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OCEAN Financial Group Pty Ltd is a Corporate Authorised Representative of Falconer Bellomo & Co Ltd (AFSL No. 244315)

Corporations Amendment (Short Selling) Bill 2008
Corporations and Financial Services Division
The Treasury
Langton Crescent
PARKES ACT 2600
Sent by Email: shortsellingbill@treasury.gov.au

Dear Sir/Madam

Up until the early 1990's the regulatory regime for short selling had worked effectively, particular when you examine the 1987's crash and instances when the 10% limitation rule (ASX Business Rule 19.5) had previously been applied in stocks like Bougainville Copper ("**BOC**").

It was only with the invention of the concept of "Covered Short Sales" by John King of Mallesons that the market has collapsed, leading to the current disaster that is occurring on the Australian market. When short selling (undisclosed) is coupled with the elements of market manipulation it is quite easy for an aggressive merchant banker or hedge fund manager to drive a particular stock lower so that existing margin loans are forced to be in essence at least partly covered. At that stage all the short seller needs to do is to show size on the selling side to drive the stock lower. This type of behaviour has been evident in our market for quite a while now, with little to no action taken by our regulators the ASX and ASIC. The only action taken, one of forcing directors to disclose their margin loans, only increased the problem, as it provided a mechanism for the short seller to quickly identify those stocks that are vulnerable to this type of behaviour.

MY BACKGROUND

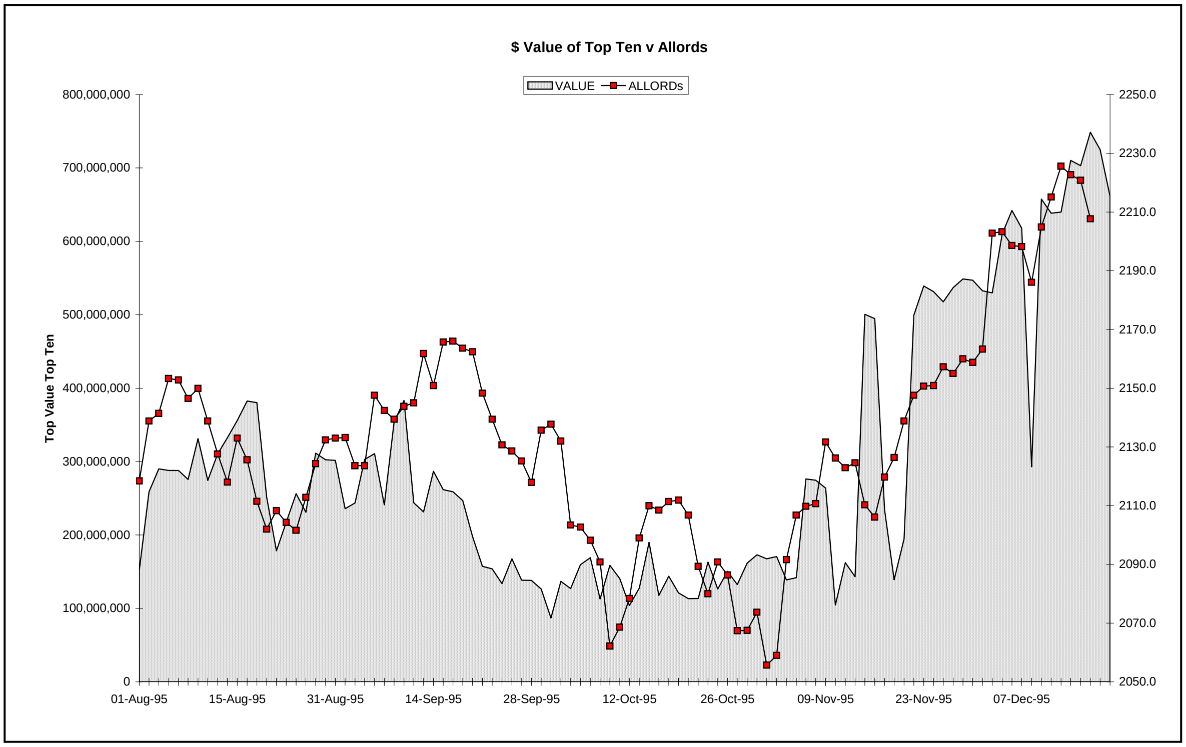
You may ask who this person is making such outrageous claims. I attached my CV as **Annexure A**. I have been a broker since the early 1980's exempt for my time at ASIC. DBSM was the first arbitrager in Australia and my role in that process was as principle trader. During my time at ASIC I was heavily involved in writing the draft papers on Short Selling (**Annexure B**) and OTC Derivatives Market. Also whilst at ASIC, I was involved in reviewing and making recommendations to the Attorney General in regard to changes of the ASX rules. In addition I have also given evidence for ASIC in regard to Nomura and Mt Kersey. Since leaving ASIC I have expressed over 300 opinions involving the market, more recently into elements of the Opes Prime fiasco. Therefore I believe that I am adequately qualified to comment upon these matters.

LACK OF ENFORCEMENT

In my opinion, the current knee jerk reaction is entirely due to the lack of enforcement of the current regime by the existing regulators. With the current changes what is gong to prevent this from this happening again. I will go into this in more detail through this paper, as it particularly addresses some of the questions that you are currently asking.

Following the review by ASIC of the Short Selling, I sourced the following graphical information (**Figure 1**) from the ASX. Whilst it only shows the top ten most actively traded stocks, it shows a high correlation between the value of the short sales (area) against the All Ordinaries Index. Also at this stage the value of the short sales in the top ten was about $700 million in a total market capitalization of $300 billion. The average exposure to short sales for the top ten ranged from 2% - 8.5%.

Figure 1: Comparison of Short Selling to the AllOrds for late 1995.



In writing the draft paper on Short Selling, I had extensive discussions with the stakeholders, including ASX and Mr. King.

In my opinion, the concept of "Covered Short Selling" does not exist. As previously stated, I am of the belief that the concept was initiated by Mr. King, in response to a legal opinion that he had previously expressed. During 1994, I had extensive discussions with Mr. King that should be documented on the ASIC files. As expressed to Mr. King at that time the reason why there was no such item as a "Covered Short Sale" is entirely due to the operation of the agreements between lender and borrower, both here in Australia and overseas, and the time of each action undertaken.

In my opinion, you can not sell securities without breaching sub-section 1020B of the Law unless you have a legal or equitable proprietary interest in securities giving rise to the absolute ability to give possession of the securities to another person now or in the near future. A script lending agreement does not give this ability.

I believe that we both agree that the legislator used an interestingly combination of words in 1972, "presently exercisable, unconditional right to vest". It is the "unconditional right" that raises the concern as no lender can lend stock that they do not current own. In this regard it is only at the time of the request to borrow the stock (which is totally different to the contract to borrow the stock) that this right is fulfilled. This request is always made after the timing of the actual trade.

There are fundamental reasons why this occurs. The lender wishing to protect its' equitable interest will require a fee, collateral and margin from the point of time in borrowing. If the borrowing occurred prior to the trade and the trade did not actually occur due to market conditions, then the borrower would be out-of-pocket by the borrowing costs, until such time as the loan was extinguished.

This is also supported by the degree of failed trades that are dated by more than T+3. If it is to be believed that current reporting is entirely due to the "Naked Short Sale", then you would expect to see a much higher level of failed trades and for longer periods. Rather there are quite a number of participants that have interpreted the law the way that I have and have reported "Covered Short Sales" as short sales. This means that the responsible citizens have been disadvantaged by reporting their trades, when others "maybe driven by legal opinion" have not.

This lack of fairness and equitability within the market due to the lack of enforcement action has seriously undermined the integrity of the Australian market place that cannot be repaired until such time as the full extent of the short selling has been made transparent. It is only at this time that fund managers will feel comfortable to re-enter the market. Until such time the short sellers are in control.

This lack of fairness is certainly known to the regulators. Mr King has made it known in his paper in 1999[1] (**Annexure C**), which has been recognised by the regulators as the expert opinion in this area. So why has the regulators done nothing about it and why will this not be the case in the future. It appears that the current amendment to the law is doing nothing in this area.

DISCLOSURE IS JUST PART OF THE REGULATORY REGIME.

I am of the opinion that short selling; especially when it is also coupled with the current market manipulation has significantly damaged the Australian market. In a recent letter to our Prime Minister, I highlighted my concerns in this area. In particular, that the activity is

[1] Securities Lending of Equity Securities in Australia, John C King, Mallesons Stephen Jacques, 1999, Fourth Edition, pXXVII

so broad spread across the spectrum. **Exhibit 1** shows the bid and offer stack for BHP on 19 September at 11:03:06am. It has highlighted an offer order for 228,500 BHP at 3619 (an unusual size order). On the right hand side we see a table for the Order History. It shows that this order was created at 9:46:59 and had been amended 10 times; however, no trades had resulted.

Exhibit 1: BHP Offer Stack with Unusual Trade.

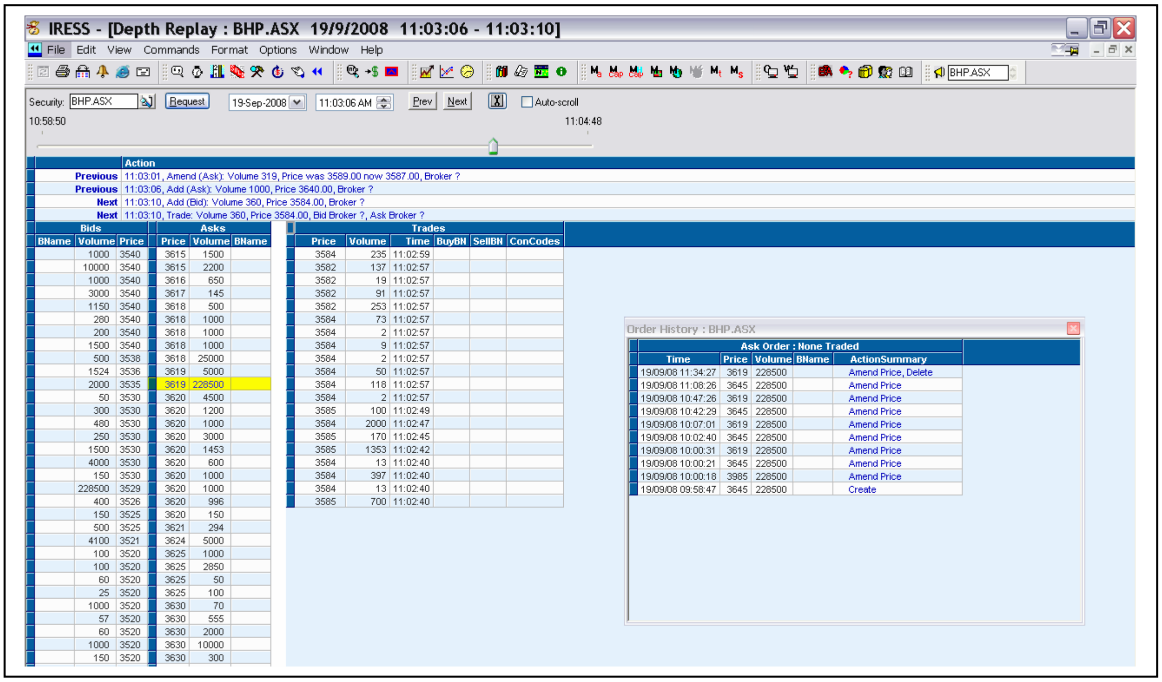


Table 1: Top 20

Stock	No of Shares
BHP	228,500
NAB	141,400
WBC	114,600
ANZ	222,700
AMP	97,700
BXB	87,900
CBA	66,300
FGL	84,600
NCM	14,300
QBE	11,500
RIO	19,400
TLS	730,700
WDC	83,300
WES	65,900
WPL	19,400

In my opinion, this is exactly the same type of behaviour that Nomura was found guilty of in the Federal Court in 1997.

