdom in its 2002 paper on short selling, to the effect that although short selling, like any other form trading, may be manipulative when misused, short selling is not in itself manipulative¹⁹.
- Most importantly, unwarranted or unreasonable restrictions on, or prohibition of short selling will permanently damage Australia's hard-won reputation as a regional financial centre. Regional and international investors will "vote with their feet" and leave Australian markets. Why? Because, as demonstrated in this Position Paper, short selling is an accepted and important risk management tool. It has been recognised as such by academics and market commentators, and by regulators, worldwide.
- AIMA Australia encourages all relevant regulators to consider its proposed solution for disclosure and transparency as set out under the previous heading. The feasibility of such a system deserves early investigation.

¹⁹ Financial Services Authority: Discussion Paper 17: Short Selling: October 2002, paragraph 4.15.

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Schedule

Summary of Relevant Corporations Act Provisions

The statutory provisions commence with a prohibition of short selling, but proceed to make certain exceptions to this prohibition.

Briefly the statutory provisions are to the following effect:

- Section 1020B(2) of the Corporations Act prohibits short selling in this jurisdiction subject to the section and the regulations. A person must not sell any "section 1020B products" to a buyer unless, at the time of the sale, the person has a presently exercisable and unconditional right to vest the product in the buyer, or believes on reasonable grounds that such a right exists. Where a person is acting as an agent (eg a sharebroker acting for a client), that person's principal must have a presently exercisable and unconditional right to vest the securities in that buyer, or the agent must believe on reasonable grounds that the principal has that right.
- The following products are "section 1020B products":
 - (i) securities, as defined in s761A;
 - (ii) managed investment products;
 - (iii) debentures, stocks or bonds issued or proposed to be issued by a government; and
 - (iv) financial products of any other kind prescribed by the Regulations.
- The meaning of "presently exercisable and unconditional right" is given further meaning by s1020B(3). For the purposes of the section 1020B prohibition,:
 - (a) the person who at a particular time has a presently exercisable and unconditional right to have section 1020B products vested in that person, or in accordance with the direction of that person, has at that time a presently exercisable and unconditional right to vest the products in another person; and
 - (b) a right of a person to vest section 1020B products in another person is not conditional merely because the products are charged or pledged in favour of another person to secure the repayment of money.

Additionally, a person who purports to, or who offers to, or who holds themselves out is entitled to sell section 1020B products, or who instructs a financial services licensee to sell section 1020B products, is taken to sell those products for the purposes of section 1020B: s1020B(7).

- s1020B(4) exempts 5 categories of short sale from the central prohibition in 1020B(2). The combined effect of these exemptions is that a great deal of lawful short selling is permitted. The 5 categories of exemption are:
 - (a) Transactions of odd-lot specialist financial services licensees: s1020B(4)(a).

- (b) Arbitrage transactions: section 1020B(4)(b). A person who seeks to short sell section 1020B products in an arbitrage transaction through a financial services licensee must inform that licensee that the sale is short: s1020B(5).
 - (c) Sales by purchasers prior to settlement: s1020B(4)(c).
 - (d) other "covered" short sales: s1020B(4)(d) in the case of "off market" transactions a person, other than an associate of the body corporate that issued the products may lawfully short sell them provided that arrangements are made before the time of the sale that will enable delivery of the products to be made to the purchaser within 3 business days of the sale: s1020B(4)(d)(i) and (ii) (such arrangements would usually involve the seller borrowing the necessary securities).
- There are 3 additional requirements where a sale is made on a licensed market:
 - (i) under the "tick test" the sale must be effected on a steady or a rising market for the securities: s1020B(4)(d)(iii). The short sale price per unit must not be below the price at which the immediately preceding ordinary sale was effected and the short sale price must be above the immediately preceding ordinary sale price, unless that price was higher than the next preceding different price at which an ordinary sale was made;
 - (ii) the operator of the stock market must be informed as soon as practicable that the sale was to be made in accordance with the "tick test": s1020B(4)(d)(iii); and
 - (iii) the person who makes the sale must endorse a statement that the sale was a short sale on any document evidencing the sale that is given to the buyer (whether or not the buyer acts on its own behalf): s1020B(6).
 - Under the "major listed company sales" exemption in s1020B(4)(e) the 1020B prohibition will not apply to a short sale if the products are stocks within a class declared by the market operator to be exempt, the sale is made in accordance with the operating rules of that market, and at the time of the sale neither the seller nor any person on behalf of whom the seller sold the products was an associate, in relation to that sale, of the body corporate which issued the products.