



Institute of Actuaries of Australia

22 October 2008

Mr Geoff Miller
General Manager
Corporations and Financial Services Division
The Treasury
Langton Crescent
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Email: shortsellingbill@treasury.gov.au

Dear Geoff

Institute of Actuaries of Australia Comments on the Corporations Amendment (Short Selling) Bill 2008

Background

I refer to the recently released Exposure Draft of the Corporations Amendment (Short Selling) Bill 2008, due for comment on Tuesday 21 October 2008.

While the Institute of Actuaries of Australia (Institute) is not an ASX market participant it is a member of the ASX Corporate Governance Council and has a particular interest in the discussion of short selling and other transactions where borrowing or any other form of encumbrance takes place.

Actuaries identify, observe and monitor risks across the whole financial system and the Institute is particularly concerned in relation to any changes to the operation of markets which may potentially impact the interests of investors, its members, financial institutions or market participants generally.

Many actuaries are involved in commercial and financial reporting roles for financial institutions and providing advice on the fair allocation of investment performance amongst their customers and members. The proper and fair valuation of assets is critical to a robust outcome. In these roles our members are concerned about market pricing, transparency and efficiency. The Institute strongly endorses the importance of an efficient and transparent market for pricing assets in general and traded securities in particular.

Furthermore, many actuaries by virtue of their statutory roles are involved in the assessment of solvency and capital adequacy of financial institutions. Other actuaries are involved in undertaking key financial risk management assessments of financial institutions. Information around security aspects that could impact security price volatility and variation (e.g. overall underlying market leverage to a stock) would be of considerable value in that context.

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Our views and opinions are not primarily directed at addressing technical implementation but are rather directed at addressing the principles that should be adopted to ensure a robust framework of market reporting.

In April 2008, the ASX released a public consultation paper on a range of possible improvements to the existing regulation of short selling in Australia. The Institute responded to that paper with the attached response.

General Comments on Short Selling

Short selling per se has a legitimate role to play in traded markets in contributing to market liquidity and efficient price discovery. Furthermore, it is inexorably linked to the overall operation of a modern financial market that provides instruments such as derivatives and other risk transfer and hedging mechanism and products. Short selling linkages include, but are not limited to, hedging net derivatives positions and the ability to replicate short selling effects via the use of synthetic (derivative) trades.

Nonetheless, we note the following high-level comments:

- a) Short selling involves additional market risk, counterparty risk, settlement risk and liquidity risk to that normally associated with the traditional purchase of physical shares.
- b) There is considerable regulation of the disclosure, transparency and governance of share purchases which does not apply to short selling. In our opinion there should be greater disclosure, transparency and governance of short selling than currently applies to physical purchases, because of the greater level of potential risk.
- c) The Institute believes that better disclosure of short selling as foreshadowed by Treasury will significantly enhance the market reporting regime.
- d) The current reporting requirements appear to result in an under-reporting of short sales, where only naked short sales are reported and covered short sales are not reported because the "shorter" is deemed to own the stock that has been borrowed (despite often having some obligation to repatriate the stock at a later date). The market would be better informed if all short positions were disclosed.

Specific Comments on the Exposure Draft

The Exposure Draft prefers Option 2 which recommends Direct Disclosure of Covered Short sales to Brokers. This involves an obligation on investors to disclose covered short sales and the broker will then be responsible for reporting this information to the market operator or any other relevant authority.

We are concerned that there are number of potential practical difficulties arising with Option 2.

Many broker clients would be most reluctant to disclose the shorting nature of a sale as it could well compromise the perceived trading position of the client. A client would be concerned that a broker would then become aware of the client's net exposure to a specific stock. Ownership levels are normally very confidential to investors as this information could affect or be perceived to affect the client's future trading activity with that broker or other brokers. For example, the advising broker could become aware that the client was vulnerable to an unexpected rally in a specific stock, and/or the broker would be aware that at some point any short needs to be bought back.

There is also a client concern that the broker could well leak that information to other broker dealers in the same firm or external firms, particularly if the trade or client was large, which could have significant financial consequences for the client.

Moreover, a large shorting trade by a well regarded investor could be well seen as price sensitive information to the market. Therefore information around a shorting sale which could be potentially regarded as price sensitive information would then require urgent market announcement under continuous disclosure rules. Listed companies are normally responsible for such disclosures but they are not in the loop on the shorting trade.

We note practical difficulties could well arise in policing any verbal indication of the short sale nature being advised to a broker. Most instructions are advised verbally. While there is a high degree of accuracy normally associated with execution of a verbal sale instruction with respect to the key outcome elements of the trade (what security, how much, what price), such accuracy may be much reduced with recording more administrative elements such as shorting indicators. Clients or brokers could easily claim to have heard a different version of events.