You might say that this is just an isolated incident, however, the law in market manipulation really only needs two or more orders to show the pattern.

In fact it was occurring in a lot more stocks, in the top 20. I have identified in **Table 1**, that 15 stocks had an equal quantity on the bid and offer at around 11:00 am. But I believe that it was occurring across almost all the stocks in the top 200.

It also was not happening just on that day. I have identified that it was occurring on everyday since the beginning of August in BHP, in the following sizes. As can be seen in **Table 2**, it varies from day to day as if the Broker is accumulating and disposing of shares through other trades (these orders do not generate trades).

With regard to the amendments that occurred, in analyzing the amendments with the existing share price in BHP, I am of the opinion that both the bids and offers are set at a predetermined price apart and are amended when the existing price comes within 20 cents of either the bid and offer price and is amended so that the bid and offer is equally distance from the current share price.

Table 2: BHP Orders

Date	No. of Shares
01-Aug-08	171,500
04-Aug-08	176,100
05-Aug-08	177,100
06-Aug-08	172,300
07-Aug-08	161,800
08-Aug-08	168,500
11-Aug-08	167,500
12-Aug-08	171,400
13-Aug-08	169,000
14-Aug-08	182,100
15-Aug-08	162,500
18-Aug-08	170,000
19-Aug-08	168,300
20-Aug-08	162,600
21-Aug-08	151,500
22-Aug-08	152,200
25-Aug-08	142,300
26-Aug-08	129,900
27-Aug-08	127,800
28-Aug-08	127,000
29-Aug-08	124,300
01-Sep-08	130,000
02-Sep-08	166,800
03-Sep-08	174,400
04-Sep-08	152,000
05-Sep-08	153,800
08-Sep-08	159,000
09-Sep-08	160,300
10-Sep-08	160,000
11-Sep-08	179,000
12-Sep-08	191,700
15-Sep-08	168,700
16-Sep-08	181,000
17-Sep-08	202,200
18-Sep-08	213,400
19-Sep-08	228,500

This also is not an isolated incident; I have been monitoring the Australia Market for market manipulation since 1983. Over the last ten years since the listing of the ASX, market manipulation, has risen by in-excess of 8,000%. It is now so evident that you do not need a system to see it. But a total lack of enforcement has prevailed.

In the process of writing this paper I have spoken to over 200 funds managers / financial planning groups about their current actions. I have only found 3 that were investing. The overwhelming feedback was the reluctance to invest into the market until such time as the regulators ASIC and the ASX, clarify the ongoing extent of the short selling including “Covered Short Sales”. Until this occurs it is my belief that our current crisis will not be abated.

WHERE TO FROM HERE?

Major crises call for drastic solutions. The current crisis is, in my opinion, even worse than the 1987 crash which I experienced as a broker. If this market is not stablised within the next two weeks, then we will no doubt be in a down-ward spiralling depression, of unemployment, resulting in falling GDP, resulting in further unemployment. It has already started in the financial industry.

The first premise I am going to propose is that from a regulatory point of view a "Cover Short Sale" should be treated in the same fashion as a "Naked Short Sale". The same advantages and disadvantages are observed (see **Annexure B**), the only difference being the potential of a failed trade at T+3, which was originally negated by the Buy-In Rule (old ASX Rule 4.4). This rule no longer exists as this liability to settle has been passed directly to the Clearing Participant.

Short selling is regulated quite differently amongst the various jurisdictions world wide, but there are rules (whether imposed by the law or by the Self Regulatory Organisation (SRO) responsible for the organisation of that particular market) that appear to be common. These Rules act as a relief value for short selling whereby short selling can occur, whilst still maintaining investor protection. They are:-

- Limitations on the total level of short selling in any particular security (ASX Business Rule 19.5 and Procedures 19.5.1);
- Approved Short List (ASX Business Rule 19.7);
- Margining requirements;
- Zero -Tick Rule (ASX Business Rule 19.3.3);
- Down -Tick Rule (ASX Business Rule 19.3.7);
- Buy - In Rule;
- Close Out Rule;
- Reporting requirements (ASX Business Rule 19.6);
- Client Obligations (ASX Business Rule 19.8);
- Securities Lending;
- Disclosure of Short Positions (ASX Business Rule 19.6);
- Transparency.

The Australian market currently has the majority of these rules in place and should be using the full gambit to meet the current crisis.

Phase 1: Stablising the Current Market

A mechanism should be imposed whereby those individuals that are currently short existing Cash Market Products are required to immediately report their existing Short Position.

Under this mechanism they will not be prosecuted due to the lack of understanding in the market (I totally dispute this, but it need to be done). The requirement is quite a simple one in that all short trades whether they be "Naked"; "Covered"; "Arbitrage"; "CFD's" or any other exemption are reported. In this way the exact known level of Total Short Selling should be able to be defined. This requirement needs to be in place with both ASX Participants and investors, using ASX Participants to report, using the current "Naked Reporting Regime". This has been in place for quite a number of years, so therefore the marginal cost to market participants and the ASX is minimal. For investor, I agree that it is part of the costs of doing business. Under the current system all Short Sales are grouped so that individual disclosure is protected

Those that fail to report must be prosecuted.

At the same time, all stock lenders will be required to report to the ASX, all current stock lending positions on ASX Listed Securities (in totality), again so that individual disclosure is protected. This may be more expensive for the script lender, but as the majority of these are already ASX Market Participants through CHESS, this should not be the case and they should be using the same system as brokers. Then there will be two ways of ascertaining the current Short Position. If everything is reported then they should be equal. Without having both ways, I am if the opinion that the abuses will continue and go unprotected due to the lack of enforcement and we will be here again to revisit.

The results should be published using the current Information Vendor mechanism (see **Exhibit 2**) which shows the information that was being disseminated by an Information Vendor known as Iress.

The length of time for this phase should only be a couple of days.

Exhibit 2: Iress Short Selling Distribution

Watchlist : S&P/ASX 200

Watchlist/Security: /XJO Request Watchlist

Security		MktCap($)	MktWeight	ShortLimit	ShortSold	Short(%)	TrTime
XJO		879B	98.08			0	10/10/08 16:1
AAC		340M	0.04			0	10/10/08 16:4
AAX		470M	0.05			0	10/10/08 16:4
ABB		1,329M	0.15			0	10/10/08 16:4
ABC		952M	0.11			0	10/10/08 16:4
ABP		499M	0.06			0	10/10/08 16:4
ABS		295M	0.03			0	25/08/08 17:0
AGK		6,083M	0.68			0	10/10/08 16:4
AGO		252M	0.03			0	09/10/08 11:5
AIO		1,539M	0.17			0	10/10/08 16:3
AIX		838M	0.09			0	10/10/08 16:4
ALL		2,203M	0.25			0	10/10/08 16:4
ALS		487M	0.05			0	10/10/08 16:4
ALZ		379M	0.04			0	10/10/08 16:4
AMC		5,059M	0.56			0	10/10/08 16:4
AMP		12,466M	1.39			0	10/10/08 16:4

<Default> <PreMarket>

Phase 2: Discovery

There are three potential outcomes from **Phase 1**. They are:

- The numbers agree and they are less than 10% Short Sold. Under this scenario, I believe that the market will react by regaining confidence in the system and those funds managers / financial planners who have been reluctant will begin again to invest.

- The numbers agree but they are greater than 10% Short Sold. Here the concerns that people are having about the market have been confirmed and this needs to be remedied. Those that are currently short will be given three trading sessions to bring the percentages back under 10%. This will be done on a pro-rata basis to the existing overvalue. There will be complaints that they are being disadvantaged, but in my opinion, the integrity of the market is more important. No more new short positions can be written until it falls below the 10% limit and only to that limit. If the stock is not on the approved list, it must be repurchased back (I am anticipating a lot of this). The ASX already has rules and procedures in regard to this, being ASX Rules 19.5.1 and 25.1.1. If a corner occurs it has the process under ASX Rule 5.9 to deal with this. Under this scenario it is my opinion that the market would quickly stablise as the buying support of the short seller would assist in halting the panic of other sellers. In addition Funds Managers and Financial Planners will also start to invest.

- The numbers don't agree. This will raise major concerns because in my belief this is the likely outcome and the numbers will be much greater than 10%. Under this scenario prosecutions must commence with actions taken by the ASX and ASIC. Under this outcome, the interests of the market must override the interest of the individual. Therefore, full disclosure is required by the ASX, in regard to each individual holding from both investors through brokers and from script lenders.

Phase 3: Prosecution

If outcomes in **Phase 2** are either of the first two, then the market should be quickly back in order and we can move onto **Phase 4**. However **Outcome 3** in **Phase 2** is a total different scenario. Under this outcome the ASX should report the actual numbers from both outcomes, it has received. This is better than the current position of no exposure. Under this Phase, investigation into potential prosecution have already commenced, however, the market needs to be kept fully informed. This can be achieved by establishing two styles of market, one in which there is no abuse, ie the short selling is within the acceptable boundaries, the second is one in which the abuse is still continuing and is currently under investigation. This can easily be done by the ASX with a code similar to the Cum and Ex market codes.

The first will settle under the current settlement regime, the second will need examination to ensure that the purchaser is not closing out an existing short position. This could be done with the assistance of the company registry and the script lenders. In particular when short sellers are closing out a position, they usually direct the registration directly back into the script lender name, rather than in the name on the contract note.

Phase 4: Wrap Up

Of course the final phase is to enshrine in legislation all the element that make up a short sale including disclosure, sizing limits, down-tick and zero-tick rules etc and of course the Transparency of it to the investing public. Of course there should remain a prohibition.

In my opinion it would be very easy to adopt the current CHESS system to ensure that script lending is quickly identified from Script Lender – Borrower – Stock Acquirer on the Market and the subsequent unwinding of the transaction. This whole process would greatly improve the audit trail.

The issue that short sellers are driving the market lower is an interesting one. Of course it directly relates to the issue of demand and supply and how through short selling the supply side of the equation is temporarily increased. But to continue the downward spiral, in the share price, the short seller needs the participation of other market participants. In this regard stocks that can be triggered with a minor movement i.e a stock with a very high percentage of margin lending are the ones that the short seller is looking for. In this regard all the short seller needs to do is shown adequate size on the selling side, thus forcing existing sellers to jump that price to be fulfilled in their trade. As the majority of this type of selling is being activated by the margin lenders, it is extremely important that this be identified along with other activities of the short seller. Of course the current ASX Condition Codes would be adequate for this purpose and would be at a minimal cost that would greatly improve the audit trail of these activities.

FEEDBACK.

Some of the other issues identified in the paper need to be explored further.

I am of the opinion that there should be a positive obligation on the AFS licensees. A number of years ago it would have been standard practice to have the contract marked as a short sale. This should be bought back in. Again the costs structure should be minimal as it was in those days.

With regard to on/off market transaction, it is important that the new regime does not drive the short selling off-market, only to have it reappear through an arbitrage transaction on market. For example it its very easy to short sell a CFD or another OTC derivative in a security that is listed on the ASX. The arbitrager buys the CFD or OTC derivative, and sells the appropriate number of shares (delta) on market to match its exposure. In my opinion this has been the biggest growth factors in short selling in Australia. Therefore the arbitrage number should be consolidated up into the total reporting numbers.

In addition over the last couple of years there is growing trend to buy and sell a portfolio through the futures market and have it converted into stock during the closing rotation that determines the value of the future on a stock by stock basis. This has raised major concerns amongst other market participants who believe that the price does not truly reflect the actual movement in the index. For example on the 21 September 2007, the September futures expired in the closing rotation. The result was a settlement price of the futures of 6435.8, where the underlying index traded in the range of 6386.8 (Opening); 6389.0 (High); 6353.9 (Low) and 6357.9 (Closing). The size of the open position is important irrespective of whether it is done by an investor or arbitrager. If this is capped to 10% in approved securities, than no major abuses should occur.

