



AIMA AUSTRALIA
SUBMISSION
ON THE EXPOSURE DRAFT OF THE
CORPORATIONS AMENDMENT (SHORT SELLING) BILL 2008

21 October 2008

**A submission prepared by the Regulatory Committee
of the Alternative Investment Management Association
Australia Chapter**

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1. Background on AIMA Australia

The Alternative Investment Management Association (**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 Australia Chapter 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.

2. Background on this Submission

On 23 September 2008, the Treasury released the Exposure Draft of the Corporations Amendment (Short Selling) Bill 2008 (**Bill**) and accompanying Commentary on the Bill (including a Regulation Impact Statement) (**Commentary**).

The current legislation in Australia regulating short selling is complex and unclear and the absence of reporting of covered short sales has heightened uncertainty about the real impact of covered short sales in Australia. This uncertainty contributed to a 30 day temporary ban being imposed on all short sales (subject to certain limited exemptions) on 21 September 2008.

The Commentary states that the purpose of the Bill is to provide for enhanced disclosure of covered short sales of securities, managed investment products and certain other financial products (**section 1020B products**)¹.

The Commentary outlines a range of possible policy options relating to the regulation of covered short sale transactions which have been considered by the Government . These policy options have included:

- (a) taking no regulatory action (**Option 1**);
- (b) requiring the disclosure of covered short sales by investors to brokers, who would then in turn be required to disclose those covered short sales to the market operator (**Option 2**);
- (c) requiring investors to disclose covered short sales directly to the market operator (**Option 3**);

¹ Exposure Draft of the Corporations Amendment (Short Selling) Bill 2008 - Commentary 23 September 2008, paragraph 51.

- (d) requiring disclosure of stock lending transactions (**Option 4**); and
- (e) undertaking a wholesale review of the existing short sales regime (**Option 5**).

The Government has selected Option 2 as the recommended approach and the Bill has been prepared on that basis.

In releasing the Bill and Commentary, the Treasury has sought public views and comments on the Bill by 21 October 2008. Accordingly, AIMA Australia has prepared this Submission to articulate its concerns in relation to aspects of the Bill and the Government's decision to select Option 2 as the recommended approach.

3. **Overview of AIMA Australia's position on short selling**

As set out in the attached AIMA Position Paper, which has previously been provided to the Australian Securities Exchange (**ASX**), and copied to the Australian Securities and Investments Commission (**ASIC**):-

- AIMA Australia views short selling as playing a key role in promoting the future growth of Australia's financial markets. Indeed, as the Government has recognised, short selling has the advantage of increasing market liquidity and pricing efficiency².
- Hedge fund activity on Australia's financial markets is an important and productive component of activity on those markets, which adds considerable depth to trading in those markets. Hedge funds are typically net long investors and if they are required to abandon long/short investment strategies, this will have a negative impact on Australia's financial markets. AIMA Australia anticipates that if the temporary short selling ban imposed by ASIC is extended beyond 30 days, there will likely be wholesale closure of many Australian hedge funds and management companies in the months ahead, in particular amongst dedicated long/short equity managers. AIMA Australia has called for an immediate lifting of the ban.
- Moreover, only a small proportion of hedge fund trading relies on short selling and a large amount of short selling in the Australia financial markets represents the risk management and hedging activities of other investors.
- Australia has one of the most detailed and onerous regimes for regulation of short selling in the world. The Australian regime is unique, in that it is based on a prohibition of short selling subject to exemptions. AIMA's view is that the scope of these exemptions and their relevance to current market conditions needs review and reform. As set out in its Position Paper AIMA Australia supports a sensible disclosure regime which enhances market transparency and price-discovery in relation to short selling.
- AIMA Australia believes that Australian law, and in particular the provisions of Part 7.10 of the Corporations Act, provide adequate protection from the sort of

² Exposure Draft of the Corporations Amendment (Short Selling) Bill 2008 - Commentary 23 September 2008, paragraph 24.

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 of trading, may be manipulative when misused, short selling is not in itself manipulative³.

- Unwarranted or unreasonable restrictions on or prohibition of short selling, are likely to significantly reduce the ability of investors (such as superannuation funds) to adequately manage risk and hedge their investment positions.

4. **AIMA's submissions on the Bill**

The key to regulatory reform in this area is enhanced transparency of short selling through disclosure.

AIMA has reviewed the Bill and the Commentary and makes the following submissions.