In summary our concerns on Option 2 are that it:

- a) Requires manual reporting around often a verbal sale instruction.
- b) Potential loss of confidentiality.
- c) Lack of reporting adherence and accuracy.
- d) Potentially a cause of price sensitive information.
- e) Lack of consistency around measurement of gross and net shorts.
- f) Significant information costs imposed on market participants.

Institute Preference for Option 4 Advising Lending Transactions

The Institute sees the best option is Option 4. Disclosure of Stock Lending Transactions.

We understand that stock lending may be effected for some purposes other than covering short sales. For example, stock lending may be occasionally undertaken by foreign shareholders who cannot utilise Australian franking credits and who wish to lend out the stock across a dividend entitlement period. However the taxation rules around franking utilisation would limit this use of stock lending.

Overall it would appear that the majority of stock lending transactions would generally relate to the use of covered short selling. Moreover, any unusual and rapid increase in stock lending is most likely an indication of an increase in short selling.

Most stock lending is provided via large ASIC licensed financial institutions, funds and/or custodians with centralised processes and with significant IT systems that could be amended to handle this type of reporting. Most would be already preparing daily stock lending reports.

We therefore see the use of these institutions, funds and custodians as a more robust reporting entity than broker dealers.

We see this implementation as more confidential and would not require disclosure of specific client positions to brokers. Each specific sponsoring client's position would not need to be disclosed by custodians which could report aggregate short total gross and net short positions.

We believe greater accuracy of short reporting would result. In summary we see the benefits as:

- a) The Option requires no trader involvement and can be automated.
- b) Would capture most shorting positions.
- c) More consistent and accurate reporting than Option 2.
- d) More anonymous than Option 2.

The Institute Separately Recommends a Wider Scope be Considered

We noted in our April 2008 submission to the ASX that "covered" short selling which requires stock borrowing effectively places an "encumbrance" or "lien" over the ownership or title to an asset which potentially limits the use and liquidity of that asset by the original owner. This is akin to a mortgage.

We also noted that there has been an explosion in the use of other forms of financing such as margin lending which similarly cause an encumbrance or mortgage over the use of an asset. These other encumbrances have recently caused some dislocation in markets and it seems sensible to consider a more holistic approach to the topic.

We continue to consider that the recent concerns around margin lending and other share financing arrangements are **not** a separate issue from the issues raised by Treasury in relation to short selling. There have clearly been a number of recent notable failures in regard to margin lending and related financing arrangements but we do not believe these are attributable to deficiencies in regard to the short selling regime.

The Institute suggests the scope adopted in market reporting should therefore be broadened to include a wider set of encumbrances than currently contemplated under the Amendment Bill.

The Institute is seeking to ensure that the Treasury treatment of short selling and other encumbrances is robust, identifies accumulating market risk and provides valuable market information without creating an undue burden of administrative complexity.

We note in this context that the reporting of margined stock would seem to be readily provided by the same institutions and/or custodians that would report under Option 4.

Other Specific Concerns of the Institute

The following points summarise a range of other related points:

- The Institute does not however consider that the reporting of gross short positions rather than net or the introduction of intraday reporting would enhance transparency. This would introduce considerable data and administrative complexity of little significant value.
- The Institute supports the maintenance of a tighter regulatory framework in regard to short selling than is typically imposed overseas. In particular the use of the tick test is recommended to be retained as it significantly reduces the potential for share price manipulation.
- Stock lending fees enhance the returns achieved by investors. We understand that the typical stock lending fee is around 40 to 60 basis points per annum. This lending fee can therefore provide a valuable source of additional investment return to long term investors who operate on a buy and hold basis. There is strong evidence to indicate that long term hold strategy is a valid investment strategy compared with

- active management which incurs transaction costs and tends to potentially forego dividends and franking credits. We would not want to limit the ability of investors to derive valuable benefit from this additional source of return.
- The Institute is concerned that the use of stock lending arrangements may not be entirely subject to robust and prudent arrangements in Australia. It appears to be a complex area, fraught with a mixture of both legal complexity and technical stock trading issues that could well result in a financial misadventure for unwitting stock lending participants. The Institute suggests the regulators consider improved supervision and monitoring of stock lending arrangements. For example a requirement for compliance monitoring or audit of any stock lending arrangements could be considered for AFS licensees.
- We do not support the practice of borrowing stock for the purpose of "vote renting" at company meetings.

I hope you will find the above views and suggestions helpful. Please do not hesitate to contact the Institute (John Maroney, CEO, tel. (02) 9233 3466 or Philip French, Director Public Affairs, tel (02) 9239 6111) if you require any further information.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Greg Martin', written in a cursive style.

Greg Martin
President