The more regulation that are applied to any market, the more that the product will drift off the market. There needs to be equality across all markets.

If you require any further information, I can be contacted on (03) 9620 0722 (work), 0418 145 915 (mobile) or pfrancis@oceanfinancial.com.au (email).

Peter Francis

PETER JOHN FRANCIS.
CURRICULUM VITAE.

I am a financial consultant and currently the principal of a broking operation based in Victoria known as Ocean Financial Group Pty Limited ("**Ocean**"). Ocean is a Corporate Representative of Falconer Bellomo & Company Limited (AFSL 244315). Under this arrangement I hold 90% of this firm.

I specialise in stock markets and market related transactions. I am a current Member of the Securities Institute of Australia, having completed the Institute Graduate Diploma. I also hold a Bachelor of Financial Administration.

Prior to Ocean I held a proper authority from Axis Financial Services **("Axis")**. Under the franchise arrangement with Axis, my role was to establish a broking office for Axis in Melbourne. Under this arrangement I held 100% of the franchisee.

Prior to Axis, I held a proper authority from Austock Management Pty Limited and Austock Stockbrokers Pty Ltd ("**Austock**"). Under my contract with Austock, I was responsible for establishing a new exchange in Australia, the Australia Pacific Exchange Limited. This exchange sort and ontained approval from the Australian Securities and Investment Commission ("**ASIC**") to run markets in property, equity and fixed interest; as well as operating the exempt markets controlled by Austock. In this role I headed up the new exchange and wrote the necessary business, listing rules and procedures of the exchange for approval by the appropriate Minister.

I first commenced trading on the Sydney Stock Exchange in 1972. During the past 35 years I have had considerable experience in the financial industry and in particular in relation to securities advisory and regulatory work.

I commenced work as an auditor in 1980. I worked initially in chartered accounting for Hungerford, Hancock and Offner (now part of KPMG) for 3½ years and subsequently as an internal auditor of two listed companies McNamara Group and Playfair Australia Ltd.

Following my time as an auditor, I had 7½ years experience in share and options trading. I was employed by two stock advisers, Dominguez Barry Samuel Montague Limited and Burdett, Buckeridge & Young Limited. My duties for each of these firms involved trading in securities on both markets of the Australian Stock Exchange ("**the ASX**") and the Sydney Futures Exchange ("**the SFE**") on behalf of broking organisations ("**principal trading**"). In particular, this trading was focused on trading in options on the floor of the ASX in Sydney.

In addition to trading in shares I was also involved in the development of trading systems to evaluate opportunities, both short and long term, including arbitrage opportunities, in markets of all securities, including shares as well as derivatives such as options and futures. I also supervised the floor trading activities of three traders with respect to the share market.

During my time as a stock adviser I wrote a number of papers in relation to the stock market changes, arbitrage and option theories. I also conducted a number of courses both internally and externally on new securities and derivatives, changes to the law and the ASX rules and the effect of these changes upon major portfolios in the market.

Between November 1991 and September 1998 I was employed by the Australian Securities and Investments Commission ("**the ASIC**"). From August 1995 to September 1998 I was employed as the Principal Markets Analyst for the ASIC based in the Victorian Regional Office. My position involved the investigation and analysis of possible contraventions of the Corporations

Law and the Business and Listing Rules of the ASX as they related to listed securities on the ASX or future contracts traded on the SFE or both.

Between 1991 and 1995 I was head of the Markets Team in the Office of the Chairman. This team was responsible for formulation of the ASIC's policy in relation to markets and their intermediaries, in addition to providing advice to the Federal Attorney General on proposed changes to the rules of the ASX and SFE. Changes to the rules involved an examination and recommendation by the ASIC to the Federal Attorney General, prior to the Federal Attorney General approving the new rules. During this time I was involved in writing papers on a variety of topics including "ASIC Report on OTC Derivatives Markets", "Exempt Stock Markets", "Individual Equity Futures v LEPOs", "Short Selling and Its Impact On Markets", "Prospectus Post-Vetting Manual" and "A Study of Forecast and Valuation Techniques in Prospectuses".

During my employment at the ASIC I was also involved in a number of criminal and civil cases expressing opinions either by statement or affidavit. In particular some of the high profile cases included Australian Securities Commission-ats-Nomura International PLC; DPP-ats-Doyle and Evans and DPP-ats-Shearer.

Prior to leaving the ASIC, I was involved in the ASIC/ASX/DPP Working Group into systems for Market Manipulation. I also had the responsibility of writing a number of papers and presenting a number of seminars.

Since leaving ASIC I have considered and expressed a number of opinions on the behaviour of advisers with regard to market practice concerning broking firms (including making recommendations to their clients, and trading on behalf of their clients) for courts or tribunals. These have included: Cornelia & Donald Alexander -ats- Capital Creation Pty Ltd and Kevin Logue; Andrea & David Barry -ats- HSBC Securities (Australia) Limited; Barry Buxton -ats- Mortimer & Chua Securities Pty Limited; Peter Andrew Cain v Prudential-Bache Securities (Australia) Limited; Clark -ats- Westpac & Deutsche Bank; George Sankovich -ats- Tolhurst Noall Ltd; Eve Corbett -ats- Colonial Stockbroking Limited & Epic Securities Limited; Denver Cove –ats- Falkiners Limited; Donic Australia Pty Ltd -ats- D & D Tolhurst Limited; Maurice Houghton -ats- Tolhurst Noall Limited; Newell Lock -ats- Lonsdale Securities Limited; Veronica & Gerldine Lombard -ats- Capital Creations Pty Limited; Quadrant Constructions Pty Ltd -ats- HSBC Australia Limited; Baken & Ors -ats- Macquarie Equities Limited; Peter Hardiman -ats- Hartleys Limited; Tudball-Smith-ats-Pearson & Peake Lands Kirwan Pty Limited; Jill Harwood -ats- Ord Minett Limited; Lazaris Services Pty Ltd -ats- Ord Minnett Limited; David McCallum -ats- Hartley Limited; Krystyna Naraniecki -ats- Hartley Limited; Newgo Pty Ltd & Simon Agar -ats- Challenger First Pacific Limited; Margaret Zorzi -ats- Merrill Lynch Private (Australia) Limited; Peter Milne -ats- J B Were Limited; Bevan & Patricia Odewahn -ats- Hartley Limited; Lao Ming -ats- Intersuisee Limited; Rahmat Ali -ats- Hartley Poynton Ltd; Tinney –ats- Epic Securities Ltd & Ors; Epic Securities Ltd -ats- Roberts; William Ranken -ats- William Noall Ltd; Mordech -ats- D & D Tolhurst Ltd; Monahan -ats- Hartley Poynton Ltd; Punkah Trading Pty Ltd -ats- Brown and Lonsdale Securities Ltd; Giannakis -ats- Tolhurst Noall Limited; Boon Hui Lim -ats- SAI Financial Service Pty Ltd & Ors; Brian William Frederick Jaggar & Ors -ats- SAI Financial Sevices Pty Ltd & Ors; Panyew Nominess Pty Ltd -ats- SAI Financial Sevices Pty Ltd & Ors; Lim -ats- SAI Financial Sevices Pty Ltd & Ors; Woodlea Computers & Ors -ats SAI Financial Sevices Pty Ltd & Ors; Lewis & Ors –ats- SAI Financial Sevices Pty Ltd & Ors; Bickford -ats- SAI Financial Sevices Pty Ltd & Ors; Piperogluu –ats- SAI Financial Sevices Pty Ltd & Ors; David Tredwell -ats- Barton Capital Limited & Ors; Sam International Pty Ltd -ats- Salomon Smith Barney Limited; Frank Hudson -ats- Tolhurst Noall Limited; Rosemary Jarvis -ats- Solomon Smith Barney Limited; Roynoor Holding Pty Ltd -ats- Macquarie Equities Limited; McGuire Media Pty Ltd -ats- MultieMedia.Com; Roman & Alexander Pty Ltd -ats- Hartley Limited; Jords Investments Pty Ltd -ats- Hartley Poynton Limited; Matthew Poole -ats- JB Were

Limited; Tania Ann Verduci -ats- Shaw Stockbroking Limited; Helen Patricia Walker -ats- Lifespan Financial Planning Pty Ltd ; Burton-ats-Deutsche Bank Ltd and Australian Outback Travel Pty Ltd -ats- Credit Suisse First Boston Australia Equities Private Ltd.

In addition I have considered and expressed a number of opinions on the behaviour of advisers with regard to market practice concerning broking firms (including making recommendations to their clients, and trading on behalf of their clients) for ASIC hearings.

As a result of my current responsibilities, my extensive work with the ASIC, my investigations into trading practice, my significant dealings with advisers, my previous and current trading responsibilities, my continued extensive dealings and contacts in the industry, my research and other training undertaken or attended in relation to adviser practice, I believe that I am aware of, and in a position to give an opinion on, the matters on which I am asked to comment.

SHORT SELLING

DRAFT RPORT

Annexure B

CONTENTS

SECTION 1: INTRODUCTION.

1. The Australian Securities Commission (ASC) is conducting a Review of the issues raised by short selling of securities within Australia. It is seeking comments on a variety of regulatory issues raised by trading conducted of this kind.

2. As there is currently no definition in the Corporations Law (the "Law") for Short Selling or Short Sale it is proposed for this paper to adopt the following defintion. Therefore Short Selling is defined as:

> "A device whereby the speculator sells securities that is not owned, anticipating that the price will decline and that the investor will thereby be enabled to 'cover', or make delivery of the stock sold, by purchasing it at the lower price. If the decline materialises, the short seller realises as a profit the differential between the sales price and the lower purchase or covering price."[1]

3. A short sale results from the sale of a security that the seller does not have ownership of or that the seller owns but does not deliver. Short selling is used to profit from an expected downward price movement or to hedge the risk of a long position in the same or related security.

4. Securities are defined in Section 92 of the Corporation Law ('Law") as:-

> "Subject to this section, 'securities' means;
>
> (a) debentures, stocks or bonds issued or proposed to be issued by a government; or
>
> (b) shares in, or debentures of, a body corporate or an unincorporated body; or
>
> (c) prescribed interests; or
>
> (d) units of such shares or of prescribed interests; or
>
> (e) an option contract within the meaning of Chapter 7;
>
> but does not include a futures contract or an excluded security."

5. Currently there is a general prohibition on short selling securities in Australia which was first introduced by way of "The Securities Industry Act of 1970"[2], the forerunner of the Law. Section 846 of the Law covers this prohibition and also provides a number of exemptions[3] from the prohibition, including an exemption

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1 1934 Report of the U.S. Senate Investigation into Stock Exchange Practices.

2 For further discussion see Appendix A "Review of the History of Short Selling", p4.

3 The exemptions are discussed in more detail in Section <   > of this report.

for sale of securities on an securities exchange (Sub-section 846(3)(e))[4]. Under this Sub-section securities exchanges can approve securites to be short sold as provided by the Business Rules of the securites exchange. Currently the Australian Stock Exchange (ASX) use his Sub-section to allow short selling to occur in it's markets. The ASX governs short selling on it's markets by way of Business Rule 2.18.[5]

BACKGROUND

6. A Position Paper[6] released by the Australian Financial Markets Practices Group (AFMPG) in February 1992 and by the applications received from the Australian Stock Exchange (ASX) to expand the context of short selling of securities within Australia has prompted this review.

7. The AFMPG in it's Position Paper (attached as Appendix <   > of this report) recommends that a Regulation be introduced which would allow unregulated shortselling in all fixed interest securities with the following except. In respect of debentures or bonds issued by a non-governmental body corporate or an unincorporated body, there would be a pre-requirement that shortselling could not occur unless not less than $100 million of the relevant stocks, having the same maturity date, had been issued. If implemented, this law reform proposal would remove the current need for fixed interest traders to comply with the exception to the shortselling prohibition in paragraph 846(3)(d) of the Law.

