

AIMA Australia

Alternative Investment Management Association (AIMA)

The Forum for Hedge Funds, Managed Futures and Managed Currencies

April 24th 2008

AIMA Australia's Response to ASX Public Consultation on Short Selling

Introduction

As the only truly representative global hedge fund association, AIMA, the **Alternative Investment Management Association**, has over 1,300 corporate members worldwide, based in 49 countries.

Members include leading hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting services and fund administrators. They all benefit from AIMA's active influence in policy development, its leadership in industry initiatives, including education and sound practice manuals and its excellent reputation with regulators, worldwide.

AIMA is a dynamic organisation that reflects its membership's interests and provides them with a vibrant global network.

Its objectives are:

- ≈ To provide an interactive and professional forum for our membership and act as a catalyst for the industry's future development
- ≈ To be the pre-eminent voice of the industry to the wider financial community, institutional investors, the media, regulators, governments and other policy makers
- ≈ To offer a centralised source of information on the industry's activities and influence, and to secure its place in the investment management community

AIMA is committed to developing industry skills and education standards and is a co-founder of the **Chartered Alternative Investment Analyst** designation (CAIA) – the industry's first and only specialised educational standard for alternative investment specialists.

AIMA offers a canon of work that has been adopted by investors and practitioners globally, and welcomed by policy makers and regulators. This includes offering practitioners and investors with practical guidelines on topics such as valuation, business continuity, fund governance and fund management.

About AIMA Australia

AIMA Australia, established in 2001, is one of AIMA's largest and most active country networks. Australian members are derived from all areas of the local alternative investment community with

the vast majority being hedge fund managers. In 2007, AIMA Australia members managed over 80% of the assets invested in hedge funds by Australian investors.

Members of the country network support individual working committees that focus on Regulation, Education, and Membership & Marketing. .

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AIMA Australia maintains an active dialogue with Australian regulators and other government agencies on issues related to the hedge fund industry.

The association organises informational forums for industry participants, as well as commissioning studies and reports pertinent to the local hedge fund industry. In addition to regular networking events, the association also confers with conference organisers to ensure interesting topics and knowledgeable speakers are included in conference agendas.

For more information on AIMA Australia, please visit www.aima-australia.org.

Overview

AIMA Australia welcomes the opportunity to respond to the important matters which are raised in the ASX's Consultation Paper on Short Selling ("the CP") and we have, for some time, underscored the market efficiency aspects of short selling and their wide spread use by market participants.

AIMA Australia has written a position paper on short selling for its members which can be viewed on the association's website, and which is attached to these submissions. We invite ASX to read our submissions and responses in the table below in conjunction with the Position Paper which is attached.

Executive Summary of AIMA Australia's position on Short Selling

AIMA Australia's position on issues relating to short selling, as discussed in the attached Position Paper, is as follows:

- 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.
- 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, 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 recognized as such by academics and market commentators, and by regulators, worldwide.

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

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- 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 the Position Paper.

Responses to ASX's specific requests for comments

In the table below we have responded to ASX's requests for comments on the specific short selling issues raised in its Public Consultation Paper. Appropriate cross references to the AIMA Australia Position Paper have been made.

ASX Request for Comment	AIMA Australia Response
1. Comments on the two alternative short-term approaches considered by ASX, and the reasons provided for not proceeding with these options.	1. AIMA Australia agrees with ASX's stated understanding that the ratio of stock lending to short selling is variable and if used as a proxy could substantially overstate the use of short selling. For these reasons, AIMA Australia believes that the solution lies either in rewriting the legislation via the ASX Rules, or rewriting the legislation in conjunction with the ASX Rules. AIMA Australia has a strong preference for the former solution and believes that its proposed solution for disclosure and transparency (set out on pages 7 and 8 of its Position Paper, could be achieved by way of ASX Rule changes, provided that ASX participants (who would be the parties bound by the ASX Rule changes) were required to cause disclosure to be made in accordance with AIMA's suggestions. AIMA Australia's suggestion is that reportable information be obtained from service providers of market participants, for instance custodians. Adopting this approach will impede the efficient and confidential flow of information which is vital to portfolio management.
2. What information should be included in the daily short sale report submitted to ASX and what detailed guidance should the ASX provide on the calculation of that information to ensure uniformity of reporting?	2. AIMA Australia believes that imposition of daily short sale reporting would be "overkill" and inconsistent with the practices adopted on international exchanges. For example the New York Stock Exchange (NYSE) imposes a monthly reporting requirement, although there is a bi-monthly requirement for certain specified stocks. See the website: www.nyse.com . As to the nature of the information to be included AIMA Australia believes that this should include (1) the number of shares reported as sold short, which should be a net number (i.e. net of

