

Company Director – November 2008 issue

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Green's Piece

The long & the short

John M Green provides a view on what needs to be done before short-selling is permitted again

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One feverish September weekend, Australia's market regulators slapped a temporary ban on short-selling. Pressure for this had been mounting for months, yet our regulators had their hands forced earlier that week when overseas regulators took similar action.

Worse, because our market is smaller, less liquid and thus easier to manipulate, we should have taken this tough step well before the others, not after them.

Back in March, I wrote the following in the *Australian Financial Review*: "Normally, short-selling is a legitimate aid to market efficiency, giving greater depth and liquidity and finer pricing, as does speculation generally. (Hedging for our commodity industries would be more costly and difficult if we banished speculators from those markets as we once did.) But in the current fear-driven stock market, with shareholders and potential buyers still cowering in the shadows, what short selling will do is spray high-octane gas onto already over-heated panic selling when its next wave hits."

In the six long, scary months to September, this happened more than once, yet our regulators had to be dragged by actions of foreign regulators to do what was obvious for ages.

To me, short-selling is like mowing lawns. In good times, cutting grass is beneficial. It cuts back exuberant spikes and wild runners. It also strengthens the underlying root system and gives greater lawn density. But during a drought, the repeated mowing of dry, withered grass can kill it. A good measure becomes a bad one.

In recent months, while panic and rumour-mongering shrivelled up buy-side liquidity, short-sellers kept slashing at the weakened grass, gleefully destroying it, when actually it sorely needed time to regenerate.

Despite my support for the short-term ban on short-selling, I agree with the government it should not be banned permanently. When the grass is again resilient, short-selling will act to strengthen it by cutting back the effects of undue exuberance and buy-side rumour-mongering, or ‘pumping and dumping’.

But importantly, before we lift the temporary ban, not after, the weaknesses in the old short-selling rules must be fixed. Thus also in late September, the Federal Government released its *Corporations Amendment (Short Selling) Bill* for public exposure.

There is little startling in the Bill, except for what it fails to do. Of course, it gets good marks for recognising that even short-selling ‘covered’ by borrowing stock is still short-selling, should be treated as such and must be fully disclosed to the market. But there are at least two things it was surprisingly silent on.

First, where are the new ASX rules to sit with this Bill? To highlight the question, take the ‘tick’ rule which prevents short-sellers dumping shares into a plummeting market. In its March consultation paper, the ASX suggested flicking the tick rule because our market manipulation laws were sufficient. Really? In its October follow-up paper, ASX still argues for this but offers an entirely different reason: trading systems complexities. The tick rule should not go, but if it does we first need better analysis than ASX’s bold yet unevicenced assertion that it could go “without having any adverse consequences”.

A far worse aspect of short-selling the Bill ignores is the now notorious practice by some 'trusted' intermediaries of lending a client's shares to short-sellers. The ASX rightly pointed this out in its October paper, suggesting the Bill should ensure disclosure of stock lending. I advocate going even further than the ASX.

Stock lending earned a paltry few hundredths of a percentage point, yet the practice helped shorts drive share prices down by tens of percentage points. A wow of a deal for a short-seller. A shocking one if they're your shares that were trashed.

Doesn't that smell like a breach of fiduciary duty? Not if the intermediary had your prior permission. But what if that permission was buried deep in some lengthy legal document you signed years ago before anyone focused on this ugly practice? The government's Bill (or an ASIC licence condition) should ban intermediaries lending clients' shares to short-sellers unless they ask clients for fresh permission, with big red flashing lights on the request.

If my intermediary asked me to lend stock to short-sellers, I might agree but only on three conditions: the lending fee is mine, no lending during a bear market or if sentiment for the particular stock is negative, and I'd want their guarantee of the borrower's solvency. Too hard? I'd rather keep my shares.

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