8. The ASX in it's submission dated 26 August 1993, proposes to make the following modification to it's Business Rules:-

- Expand the listed of approved securities that can be short sold;
- Removal of the Arbitrage Rule from the Business Rule;
- Changing the reporting requiremetns of a Short Sale;
- Changing the definition of a Short Sale; and
- Notification to the market of the Short Sales Positions.

STRUCTURE OF REPORT.

9. The structured of this report is as follows:

4 For further discusion on this Sub-section refer to paragraphs <   > of this paper.
5 A more detail discussion of the Business Rule is contained in Section <   > of this report.
6 Position Paper: Short Selling of Fixed-Interest Securities, issued by the Australian Financial Practices Group in February 1992.

- **Section 2** discuses why short selling occurs, the benefits and the dangers in short selling.

- **Section 3** contains a review of the regulation of short selling including a brief review of the history of short selling particularly within Australia. Discussing the regulatory objectives in limiting or prohibiting short selling. A review of the current regulatory structure under the Corporation Law (the Law).

- **Section 4** discusses the current regulatory structure of short selling within the fixed interest market. An overview of the Position Paper from AFMPG and their recommendation for changes.

- **Section 5** discusses the current regulatory structure of short selling upon the ASX, the proposed changes and the impact that these changes will have upon the short selling occuring on the ASX.

- **Section 6** discusses potential law reforms.

- **Section 7** definitions.

- **Appendix A** a Review of the History of Short Selling.

- **Appendix B** a Review of the Fixed Interest Market.

- **Appendix C** a Review of the Current ASX Regime.

- **Appendix D** a Review of the Regulatory Isues in Relation to Short selling in the U.S.

- **Appendix E** a Review of the Regulatory Isues in Relation to Short selling in the U.K.

- **Appendix H** a Draft Practice Note.

SECTION 2: WHY SHORT SELLING OCCURS?

10. Short selling occurs because of:-

- the desires of intermediaries to meet the requirements and the needs of their clients;
- the desires of intermediaries and other market participants to derive a profit from trading in the securities markets.
- the need to hedge current long term exposure where there is currently no available hedging tool in the marketplace.

11. Short sales of securities by market intermediaries arise in a number of situations these are:-

- Market Making;
- Hedging;
- Arbitraging;
- Yield Curve Positioning; and
- Outright Positioning.

MARKET MAKING.

12. The intermediary in facilitating business and without possessing the security makes a two-way price to his client. The client deals at the offer price. The intermediary may re-purchase the securities that same day, or elect to cover the position on another day.

SELLING ONE ISSUE SHORT TO HEDGE A LONG POSITION.

13. The intermediary may have facilitate business for a client, thereby purchasing a security, which he currently finds that he is unable to sell in the market place. Wishing not to have this long exposure to the market or to this individual security, he might sell another security with the same type of attributes as the security in which he bought, thereby limiting the overall market risk.

ARBITRAGE / SPREAD TRANSACTION.

14. The intermediary may feel that the price of the security is currently over-priced relatively to the market or to other securities in the market place. To be able to benefit from this perceived abnormality, but not wishing to have any overall market risk, the intermediary could sell the security which appears to be expensive and buy the security or securities that appear to be cheap relatively to the security sold.

YIELD CURVE POSITIONING.

15. This type of positioning occurs in the fixed interest markets. The intermediary may feel that the yield of the security is currently over-priced relatively to the yield curve. ie thereby expecting a flattening of the yield curve. To be able to benefit from this perceived abnormality, but not wishing to have any overall market risk, the intermediary could sell the security which appears to be expensive and by security or securities that appear to be cheap relatively to the security sold.

OUTRIGHT POSITIONING.

16. The intermediary may decide to take an outright short position in this stock. This could have been part of facilitation of the client purchase order, or it could be going directly to the market to execute this position. In either case the intermediary has decide to have this short position uncovered, thereby benefiting from any fall in the price of the security.

BENEFITS OF SHORT SELLING.

17. The crux of the arguments in defence of short selling is that it helps to maintain an orderly market and to stabilise price fluctuations. Advocates of shortselling argue that it facilitates the operation of an open market for securities because it enables the market to meet a large demand for a particular security and thus promote the depth and efficiency of the market.

18. Louis Loss, in his work on the United States Security Regulation, quotes the Report of the Committee on Banking and Currency (1934) as follows:

> "Few subjects relating to exchange practices have been characterised by greater differences of opinion than that of short selling. The proponents of short selling contend that it is necessary feature of an open market for securities; that in a crisis short sellers are useful in maintaining an orderly market; and that their activities serve to as a cushion to break the force of a decline in the price of the securities. Its opponents assert that short selling unsettles the market, forces liquidation, depresses prices, accelerates declines, and has no economic value or justification."[7]

CUSTOMER DEMAND.

[7] Louis Loss see (5)

19. Where professional "specialist" traders exist, short selling performs a valuable and constructive service for the market, by marshalling the supply of shares to meet any large demand, and thus widening the market and contributing to its efficiency. Properly regulated short selling can contribute to the stability of the market, as can be seen in the case of the non-speculative (and permitted) short selling actions of arbitragists and odd lot dealers. Similarly other forms of short selling (such as hedging, sale for tax and put options) also can contribute to the efficiency of the market. It is generally acknowledged that short selling is for the sophisticated share traders and not for the amateur.

REDUCES PRICE VOLATILITY.

20. Short selling can have the effect of levelling out fluctuations in market prices. It can assist in establishing a ceiling on a rising market in a particular security and likewise, the subsequent buy-in transaction that covers the short position, can assist in providing buyers in a falling market when traditionally investors are reluctant to buy. Thus, short selling can act as a moderating force when the price of a security, or the market generally experiences an undue price rise or fall.

ENHANCES LIQUIDITY.

21. Substantial market liquidity is provided through short selling by market professionals, such as market makers, block positioners, and specialists, who facilitate the operation of the markets by offsetting temporary imbalances in the supply and demand for securities. To the extent that securities professionals effect short sales in the market, such short sale activities 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 temporary contraction of supply.

PRICING EFFICIENCY.

22. Arbitragers contribute to pricing efficiency by utilising short sales to profit from price disparities between a stock and a derivative security, such as a convertible security or an option on that stock. For example an arbitrager may purchase a convertible security and sell the underlying stock short to profit from a current price differential between two economically similar positions. Where an issuer proposes to issue securities (of a class already outstanding) in exchange for the securities of another issuer, pursuant to a merger or exchange offer, arbitragers may sell short the security proposed to be issued to hedge their purchases of the security proposed to be acquired.

23. Efficient markets require that prices fully reflect all the buying and selling interest. When a short seller speculates on a downward movement in a security, the transaction is a mirror image of the person who purchases the security based upon speculation that the security's price will rise. Both the purchaser and the short seller hope to profit by buying the security at one price and selling at a higher price

- the primary difference being that the sequence of transactions is reversed. Market participants who believe a stock is "overvalued" may engage in short sales in an attempt to profit from the perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions assure that their perceptions of future stock price performance are reflected in the market price.

ENHANCES THE DEPTH OF THE MARKET.

24. To the extent that short selling increases the total volume of a company's securities effectively available, it can contribute to the continuity, depth and liquidity of the market in the company's securities.

MARKET MAKING.

25. Where professional "specialist" traders exist, short selling performs a valuable and constructive service for the market, by marshalling the supply of shares to meet any large demand, and thus widening the market and contributing to its efficiency. Properly regulated short selling can contribute to the stability of the market, as can be seen in the case of the non-speculative (and permitted) short selling actions of arbitragers and odd lot dealers. Similarly other forms of short selling (such as hedging, sale for tax purposes and put options) also can contribute to the efficiency of the market.

ASSIST IN PRICE DISCOVERY.

26. Short selling by market makers can assist in the price discovery by the market to the extent that market makers will still make a market even in illiquid securities, for which there is currently no quote.

DANGERS OF SHORT SELLING.

27. The crux of the argument against short selling is that it impedes the efficient operation of an orderly market.

28. Unregulated unrestricted shortselling can cause the following problems-

- an accelerated decline in market prices. Market disorder can occur where stock has been speculatively oversold;

- the creation of false markets where the market is narrow or where there are no disclosure requirements of short positions or where the process of delivery is not under strict supervision. The creation of artificial indications of supply and demand can lead to the manipulation a short term move of the market price;

- the threat of default in delivery by shortsellers that may undermine confidence in the markets and be detrimental to market efficiency. The Campbell Committee commented that shortselling by relatively unsophisticated investors could expose them to excessive risk and that the stability of the stockbroking industry would be undermined by the failure of a major shortseller to meet its obligations;

- the development of unfunded speculation, where no margins are imposed.

29. "The conclusion which is justified on short selling is that it does not operate as a depressive influence on the market as a whole and has little permanent influence on the long-term price of a stock; that on the other hand it performs no useful service in the market; that it is purely an instrument in the hands of the pool operator, the floor trader and the speculating specialist; that it can be used for that purpose; that it could perform a useful purpose in checking inflationary price rises if it were not for the fact that in practise the technique of trading has taught the broker that the time to apply short selling to the market is after the stock has begun to decline as a result of other forces."[8]

UNEQUAL ACCESS TO INFORMATION.

30. If there is a lack of transparency in the market with regard to short selling, then there appears to be unequal access to information by those persons who are not short sellers. For example,

MANIPULATION OF PRICES.

31. Market manipulation - or even the perception of it - can undermine the integrity of the marketplace, cause participants to withdraw, and produce higher costs for the issuer. If the market is narrow or not fully informed of an existing short position, or if the mechanics of delivery are not strictly controlled, false markets can quickly develop.

MARKET SUPPLY AND DEMAND.

32. Short sales of securities generally increase the total number of securities of that company's stock owned beneficially by investors. As a consequence, the short sale creates a situation in which the total number of securities owned beneficially by investors exceeds the number of securities issued by the issued corporation. If the purchaser of the shares sold uses the purchased shares to close out a short position, then there is no increase in investors' total holdings of this stock.

[8] J.T. Flynn Securities Speculation (1934) see (5)

33. The result of such short selling and securities lending, in the aggregate, are that short sellers and script lenders, as a group, do not record ownership of as few shares of the security as they beneficially own. This analysis assumes either, that the security is delivered by the short selling broker from securities borrowed from script lenders. Or that securities are not delivered by the short selling broker.

34. This process of nominal securities expansion through securities lending and short sales are very similar in its mechanics to the process of money expansion through bank lending. In both cases, the public holds a major part of its holdings, its money balances, and its securities, in accounts with intermediary institutions.

35. The same thing is now happening in securities industry. The total number of securities belonging to investors on paper, exceeds the total reserves of registered or issued shares in the company when short sales have occurred.

MISLEADING SIGNALS ABOUT SUPPLY.

36. Any expansion in the supply of a particular asset that investors must hold will normally drive down the price, at least temporarily. Only when there is a perfectly elastic demand for that asset, which is extremely rare in the stock market, will price be unaffected when the supply expands. An abrupt supply change, in particularly, can be disruptive if it takes place without prior announcement and without advance market preparation.

37. The distribution of new securities into the equity market through a company offering represents the kind of supply expansion that can be disruptive if done abruptly without prior warning. For this reason, among others, elaborate disclosure rules have been put in place to fully inform investors about what is going on when a company sells new securities in this manner. Investors thereby have a fuller understanding of the factors underlying any price decline or increased trading volume they may see in the security in which a distribution of new security is taking place or is planned.