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	those shares closed out intra period); and (2) ASX should calculate that number as a percentage of the current issued shares of the underlying security (i.e. the company under consideration).
3. What information should be included in the daily short sale report published by ASX?	3. See response number 2 above.
4. What time should the short sale report be published each day?	4. Generally see response 2 above. AIMA Australia believes that the information should be reported and published monthly, with perhaps specific securities being reported bi-monthly (as is the practice on the NYSE there could be a separate schedule of the stocks to be reported bi-monthly, which would generally be hard to borrow or illiquid stocks).
5. Any other measures to improve transparency in relation to short selling activity.	5. AIMA Australia believes that ASX should investigate segregating liquid and illiquid stocks along the lines adopted by the NYSE which has introduced a "Easy to Borrow" List. See the NYSE Information Memorandum: "adoption of new provisions affecting the regulation of short sales" number 04-54, October 12 2004.
6. Comment on whether the tick test should be retained, including whether it should be retained for all securities, or only retained for some securities (eg those not in the Approved List), and why this should be the case.	6. AIMA Australia believes that the tick test should not be retained for any securities. It is significant that the NYSE temporarily suspended the tick test, beginning in 2004 and adopted a pilot test which indicated that tick test restrictions only modestly reduced liquidity and did not appear necessary to prevent manipulation. In addition the empirical evidence of the pilot did not provide strong support for extending a tick test to either small or thinly-traded securities not currently subject to a price test. Accordingly the tick test was eliminated and the amendments achieving this were approved by the US Securities and Exchange Commission (SEC). (See NYSE Regulation Information Memo "SEC Repeal of Short Sale Tick Test" number 07-63, June 29 2007).

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<p>7. Comment whether the tick test should apply to all types of short sale, or only in relation to some types of short sale, and why this should be the case.</p>	<p>7. See response number 6. AIMA Australia believes that the tick test should be abandoned.</p>
<p>8. Comment as to whether the current market capitalization and liquidity tests remain relevant.</p>	<p>8. AIMA Australia understands that the current market capitalization and liquidity tests apply to permit trading in naked shorts, under the current regime. For the reasons set out in response number 10, AIMA Australia believes that naked short selling should not be permitted. Further, AIMA Australia believes that market capitalization and liquidity tests are extremely prescriptive and not as useful as some tests applied in other international exchanges. For example, on the NYSE the Easy to Borrow list and the issue of Threshold Securities and the Exchange's issue of "Threshold Securities Declarations" allows market participants input into the appropriate segmentation of the universe of shares available for short selling. This is a simpler and more user-friendly system than the one available under the current ASX tests. That being so, market efficiency and price discovery are enhanced.</p>
<p>9. Comment on the settlement failure fee regime, in particular the principles which ASX proposes will underpin the new Settlement Fail Fee regime.</p>	<p>9. Again, AIMA Australia invites ASX to carefully consider the practices adopted on other international exchanges. For example, if an Easy to Borrow regime such as that on the NYSE were adopted and settlement is T+3, then the likelihood of settlement failure would be remote. In the case of Hard to Borrow securities ("Threshold Securities") ASX should in the opinion of AIMA Australia consider reintroducing a buy-in mechanism which would be triggered 10 business days after T+3. AIMA Australia supports an extension of the time period to 10 business days after T+3 on the basis that this seems to be an equitable step in light of the additional exposure which would be suffered by brokers if a buy-in mechanism is reintroduced. See also our response number 10 as to naked short sales.</p>

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<p>10. Comment on the settlement failure fee regime, in particular views on other mechanisms to further improve timely settlement of equity trades.</p>	<p>10. AIMA Australia believes that ASX should give early consideration to the prohibition of naked short selling. This prohibition is perhaps more extensive internationally than is indicated by ASX's table on page 14 of its Public Consultation Paper. In particular, that table shows that the NYSE allows naked short selling. Although that is strictly speaking accurate, the NYSE regime treats a short sale as a naked short where there is no existing arrangement to borrow the necessary security but the relevant party has "reasonable grounds" to believe that the security can be borrowed so that it can be delivered on the delivery date, and has documented compliance with the rule. NYSE Rule 203 requires broker-dealers, prior to effecting short sales in all equity securities, to locate securities available for borrowing. Rule 203(b) imposes specific further requirements in this regard. (See NYSE Information Memorandum "Adoption of new provisions affecting the regulation of short sales" number 04-54, October 12, 2004). The elimination of naked short selling will go a long way towards eliminating many of the aspects of settlement risk discussed in the ASX Public Consultation Paper.</p>

Contact points

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