(a) **Reporting short positions - Option 2**

In implementing the approach recommended in Option 2, the Bill provides that the executing broker must report short positions. This approach is supported by the ASX, which has existing relationships with executing brokers, as they are participants on ASX. However, AIMA has the following concerns in relation to Option 2:

- (i) **Inefficient and costly** - Executing brokers currently do not have the requisite systems to enable them to track and report this information. That is, to convert trade data, including the opening of new short sales positions, increasing existing short sales, reducing and closing existing short sales (i.e. purchases) into position data will be an enormous undertaking and will require a sophisticated systems solution. Therefore, there would be significant delays and costs involved in implementing this reporting arrangement, whilst executing brokers effect the necessary systems changes;
- (ii) **Unreliability of information** - There is no way of ensuring the reliability of the information provided by executing brokers. Typically brokers do not carry a record of holdings for their clients and investors may use multiple brokers to achieve a desired position. In addition, there is no way for the executing broker to check the truth of the source, that is, they are relying on their client notifying them that a sale is short;
- (iii) **Unfairness and loss of confidentiality** - Not only would the Option 2 approach involve the disclosure of commercially sensitive information and active investment research related information to other investors and market participants, but it could give rise to the real risk of gossip, market manipulation, front running and other free rider behaviour;

³ Financial Services Authority: Discussion Paper 17: Short Selling: October 2002, paragraph 4.15.

(iv) **Ineffective and incomplete:**

- (A) Option 2 will not capture all short sales - direct market access users do not use executing brokers, so their short sales will not be captured; and
- (B) the 'moment of truth' is settlement - therefore, executing brokers could also be reporting incomplete or erroneous trades.

(b) **Why a variation of Option 3 is preferable to Option 2**

AIMA Australia submits that Option 3 varied as suggested below, is preferable to Option 2, because it would involve the disclosure of all aggregate short sale positions by investors or their agents (such as prime brokers and custodians) directly to the market supervisor, ASX, on a timely basis.

Investors' prime brokers and custodians are best equipped to track and report the required information. Custodians who carry short positions on behalf of their clients would already capture, settle and report this data daily on a traded and settled basis. Positions will also include unlisted off-market transactions for which they act as custodian. Under this approach, each client's account will be aggregated across every security. The fact that some clients will have offsetting long positions is not relevant, because the fact that one arm of the client has borrowed stock (or sold in advance of borrowing stock or settling) as principal or for an underlying client is what is required to be captured, and will be captured using this approach.

In addition, there are fewer custodians than either investors or brokers. Accordingly adoption of AIMA Australia's variation to Option 3 could result in reduced regulatory costs and administrative complexity. AIMA Australia's discussions with custodians have confirmed that these advantages would be available.

In summary, AIMA Australia believes that the most effective method of reporting short selling would be reporting to the market operator, and that responsibility for this, where the investor has appointed a prime broker or custodian, would lie with the prime broker/custodian.

AIMA Australia contends that this variation to Option 3 would more completely satisfy the key regulatory imperatives: increased transparency through ready access to complete and reliable market information.

(c) **Frequency of reporting and content of reports**

AIMA's view is that daily short sale reporting would be "overkill" and inconsistent with the practices adopted on international exchanges. A reasonable objective would be to report net short sales on a bi-monthly, or fortnightly basis. The New York Stock Exchange, for example, imposes a monthly reporting requirement for most stocks, and requires bi-monthly reporting for certain specified stocks. Moreover, AIMA Australia submits that international experience is that data provided fortnightly serves the market well and that there is little movement from one fortnight to the next.

(d) **Timing**

The Commentary states that the Bill will replace ASIC's interim arrangements regulating short sales⁴. Under ASIC's interim arrangements, the operation of section 1020B of the Corporations Act has been temporarily suspended such that, from 22nd September 2008, ASIC has temporarily:

- (i) banned naked short selling;
- (ii) banned covered short selling (subject to certain exemptions); and
- (iii) introduced an interim disclosure requirement for the permitted covered short sales.

AIMA Australia submits that, if the temporary ban on short selling remains in place until the Bill becomes an Act, then this will have a severely negative impact on the Australian financial system in the meantime. ASIC's temporary ban, which is far more onerous than the arrangements implemented by the regulators in any other comparable jurisdictions, such as the United States and the United Kingdom, has severely undermined effective price discovery in listed Australian securities and liquidity in general on the ASX. If the purpose of the ban was to mitigate "unwarranted price fluctuations" and to maintain "fair and orderly stock markets", AIMA Australia submits that the short selling ban has failed.