38. Short selling causes a similar security expansion. New investors must be induced to purchase the securities being offered by short sellers, or existing holders must be induced to increase their holdings, so that the increased quantity of securities can be absorbed. An unannounced share expansion that arises from short selling can, therefore, be just as disruptive to market pricing as an unannounced distribution of new issue would be.

39. Holders of securities who sell generally do not seek to profit from a further decline in the stock price.In fact they may not expect any decline. They merely may need cash or may prefer other investments. In fact, if they sell only part of their holdings, then they clearly want the rest to their securities to appreciate further. For these reasons, their sales do not necessarily suggest a negative evaluation of the security.

40. Short sellers, on the other hand, clearly expect and seek to profit from a decline in the price. Their motivation and expectations are different. When short sellers are active, other investors must expect that these short sellers hold a highly negative evaluation of the security and may drive the price down through further short selling. Short selling, furthermore, has the added significance of expanding the market's total holdings of the security, which may require a price decline merely to induce new investors to absorb the new securities.

41. For this reason, investors should have accurate and timely information about all significant distributions of new securities that arise because out of short selling. Absent this information, investors are presently unable to distinguish between heavy sales by current holders and the introduction of new book entry securities into the market through short selling. As a result, they may inappropriately infer that existing holders who are reducing their holdings are responsible for an observation of heavy trading volume and a price decline when, in fact, these are due to a supply expansion caused by short selling.

GREATER PRICE VOLATILITY.

42. Short selling can accentuate and accelerate a price decline, either in a single security or the market generally, to a level below which it otherwise would have stabilised were it subject to the normal market forces.

SPECULATION.

43. Unrestricted short selling, without margins, could enable the outright speculator to speculate without having to put up any funds. Problems also arise from the short selling by amateurs of speculative stock where such activities are not properly regulated and identified.

EXCEED FINANCIAL CAPACITY.

44. As discussed earlier[9] history has shown that short selling enables speculators to gamble without holding the stocks and without the funds to enable purchase prior to delivery. The nil entry price for such gambles may lead sellers to assume exposures which exceed their financial capacity and which could threaten their financial stability.

45. This was reaffirm by the AFMPG in their submission, but AFMPG argued that the problem was with the trader rather than with the practice per se. Their arguement went along the following lines,

> "that traders can exceed their finanacial capacity in all markets, physical or forward, on both the buying and selling side. Traders can, for example,

9 Refer to paragraphs <   > above.

contract to purchase forward more than they can afford. The focus on short sellig as a practise where this behaviour is more likely seems inappropriate. Also, most participants in the fixed-interest markets include forward purchase and sale commitments in measuring credit exposure to counterparties".

NON DELIVERY.

46. Short selling can disrupt the market if an attempt fails and the "shorts" cannot eventually obtain script to settle their deals. Corners take advantage of this situation and "hold the shorts to ransom". This can lead to a disorderly market, one manifestation of which is inconvenience to buyers who, having unwittingly purchased from short sellers, have difficulty in obtaining delivery of share script from the sellers. Given the limited size and nature of the Australian markets, unrestricted short selling would involve risks for both brokers and their clients, and could have a "domino effect" on the whole market and not just on the securities of the subject company.

COUNTERPARTY CREDIT RISK.

47. Counterparty credit risk is the risk of the counterparty defaulting or otherwise failing to perform under the terms of the contract. The risk in relation to the transaction involving short selling usually involves the non-delivery of the script to settle the transaction (as discussed above).

SECTION 3: REGULATION OF SHORT SELLING.

HISTORY OF SHORT SELLING.[10]

48. Short selling was first regulated in Australia in 1938 by the Melbourne Stock Exchange, but it was not until the introduction of the Securities Industry Act of 1970, that the prohibition was limited by the law. The Rae Committee in 1974 examined some of the problems associated with the stock exchanges' self regulation of short selling. This lead to the introduction of section 54(3) of the Securities Industry Act (NSW) of 1975, the forerunner of Sections 849(3)(a) - (d) of the Corporations Law.

49. The law was further broaden by the introduction of Sections 68(3)(e) and 68A into the Securities Industry Act of 1980 by the 1985 Amendment Act. These new sections are the forerunners of section 846(3)(e) and 847 of the Corporations Law. An additional two section were added to the Law by the way of the regulation in the late 1980's these are Reulation 7.4.07 and 7.4.08.

WHY SHORT SELLING SHOULD BE REGULATED.

PROTECTION OF RETAIL CUSTOMERS.

50. The regulatory framework in Australia is based on the presumption that, largely for investor protection reasons the prohibition on short selling should apply. The prohibition was supported by the Campbell Committee comments that short selling by relatively unsophisticated investors could expose them to excessive risk and that the stability of the stockbroking industry would be undermined by the failure of a major shortseller to meet his obligations.

51. To this end the Law envisages that the deliverability facets of both the Law and the Exchanges Business Rules will prevent this type of failure thereby providing a stable and sure environment for the trading of securities by retail customers.

FAIR, ORDERLY AND EFFICIENT MARKETS.

52. Accurate and timely information for investors is essential for a fair and efficient securities market. The unchallenged and unpunished circulation of false or misleading reports about company affairs destroys fair markets.

53. There is a belief that small companies are especially vulnerable to campaigns of intentional distortion about their affairs, for two reasons. First, they lack the resources usually available to a larger company to conduct an expensive

[10] A more detail of the histroy of short selling is contained in Appendix A.

information campaign to combat false rumours directly. Second, knowledge of their affairs among the financial press and securities professionals, who may be able to evaluate false charges critically and render a constructive independent judgement, are generally much less widespread than knowledge of large companies.

HOW IS SHORT SELLING REGULATED.

54. Short selling is regulated quite differently amongst the various jurisdictions world wide, but there are rules (whether imposed by the law or by the Self Regulatory Organisation (SRO) reponsible for the organgisation of that particluar market) that appear to be common. These Rules act as a relief value for short selling whereby short selling can occur, whilst still maintaining investor protection. They are:-

- Limitations on the total level of short selling in any particular security;
- Margining requirements;
- Zero -Tick Rule;
- Buy - In Rule;
- Close Out Rule;
- Reporting requiremnts;
- Client Obligations;
- Securities Lending;
- Disclosure of Short Positions;
- Transparency.

CURRENT LAW.

SECTION 846(2).

55. It states that if you have a presently exercisable and unconditional right to have securities vested in you are deemed to have the same right to vest them to someone else. This is, itself, significant.

56. Sub-section 846(2)(a) states that if you have a presently exercisable and unconditional right to have the securities vested in accordance with your directions, then you are deemed to have the same right to vest them in someone else. This latter point has two important implications:-

- Legal and equitable titles are equated, that is, an equitable right, that is unconditional and presently exercisable, to have securities vested in you are the same as having the right yourself.

- In these circumstances, if all that you need do is give a direction to vest the securities in another, it implied that this does not make your right unconditional.

57. This is the first way that a market participant can potentially satisfy the obligations of the provisions, he can sell (and not be selling short) if he is the beneficially owner and his equitable right is presently exercisable and unconditional or if all he needs to is give a direction to vest the securities in another.

58. The second way that the provisions on short selling can potentially be satisfied is by sub-section 846(2)(b). Kedzior[11] sums up succinctly; stating this sub-section "..enable securities to be used as a means of securing debt without effecting any presently exercisable and unconditional right to vest the securities in another".

59. Some guidance to the term "unconditional" is provided by this sub-section. The legislators saw that the existence of a charge over, or a pledge of, the securities as a potential condition (and hence the need for this paragraph). The form of such condition could be, anything from the fact that chargee must give consent to transfer through to the simple fact of there being a charge.

SECTION 846(3)

60. There are currently five individual sub-sections, to this Section of the Law. Each sub-section stands alone and is not operative by any other sub-sections contained in this section.

Sub-section 846(3)(a).

61. This is the third method for avoiding the basic prohibition. It is an exception to the prohibition, and relates to dealers who specialise in odd lot's transactions (less than marketable parcels) trading as principal. It should be noted that the following conditions that apply to other sub-sections in this Section of the Law do not apply to this sub-section:

- arrangements do not necessarily have to be made prior to the sale to enable delivery to the buyer within three days after the date of the transaction.

- there is no zero tick rule so that should the odd-lot specialist wishes to short sell they can sell below the last sale. If it occurs on a stock market, this is

[11] Kedzior, Short Selling in Australia, 1988, Adel LR337.

also the case, due to the operation of Rule 2.18(2) contained in the Business Rules which states:-

- "A Broker shall only effect a Short Sale in accordance with the provisions of this Rule ***or*** as otherwise permitted by the Corporations Law".

- there is no requirement that the short seller and the securities issuer are unrelated.

Sub-section 846(3)(b).

62. This is the fourth method of avoiding the basic prohibition for Short Selling. It is another exemption, for arbitrage transactions. Arbitrage transaction is defined in Section 9 of the Law[12]. Again for this sub-section conditions that apply to other sub-sections in this Section of the Law do not apply to this sub-section:

- arrangements do not necessarily have to be made prior to the sale to enable delivery to the buyer within three days after the date of the transaction.

- there is no zero tick rule so that should the arbitrager wishes to short sell they can sell below the last sale. If it occurs on a stock market, there is an obligation on the arbitrager to be abide by Business Rule 2.2. This states that the arbitrager must register its name with the Exchange as an arbitrager. There is a requirement that the broker covers the sale prior to the close of business on the second day after the sale; or to notify the over-sold position to the Exchange by that time and daily until the sale is covered (Business Rule 2.2(1)). Business Rule 2.2(2) authorises the Exchange to cancel the registration of a broker as an arbitrager where the broker has effected a sale in another market which in the opinion of the Exchange is not a bona fide arbitrage transaction.

- there is no requirement that the short seller and the securities issuer are unrelated.

- there is no requirement if the trade occurs off a securities exchange that the document evidencing the sale contains a statement that the sale was a short sale.

63. There is a further additional condition to be met if the sale is made through a licence dealer, that is the seller when making the request must inform the licence dealer that the sale is short.

Sub-section 846(3)(c).

12 Refer to paragraph <   > for the meaning of arbitrage.

64. This is the fifth method of avoiding the basic prohibition. Under this sub-section a seller, who before the time of the sale had entered into a contract to buy the securities, will not have the right conditional merely because one or all of the following remains undone at the time of the sale:

- the seller has not paid the consideration of the purchase;
- the seller has not received the transfer instrument for the purchase; or
- the seller has not received the title documents or the securities documents for the purchase.

65. Again for this sub-section conditions that apply to other sub-sections in this Section of the Law do not apply to this sub-section:

- arrangements do not necessarily have to be made prior to the sale to enable delivery to the buyer within three days after the date of the transaction.
- there is no zero tick rule so that should the seller wishes to sell below the last sale price he can.
- there is no requirement that the short seller and the securities issuer are unrelated.
- there is no requirement in the trade occurs off a securities exchange that the document evidencing the sale contains a statement that the sale was a short sale.

Sub-section 846(3)(d).

66. This sub-section provides two exceptions (the sixth and seventh) to the prohibition, one for unlisted securities and a tighter version for listed securities.

67. The conditions for short selling of unlisted securities are that:-

- the short seller and the securities issuer are unrelated.
- arrangements are made before the time of the sale that will enable delivery to be made to the buyer of the securities of a class sold within three business days of the sale.
- if the trade occurs through a licence dealer, the seller must inform the licence dealer at the time of making the request for the sale, that the sale is short sale.

68. However for this sub-section conditions that apply to other sub-sections in this Section of the Law do not apply to this sub-section:

- there is no zero tick rule so that should the seller wishes to sell below the last sale price he can.

- there is no requirement in the trade occurs off a securities exchange that the document evidencing the sale contains a statement that the sale was a short sale.

69. The conditions for short selling of listed securities under this subsection are that:-

- the short seller and the securities issuer are unrelated.
- that there has been power vested in the Commission to suspend trading for a period of up to 21 days[13] (Section 847).
- arrangements are made before the time of the sale that will enable delivery to be made to the buyer of the securities of a class sold within three business days of the sale.
- the requirement to obey the zero and zero-plus tick rules.
- the securities exchange is informed of the short sale.
- the endorsement of any document evidencing the sale contains a statement that the sale was a short sale.
- if the trade occurs through a licence dealer, the seller must informed the licence dealer at the time of making the request for the sale, that the sale is short sale.

Sub-section 846(3)(e).

70. This is the eighth method of avoiding the basic prohibition. This paragraph was insert in 1985[14] and for many market participants seemed instrumental in permitting the first short selling since the 1970 Act[15]. The gist of the paragraph is to allow the Business Rules of the Exchange[16] to allow short selling of certain listed subject to the following conditions:

- that the securities are in a class approved by the Exchange.
- that there has been power vested in the Commission to suspend trading for a period of up to 21 days[17] (Section 847).
- that the sale is made in accordance with the Business Rules of the Exchange.

13 Refer to paragraphs < > for further comments.
14 For discussion on this refer to paragraphs < > above.
15 For discussion on this refer to paragraphs < > above.
16 For a more detail discussion refer to paragraphs < > below.
17 Refer to paragraphs < > for further comments.

- the short seller and any person associated with the short seller and the securities issuer are unrelated.

- the securities exchange is informed of the short sale.

- the endorsement of any document evidencing the sale contains a statement that the sale was a short sale.

- the seller must informed the licence dealer at the time of making the request for the sale, that the sale is short sale.

71. Again for this sub-section conditions that apply to other sub-sections in this Section of the Law do not apply to this sub-section:

- arrangements do not necessarily have to be made prior to the sale to enable delivery to the buyer within three days after the date of the transaction.

REGULATION 7.4.07.

72. This is the ninth exception to the basic prohibition. This sub-section allows the sale to occur of a security that is not physically held at the time of the exercise of the option.

73. The following conditions of short selling do not apply to this regulation:

- there is no zero tick rule so that should the seller wishes to sell below the last sale price he can. This is because an option is exercised at an Exercise Price.

- there is no requirement that the document evidencing the sale contains a statement that the sale was a short sale.

- there is no requirement that the seller must informed the licence dealer at the time of making the request for the sale, that the sale is short sale.

- arrangements do not necessarily have to be made prior to the sale to enable delivery to the buyer within three days after the date of the transaction.

REGULATION 7.4.08.

74. This is the tenth exception to the basic prohibition. This paragraph allows the sale of a security that is not physically held at the time of the sale to occur, subject to having or able to obtain at the time of sale a number of options that if exercised would be able to obtained at least the number of the shares sold. It should be noted that there is a limitation (Regulation 7.4.08(3)) on those options which are allowable to be exercised. This is limited to in-the-money and at-the-money options (where the price of the option is greater than the exercise price less the sale price).

75. The following conditions of short selling do not apply to this regulation:

- there is no zero tick rule so that should the seller wishes to sell below the last sale price he can. This is because an option is exercised at an Exercise Price.

- there is no requirement that the document evidencing the sale contains a statement that the sale was a short sale.

- there is no requirement that the seller must informed the licence dealer at the time of making the request for the sale, that the sale is short sale.

- arrangements do not necessarily have to be made prior to the sale to enable delivery to the buyer within three days after the date of the transaction.

SECTION 847.

76. Under this sub-section the ASC is effectively granted the ability to prohibit short selling as currently permitted by the Business Rules of an Exchange. The opinions that the ASC must form are either:

- that it is necessary to do so in order to protect persons who might sustain financial loss if they were to buy and sell securities in this manner; or

- that it is necessary to protect the public interest.

TABLE OF CONDITIONS.

77. The following table summarises the conditions that must be met to enable short selling of securities under the Law.

Condition	**2(a)**	**2(b)**	**3(a)**	**3(b)**	**3(c)**	**3(d)**	**3(d)**	**3(e)**	**7.4.07**	**7.4.08**
Zero-tick Rule	N	N	N	N	N	N	Y	Y	N	N
Arrangement for delivery in three days	N	N	N	N	N	Y	Y	N	N	N
Documentation evidencing short sale	N	N	Y/N	Y/N	Y/N	N	Y	Y	N	N
Requirement to inform licensed dealer	N	N	N	Y	Y	Y	Y	Y	N	N
Short seller and issuer can not be related	N	N	N	N	N	Y	Y	Y	N	N
Sale is in accordance with the Business Rules	N	N	Y	Y	N	N	Y	Y	N	N
Exchange informed	N	N	N	N	N	N	Y	Y	N	N
On-market / Off-market	Y/N	Y/N	Y/N	Y/N	Y/N	N	Y	Y	Y	Y

ISSUES ARISING FROM THE PROHIBITION.

78. There are a number of issues that arising from the prohibition that leads to the potential uncertainity under the Law. In this section the ASC will try to clarify how this uncertainity. The issues that will be look at are:-

- What securities fall under the prohibition?
- What is meant by "Presently Exercisable"?
- What is meant by the useage of the word "unconditional"?
- What does the "vest" really mean?
- Is the term "right" used in it's common law aspect?
- What effect does the usuage of the term "arbitrage" have upon short selling?
- The lack of a definition in the Law of Short Selling or of a Short Sale.

SECTION 92(1) "SECURITIES".

79. Section 92(1) of the Law defines the usage of the definition of securities in Section 846 of the Law (the Short Selling Prohibition Section). The term "securities" is now complex, within the primary definition alone, there are at lest nine sub-definitions, all of which contain terms that are defined. There is an estimation that within the Law; some fifty definitions give meaning to the term "securities".This occurs through the use of definition; sub-definition; sub-sub-definition and so on.

80. The term "securities" has been defined at least four times (corresponding to the 1970 Act, 1975 Act, 1980 Act and the Law regimes) and undoubtedly many amendments have been made to the term during the currency of these regimes. A full history of the term, and postulation about why changes may have come about, is beyond the scope of this paper. However, it is a useful opportunity to look at some of the issues.

81. The definition was, under the 1970 Act, 1975 Act and the 1980 Act, always contained in a piece of the legislation aimed solely at the regulation of the Securities Industry. Even the 1980 Act regime was, in fact, the Securities Industry Code rather than the Companies Code itself. It was not until the advent of the Law (and the Law's consolidation of the up-till-then separate securities industry regime) that the term "securities" became a common term for the Securities Industry regulation and other corporate and incorporate regulation.

82. The 1970 definition of "securities" was relatively short. The only sub-definition was that of "interest", being in effect the Companies Act 1961 definition for today's "prescribed interest". The 1970 Act definition was unchanged with the introduction of the prohibition on short selling into the Act in 1971. It is worth noting that all the interests defined as being a security in the 1970 Act remain in the current definition of security, the only exception being that options were eventually excluded from the definition by the operation of the regulations; first made under the 1980 Act (regs 32 & 33) which now still appear in the Law (regs 7.04.07 & 7.4.08) although now more refined.

83. The listing or non listing of a security does not effect its status as a security. This implies that the prohibition now in paragraph 846 of the Law should apply equally to both categories.

84. The exclusion of futures contracts from the definition of securities. This was done during the regime of the 1980 Act and remains today in paragraph 9 of the Law. The nature of that market demands that short selling not be prohibited.

85. Short selling of government and semi-government bonds have always been part of the regime. They were included in every definition of securities since the 1970 Act became operative.

86. The width of the definition of securities may indicate an intention by Parliament to prohibit the short selling of as many forms of investment activity as possible. Indeed, the consistency of the 1970 Act, 1975 Act and 1980 Act definitions would support this (Parliament having had numerous opportunities to review the scope of the term and choosing apparently not to do so). Kedzior in his article[18] also comments that the:

> "very width of the definition would seem to indicate an intention by the Parliament to have as many forms of investment activity covered by the nation scheme".

SECTION 846(1).

87. This section of the Law covers the general prohibition on short selling. The Law provides limited guidance to the meaning of the terms used and there are only three reported cases in the area, none of which press the technical meaning of the provisions.

Presently Exercisable.

88. There appears to be a choice of meanings. The Macquarie Dictionary describes it as, "in a little while or soon" or "at this time, currently". The Oxford Dictionary describes the former of these as the blunted sense of the word.

89. There is a belief that the difference in the meaning is significant when the word "unconditional" also appears, qualifying the meaning of "right". The term could have either meaning and the conclusion is that the term means currently, or

18 Kedzior, Short Selling in Australia, 1988, LR335.

without delay/soon/shortly. The more important meaning, in terms of the prohibition, is that there be no conditions upon the action being able to be taken.

Unconditional.

90. This is another key word, and describes the nature of the right a person must have. The Macquarie Dictionary describes it as "not limited by conditions". The Oxford Dictionary describes it as "Not limited by or subject to conditions or stipulations: absolute, unlimited, complete". Therefore what is a condition.

91. In law, "condition" is (or can be) a term of art. That is, it can be seen as a stipulation in a contract, the breach of which gives rise to a right repudiates (as opposed to a warranty). Therefore the usage of unconditional in this sense, given the existence in this section, paragraphs like sub-section 846(3)(c)(i) - (iii), which lists certain events that could be construed as events that cause a right to vest securities to become unconditional. Simply, the events listed in those sub-paragraphs are not always conditions of the contract - particularly the right to receive the documents that are the securities or the documents that are tittle to the securities.[19]

92. Even if the events listed in paragraph 846(3)(c)(i) - (iii) are conditions of a contract in every sense, however, it could be argued that "unconditional" is not being important with this narrow technical legal meaning.

93. Therefore "unconditional" is given a non legal usage. That is, to adopt CCH Macquarie Dictionary; it means the absence of a provision that makes the existence of a right dependent upon the happening of an event. It means a right of an absolute nature rather than conditional right.

94. Further, "unconditional" should not necessarily be exclusively associated with either of the meanings "without express condition" or "without implied conditions". It is submitted that it could mean either situation, that is, aright to vest could be conditional by virtue of the right being destroyed (or itself divested, if you like) by the happening of an event.

95. The conclusion is that "unconditional" should not be narrowly or technically read. However there is no case law to clarify this.

Vest.

96. The term has not been defined by the 1970 Act, the 1975 Act, and the 1980 Act or the Law. The Oxford and Macquarie Dictionaries provide similar definitions. The Macquarie Dictionary defines vest to mean, "to place or settle something (especially property rights, powers tec) in possession or control of a person or persons...". The Oxford Dictionary defines the term to mean, "to put, place or establish (a person) in full or legal possession or occupation of something". The

19 Sub-paragrpah 846(3)(c)(iii).

CCH Macquarie Concise Law Dictionary defines vest to mean, "to accrue to a person as a present legal entitlement".

97. It is therefore the opinion that the use of the word "legal" in either the Oxford or Macquarie Law Dictionaries (above) can be used in a sense opposed to "equitable", such an implication would mean that equitable rights could not be vested. Whilst this would mean a narrow (and favourable) interpretation of paragraph 846(1) of the Law, there is no thought that such an interpretation is tenable; especially in light of the broad nature of the definitions contained in the dictionaries. Even if it was so, having considered the structures of the legislation, it is not considered that the legislators intended to employ the word "vest" so narrowly.

Right.

98. The term has not been defined by the 1970 Act, the 1975 Act, and the 1980 Act or the Law. The Oxford and Macquarie Dictionaries address this term at some length, the former by some fifty uses, the latter with eleven pages of erudition. The Macquarie Dictionary states it is, "that which is due to anyone by just claim". The Oxford Dictionary states it is, "a legal or equitable or moral title or claim to the possession of property or authority, the enjoyment of privileges or immunities etc".

99. In looking more for the feeling of the term, Osborne's Dictionary cites two other authorities, "An interest recognised and protected by the law, respect for which is a duty and disregard of which is a wrong (Salmond). A capacity residing in one man of controlling, with the assent and assistance of the State, the actions of others (Holland)".