AIMA Australia further believes that the short selling ban may, perhaps in the medium term, impact poorly on Australia's reputation for sensible, flexible and restrained market regulation. The ban will certainly do nothing to enhance Australia's profile or attractiveness as a regional or global market place.

AIMA Australia recognises that the current turmoil in financial markets is being caused predominantly by a crisis in banking and credit markets, and accordingly it supports any and all measures that can deliver stability and build confidence in these markets. But it is a serious mistake to attribute the current banking and credit crisis to short selling.

In light of the removal of all covered short selling restrictions in the United States and the recent authorisation of short selling in other markets over the last 30 days, the temporary ban in Australia is causing long-term damage to investors, ASIC-licensed entities and market mechanisms. It should be abolished as soon as possible.

An interim solution, pending introduction of the Bill could be to require that current short sale positions held with prime brokers be submitted to the ASX as soon as possible. Prime brokers are ASX-regulated entities and would be able to provide this information without delay, to the ASX. The advantage of this is that prime brokers also hold the vast majority of hedge fund positions and capture trading information from this group on a timely basis. As other custodians finalise and update their systems, they could fall

⁴ Exposure Draft of the Corporations Amendment (Short Selling) Bill 2008 - Commentary 23 September 2008, paragraph 14.

under an obligation to report under this interim proposal. This would, for example, result in the capture of institutional shorting in the "130/30" type funds.

(e) **Reporting stock lending - Option 4**

Option 4 canvassed in the Commentary would involve requiring disclosure of all stock lending transactions on the grounds that it is a suitable proxy for the level of covered short selling in a given security. However, AIMA Australia submits that this would not be an accurate or practical way of identifying the levels of short selling activity in the Australian market, because that stock lending can be used for purposes other than short selling.

Moreover, stock lending transactions may involve a security passing through many hands (stock lending is a deep and liquid market) before it finally reaches a short seller. For example, a fund manager may ask its prime broker for stock availability. The prime broker may then draw the stock from its own/its client's inventory or go to the market to borrow the stock for the fund manager. To the extent this occurs, the reporting of any such stock lending activity will further overestimate short selling. The market and regulators only need to know the level of net short selling, not the flows in the stock lending market.

Background discussion on short selling

The Schedule to this Submission contains AIMA Australia's Position Paper on short selling, which was provided to Treasury, ASIC and the ASX in April 2008 and has been discussed with these authorities and other industry groups.

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Schedule

AIMA Australia - Position Paper on Short Selling



AIMA AUSTRALIA
POSITION PAPER
ON
SHORT SELLING

April 2008

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

AIMA AUSTRALIA
POSITION PAPER ON SHORT SELLING
April 2008

AIMA Australia

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 Chapter 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 manipulative⁵.
- 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."⁶

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.⁷ 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.⁸

⁵ Financial Services Authority: Discussion Paper 17: Short Selling: October 2002, paragraph 4.15.

⁶ *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.

⁷ Lexis Nexis Australian Corporation Law Principles and Practice: <https://www.lexisnexis.com/au/legal/delivery>.

⁸ 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 funds⁹).
- 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.¹⁰
- 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.¹¹
- 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".¹²
- 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.¹³

The US Securities Exchange Commission in its report "SEC Concept Release: Short Sales"¹⁴. 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."

⁹ FSA Discussion Paper 17 op cit Paragraph 4.3; and the Goldwasser "*Short Selling Revisited*" (1994) 12 C & SLJ page 277 at 286.

¹⁰ Goldwasser op cit at page 287, citing JA Walker "*Selling Short - Risks Rewards and Strategies*" (John Wiley and Sons, 1991) page 6.

¹¹ FSA Discussion Paper 17 op cit Paragraph 4.4.

¹² FSA Discussion Paper 17 op cit Paragraph 4.6.

¹³ Deutsch "*Short Selling*" op cit at page 50, citing report by Brisbane Stock Exchange (1971).

¹⁴ <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.¹⁵
- 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.¹⁶
- 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.¹⁷

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.

¹⁵ See generally FSA Discussion Paper 17 op cit Paragraphs 4.9 and 4.10. See also R Deutsch op cit at page 150.

¹⁶ AIMA Response to FSA Discussion Paper No 17, November 2002: <http://www.aima.org/aima.asp?id=4>.

¹⁷ 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.¹⁸

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.¹⁹ "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.²⁰

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.

¹⁸ FSA Discussion Paper 17 op cit Paragraph 3.15.

¹⁹ Goldwasser op cit Page 287.

²⁰ 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 paper²¹ 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

²¹ 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 FSA²² 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).

²² 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 manipulative²³.
- 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.

²³ 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.