100. It is noted that the word "right" appears in the definitions of prescribed interest and participation interest both in section 9 of the Law, thereby offering some guidance. These definitions speak of rights, "whether enforceable or not, whether actual, prospective or contingent" and , (in the definition of participation interest), whether "evidenced by a formal document or not".

101. It is arguable that these definitions in the Law give us an idea of the sorts of rights that wander a draftsman's mind, but there are many adjectives that can describe "right", contingent, actual, prospective, proprietary, enforceable, moral and legal. Which one did the legislator mean? Deutsch[20] argues that the existence of paragraph 846(3)(c) (which deals with the case where a contract for short sale has previously been entered into) justifies the conclusion that right must include proprietary right. The legislator only saw fit to limit the scope of the word "right" to the adjectives "presently exercisable" and "unconditional" and further; the right must be a right to vest.

[20] Deutsch R, Short Selling, 1983, CSLR 142.

102. In the light of the discussion as to the meaning of "vest" above, there should be no reason why "right" (which probably necessarily includes proprietary right) would not encompass both legal and equitable rights, so long as those legal or equitable rights were presently exercisable, unconditional and of a nature so as to be a right able to be vested.

103. If there is acceptance that "right" can include equitable rights, can equitable rights be said to be conditional by nature and hence outside the terms of paragraph 846(1) of the Law. This is fairly important sort of hurdle. If the proposition that equitable interest can be transferred, and applying the Nemo dat rule (if all you have is an equitable interest, then that's all you can give), it is logical that if you have an equitable interest in securities, you can give someone that equitable interest and no more.

104. Restating the above paragraph; the holder of an equitable interest in securities potentially has a presently exercisable right to vest that equitable interest in the securities to the buyer. But what of the use of the word "unconditional" in this sub-section?

105. However, it is queried whether an equitable interest can give rise to the unconditional (or absolute) ability to give possession of the securities to another person. How can a holder of an equitable interest grant possession to another person without there being the necessarily condition that, at the very least, the recognition of equitable interest by the Law and (perhaps) enforceable? Simply put, the possession of the securities (the vesting in another person) is meant to be absolute (unconditional), not dependent upon equity recognising that the beneficial holder should be the legal holder.

106. If this is true (that equitable interests are, by nature , conditional) then the conclusion is that you need to have a legal interest to satisfy sub-section 846(1) of the Law. This is a fairly strict interpretation, but lets see how it fits with the balance of the provisions?

107. The scheme (namely sub-section 846(3) of the Law) provides some albeit negative assistance to what conditional at least is not! It is not conditional simply because there has been no payment of the consideration, or receipt of title or transfer documents. This sits poorly with the interpretation above. It implies that, whilst these three conditions are unfulfilled; you are still fine in terms of paragraph 846(1) of the Law. But, the truth is that whilst these three conditions are unfulfilled, there is no more than an equitable interest.

108. Sub-section 846(2)(a) of the Law also sits poorly with the interpretation. These sub-section states that if you have a presently exercisable and unconditional right to have securities vested in accordance with your directions, then you are deemed to have the same right yourself to vest the securities in someone else. This will mean that the need to give a direction cannot of itself cause the right to vest to be conditional. But, if you are in position to give directions, then it seems that you must be holding no more than an equitable interest.

109. In light of these arguments, the current thinking is that there can be acceptance of the argument that "right" cannot include equitable right (because equitable rights are, by nature, conditional). Therefore the usage of "right" must include both equitable and legal rights, even though the word "unconditional" is employed.

Overview.

110. In putting all these interpretations together you derive the following:

> You can not sell securities without breaching sub-section 846(1) of the Law unless you have a legal or equitable proprietary interest in securities giving rise to the absolute ability to give possession of the securities to another person now or in the near future.

ARBITRAGE.

111. Largely due to the impression of words used in the definition of "Arbitrage Transactions" in the Corporations Law; arbitrage transactions may be made which appear in many cases to be no more than disguised Short Sales. This particular relevant upon the ASX whereby traders use Business Rule 2.2 as a disguised for Short Selling. Arbitrage transaction is not defined in the ASX Business Rules. Business Rule 2.2 merely refers to how an arbitrage transaction may be made. The original intent of this Rule was to allow arbitrage among the six state Exchanges prior to the amalgamation of the ASX in 1987. Such a provision facilitated an efficient marketplace by enabling the minimisation of price differentials for the same Securities among the separate markets.

DEFINITION OF ARBITRAGE.

112. Section 9 of the Corporations Law defines "Arbitrage Transactions" as:-

"Arbitrage Transaction" means a purchase or sale of securities effected in the ordinary course of trading on a stockmarket together with an off-setting sale or purchase of those Securities effected at the same time, ***or at nearly the same time as practicable*** (emphasis added) in the ordinary course of trading on another stockmarket for the purpose of obtaining a profit from the difference between the prices of those securities in the two stockmarkets."

CHARACTERISTICS OF ARBITRAGE TRANSACTIONS.

113. Key characteristics of arbitrage transactions which make them appear to be no more than disguised Short Sales are that:-

- there is no pre-requisite that a person owns the Securities the subject of the arbitrage transaction ***prior*** to making the arbitrage transaction.

- the offsetting purchase can occur some time after the initial sale.

- the second leg of the transaction is made on "another stockmarket". In the context of the Corporation Law, this would mean an overseas stockmarket, as the ASX provides the only approved stockmarket for dealing in underlying securities in Australia, through the facility of the Stock Exchange Automated Trading Systems (SEATS).

114. Accordingly, a Broker could sell Securities on the market provided by the ASX, and at some later time, buy back those Securities on an overseas stockmarket. While such a transaction would fulfil the requirements of arbitrage in accordance with Business Rule 2.2, it also constitutes key ingredients of a Short Sale in accordance with Business Rule 2.18.

115. However, this duality can result in a trader opting to classify the transaction as arbitrage rather than a Short Sale, due to the considerable advantages conferred on the arbitrager, vis a vis a constraint on a Short Seller by the provisions of Business Rule 2.18.

116. Specifically, the "Arbitraging Broker":-

- avoids the Short Selling prohibition on selling at a price lower than the last reported sale of Approved Securities at an Office meeting;

- avoids the restriction on the sorts of Securities which may be short sold in accordance with the Business Rules (ie. only Approved Securities); and

- avoid the reporting requirements embodied in the Short Selling provisions.

117. The retention of Arbitrage Business Rule 2.2, enables transactions to be made under this Business Rule for sales of Securities made on the Australian market, before an offsetting purchase of those Securities is made on another market (overseas market). On the other hand, if the sale and subsequent purchase are made on the Australian market, the Broker would be unable to take advantage of this Arbitrage Rule and be forced to use the Short Selling Business Rule 2.18.

118. Another area of uncertainty that arises in respect to the Arbitrage Business Rule relates to a sale of Securities on SEATS and an offsetting purchase of Exchange Traded Options over the same Securities on the Australian Options Market. The wording of existing Business Rule 2.2 refers to selling of Securities but not to what kind of Securities may be bought "in another market". Accordingly, it could be argued that a subsequent offsetting transaction in the Australian Options Market could constitute arbitrage for the purpose of Business Rule 2.2. It acknowledged that where a Broker has already purchased a Call Option over Securities, then a later sale of those Securities on the underlying securities market would represent an exemption from the provisions of Short Selling pursuant to Regulation 7.4.08 of the Corporations Legislation.

SCRIPT LENDING.

119. There appears to be a quite a degree of uncertainty in the market place in regard to the range of arrangements that can be made to satisfy the requirements in sub-section 846(3)(d). Many participants argue that the stock lending facilities made available by issuers and other market participants, and the ready access to the active market in repurchase agreements, constitute satisfactory arrangements.

120. Script lending facilities are characterised by the following common features:-

- standard blanket agreements between the lender and the short seller to borrow script;
- requirements by lenders for the borrower to place orders by a particular time of the day;
- the right of the lender to charge fees with respect to the amount of stock currently being lent;
- the right of the lender to restrict and/or manipulate the amount of stock available pursuant to the lending facility;
- obligation of the borrower to place a security for the loan, and the right of the lender to waiver this obligation;
- no time period for borrowing is established at the time of borrowing, although the lender in most cases has the right to have the script at call; and
- the right of the lender to limit access to this facility.

121. If a stock lending facility of the type described above constitutes an "arrangement", then a case can be made that short selling of securities by dealers covered by these arrangements is allowable. There is perhaps less certainty whether access to repurchase agreements represent a recognisable arrangement.

Even where there are arrangements, the words "will enable" may be problematic. If this implies that the seller must have some form of "unconditional right"[21] of access to these securities to enable delivery, then it is clear that these lending facilities and repurchase agreements do not generally convey this right. In practise, however, lenders do not decline new requests to borrow securities, as to do so would threaten the long term viability of the script lending operation.

[21] See dicussion on this in preceding paragraphs <   >.

SECTION 4: THE FIXED INTEREST MARKET.

THE AFMPG APPLICATION.

122. The AFMPG submission goes beyond the Campbell Committee's proposals in two major respects, namely

(a) the Committee's recommendations did not extend to non-government fixed interest stocks; and

(b) the Committee did not recommend unregulated shortselling.

123. The AFMPG submits that most substantial issuers of fixed interest securities specially employ market makers to enhance the liquidity and depth in the secondary markets for fixed interest stocks. They also submit that shortselling is an integral part of market making, particularly where a market maker quotes two way prices in a wide range of stocks.

124. The AFMPG submit the shortselling prohibition was introduced to counter the effects of shortselling in the equities markets, not the fixed interest markets. Whilst the initial prohibition introduced in the 1970s may not have been specifically directed to fixed-interest markets, parliament has subsequently chosen to retain a very wide definition of "securities" in the 1975, 1980, 1985 Securities Industry Acts and in the Corporations Law. Several legal commentators have interpreted this as indicative of a general legislative intention to prohibit the shortselling of as many forms of investment activity as possible.

125. The AFMPG argues that it has not been demonstrated that there are regulatory and investor protection benefits in applying the prohibition to off-exchange fixed interest markets, being large liquid markets conducted by professionals.

126. Support for this submission as to the professional nature of the fixed interest markets in government fixed interest securities can be found in the joint exposure draft on shortselling prepared by the AASE and the NCSC in April 1985[22], which commented that "shortselling of public securities has no relevance to the retail market". The report went on to conclude that -

> "The important point to note is that the ability to short sell enables dealers to limit risk and provide liquidity to the market. It is a necessary part of a professional and deep market in public securities and is an essential feature of those markets overseas.
>
> The risks in public securities relate not to the solvency of the borrowers but to the risk of a variation in the value of the securities due to a change of

22 Short Selling Securities on Australian Stock Market, AASE & NCSC, April 1985.

interest rates. Thus should interest rates rise, the value of debt securities fall".[23]

127. The Campbell Committee recommendations and the current on-exchange method of regulating shortselling provide useful guidelines as to when shortselling may be permitted without undermining regulatory concerns. Both these sources recognise that in order to maintain stability in the markets; there must be substantial capitalisation of issuers, liquidity of the market and marketability of the securities.

128. The AFMPG acknowledges that where short sales are large in relation to, or exceed, the amount of the underlying stock, market prices can move significantly from the "correct" level

CAPITALISATION.

129. In respect of government issuers, their credit rating or financial worth is strong because there is no risk of default in the repayment of the face value of the fixed interest stock. The financial backing of semi-government borrowers will vary depending upon the authority concerned. Whilst some authorities may have implicit Commonwealth guarantee, other authorities are specifically not guaranteed or are individually credit rated. By contrast, in the corporate bond markets, there is an increased number of issuers all with varying credit rankings. These include financial institutions, industrial and commercial corporations and superannuation bodies. Consequently, it is more difficult to assess whether there is sufficient capitalisation of issuers in these markets.

LIQUIDITY.

130. Government and semi-government markets are generally recognised as offering very liquid longer term securities. The AFMPG submits that the standard minimum trade is $5 million with an average daily turnover of $3 billion. As stated above, the AFMPG has not made any detailed submission specifically in respect of corporate bonds[24]. Whilst the markets in non-government securities are growing, the liquidity of these markets fluctuates depending on movements in the interest rates. Where there is uncertainty about investing in longer term securities (eg. due to prevailing high interest rates) the corporate borrowers are usually hardest hit as compared to the government and semi-government borrowers. Estimated daily turnover in corporate bond markets is approximately $500 million.

MARKETABILITY.

131. Government and semi-government bonds are traded in homogeneous parcels that increase their marketability. By contrast, corporate bonds are less homogeneous in

[23] *Id.* P10 of the Explanatory Memorandum.
[24] Page 3 of the submission.

nature. For example, the AFMPG submits that the market in private sector mortgage backed securities are small and characterised by non-homogeneous securities, non-standard documentation and low liquidity. Issues by industrial and commercial corporations have been quite small.

132. The AFMPG submission acknowledges that if paragraph 846(3)(d) requires that a dealer has some form of unconditional right to access to the subject securities to enable delivery, then the stock lending facilities and repurchase agreements do not generally convey this right. The submission goes on to state that, in practice, issuers do not decline new requests to borrow stock and that most actively traded stocks are usually available in the repurchase market. However, such market practice relies upon principles of goodwill and not upon any enforceable rights.

133. In order to fall within the ambit of paragraph 846(3)(d), it would appear that the fixed interest market's standard stock lending and repurchase agreements would need to be amended so as to remove those conditions that potentially hinder delivery being made within 3 days of the transaction.

134. The submission recommends that the Corporations Law be changed to permit short selling of fixed-interest securities with no restrictions. This would obviate the need for traders to enter special arrangements to comply with the Law.

135. The submission recommends a new Regulation 7.4.07A as follows:

> "Section 846 of the Corporations Law does not have effect in relation to a sale of;
>
> > debentures or bonds issued or proposed to be issued by a government; or
> >
> > debenture or bonds of a body corporate or an unincorporated body, where not less than $100 million of the debentures or bonds with the same maturity date and coupon have been issued or are proposed to be issued."

DELIVERABILITY

136. The AFMPG submit that there are strong legal and commercial motivations for a shortseller to complete delivery and that the market facilitates a shortseller through stock lending and repurchase agreements, thereby making the likelihood of default extremely low

SECTION 5: THE ASX SUBMISSION.

137. The ASX in it's submission dated 26 August 1993, proposes to make the following modification to it's Business Rules:-

- Expand the listed of approved securities that can be short sold. This expansion is by way of amendment to Rule 2.18(13) which states under what requirements the ASX can declared a security an approved security. The current requirement is for there to be 50 millions shares of the same class are currently on issue, representing a capitalisation in excess of $100 million[25]. The new proposal is to reduce this to 10 million shares and a capitalisation of $20 million.

- Removal of the arbitrage rule, Rule 2.2 from the Business Rules of the exchange. The ASX believes that "largely due to the imprecision of words used in the definition of 'Arbitrgae Transaction' in the Corporations Law, arbitrage transactions may be made which appear in many cases to be no more than disguised Short Sales"[26].

  This Rule was orginally established to allow bona fide arbitrage transactions to occur between the six individual markets formerly provided by the Australian Capital City Stock Exchanges. Such a provision facilitates an efficient marketplace by enabling the minimisation of price differentials for the same Securities among the seperate markets. However thge introduction of the Stock Exchange Automted Trading System (SEATS) in October 1987, which was extended to all Securities in October 1990, created a single national market and therefore rendered obsolete the orginal justification for the Arbitrage Business Rule.

- Changing the reporting requirements of a Short Sale to not only incorporate not only those sales made in accordance with the Business rules but also those sales made pursuant to the Corporations Law.

- Changing the definition of a Short Sale to incorporate those securities which have been borrowed before the time of the sale.

- Notification to the market of the Short Sales Positions. This has been addressed by the exchange by the incorporation of a new Business Rule, 2.18(14A). This Rule requires the Exchange to make available to the market before the commencement of Normal tarding on each day, the number of Securities included in all open Short Sale positions. This information will be made available to the market via information vedors and the media generally.

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25 A more detail discussion of the ASX Business Rules is contained in Appendix < >.
26 Refer to ASX Submission attached as Appendix < >

SECTION 6: LAW REFORM.

138. This part of the Report deals with issues that were raised during the review that, if they are to be addressed, will require amendment to the current provisions of the Corporations Law. Modern innovations in the clearing and settlement of securities transactions and the widespread adoption of book entry record keeping systems have dramatically increased the market opportunities for short selling transactions.

139. The ASC's views and suggestions on these issues are based on its analysis of the structure of all the Securities markets, the regulatory issues involved, and the changes that have taken placed in those markets over recent times, in particular the development and impact that derivatives have on these markets.

140. The proposed law reform reflects the ASC's principle concerns in relation to:

- legal and commercial uncertainty;
- fair, orderly and efficient markets; and
- investor protection.

PRESENTLY EXERCISABLE AND UNCONDITIONAL RIGHT TO VEST.

141. The law does not define the meaning of the phrase, "presently exercisable and unconditional right to vest" for the purposes of the short selling prohibition. As mentioned earlier[27] there is currently legal uncertainty surrounding this phrase.

142. Some guidance on the meaning of the phrase is provided in paragraph 846(2)(a) that refers to a person who, at a particular time, has a presently exercisable and unconditional right to have securities vested in the person or in accordance with the directions of the person has at that time a presently exercisable and unconditional right to vest the securities in another person. This means that a seller who is a beneficiary of a trust or for whom securities are held by a nominee and who has a presently exercisable and unconditional right to call on the trustee or nominee to vest the securities in the seller, is not restricted.

143. Paragraph 846(2)(b) of the Law also provides some guidance. It provides that the right of a person to vest securities in another person are not conditional merely because the securities are charged or pledged in favour of another person to secure the repayment of money.

144. Subject to the provisions of section 846, it is the opinion of the ASC that it is sufficient, in order for a person to have "a presently exercisable and unconditional right to vest securities in a buyer", that a person has a proprietary interest, either

[27] Refer to paragraph <   > above.

legal or equitable in nature, which gives the person the absolute ability to give possession of the securities to the buyer at the time of sale.

145. In outlining these opinions the ASC proposes to release a draft practice note as contained in Section 10 of this report.

DELIVERABILITY.

146. Sub-section 846(3) provides several exceptions to the short selling prohibition. In particular, the ASC is aware[28] that uncertainty exists in some markets as to the operation of the exception set out in paragraph 846(3)(d).

147. Paragraph 846(3)(d) of the Law provides that section 846(1) of the Law will not apply to a sale of securities where arrangements are made **before** the time of sale that will enable delivery of securities of the class sold to be made to the buyer within 3 business days after the date of the transaction effecting the sale. If the sale is on the stock market of a securities exchange, the price must be at least as great as the price per unit in the immediately preceding ordinary sale and the stock market must be informed that the sale is made short.

148. It is the opinion of the ASC that the inclusion of the words "that will enable delivery" requires that the arrangements must be of sufficient certainty and of such an effect so as to ensure that the person selling the securities will, within three business days after the date of the transaction effecting the sale, have a presently exercisable and unconditional right to vest the securities in the buyer. Paragraph 846(3)(d) would be satisfied where the seller has before the time of sale entered into an enforceable agreement, written or oral, pursuant to which the seller's right to vest securities in a buyer will become absolute and unconditional within 3 business days after the date of the transaction effecting the sale.

149. It follows that it is insufficient for the purposes of paragraph 846(3)(d) that the seller has a loose arrangement or an unenforceable understanding with a third party whereby the third party will endeavour to provide securities to the seller for the purposes of the seller satisfying its delivery obligations under the sale. Similarly, arrangements that give discretion to the third party to refuse or restrict the seller's right to access to the relevant securities or which contains any conditions that may potentially hinder delivery being made within the prescribed 3 day period, would not satisfy the test in paragraph 846(3)(d). In such circumstances, the requisite element of certainty is absent and there is no guarantee that the seller by virtue of its arrangements with the third party will be able to make delivery within 3 business days of the sale. It would also be insufficient for the seller to rely upon the fact that a third party is merely accustomed by virtue of its group company structure to acting in such a way so as to place the seller (being a company in the same group of companies) in a position to meet the seller's delivery obligations. It is the opinion of the ASC that paragraph 846(3)(d) is intended to permit a

28 Refer to pargraphs < > above.

prescribed delay in delivery but it does not allow for the possibility of default by the seller.

150. The ASC is aware that in certain markets, participants rely upon stock lending facilities and repurchase agreements to satisfy the exception in paragraph 846(3)(d). The question of whether such facilities and agreements fall within the terms of that paragraph will always depend upon the terms and conditions of the particular agreement. In order to satisfy the obligation to deliver referred to in paragraph 846(3)(d), there must be no obligation upon the shortseller under the stock lending facility or the repurchase agreement to return the exact securities borrowed or purchased but rather an obligation to return or sell back securities equivalent to those borrowed or purchased. Presumably most facilities and repurchase agreements will satisfy this initial criterion. In addition, the facilities and agreements would need to satisfy the criteria of ensuring certainty of delivery, as outlined above.

151. In outlining these opinions the ASC proposes to release a draft practice note as contained in Section 10 of this report.

TRANSPARENCY.

152. The ASC strongly believes that the level of transparency[29] in the market is of particular importance for investor protection in markets that are allow short sales. In particular investors in those markets should have the right to obtain information concerning the open position of all short sales within the market, not just the open position for which the trade has not been settled by script borrowing[30] as currently operates within the ASX.

153. It is therefore the ASC's belief that short selling should be allowed to occur in those markets that show adequate investor protection criteria. This criteria includes:-

- A high level of market transparency, in particular in relation to the size of the current short position;
- A buy-in regime that allows the buyer of the security to be able to fulfil the contract, and penalties upon the seller should the contract be unfulfilled.

154. In support of the high level of market transparency, the ASX is currently considering extending their short selling list, to not only those securities that have not been delivered, but to the total level of short sales.

155. The ASX in its submission to the ASC[31], attached as Appendix B made the following comment in support of the argument for transparency:-

29 Refer to paragraphs <   > above.

30 Refer to discussion of the ASX contained in paragraphs <   > above.

61 Policy Issue Paper on Arbitrage and Short Selling, ASX, 6 February 1992.

- "That a submission be made to the Attorney-General suggesting that the Corporations Law be amended to require a Short Seller of not less than 5% of the voting shares of a body corporate be obliged to disclose details of a short sale to the market."

156. As "full information is essential to the efficient operation of the marketplace" then disclosure of a single person's short sale should be available to the market in general. This is compatible with the arguments presented by the House Committee on Government Operations report into "Short-Selling Activity in the Stock Market: Market Effect and the Need for Regulation".[32]

157. Currently only those stocks that can be short sold are on the Approved List of the ASX. The Approved list of Securities has tended to be leading companies and therefore 5% of any of the top companies would run into millions of dollars. The voting of these shares will also be very important as confusion may break out if we ended up with 105% of the capital being owned. It appears, that if a person was to be short of 5% of a company; disclosed the position, then a major voting item came up, the lender of the shares would want to recall the shares (which it is believed would be allowable under most scrip lending schemes). The market would be aware of the very large short and the squeeze would be on. This form of volatile market is not desirable.

ARBITRAGE.

158. As mentioned earlier[33] there is currently legal uncertainty surrounding the definition of arbitrage. The current unequal treatment enables brokers to disguise Short Sales as Arbitrage Transactions.

159. The Corporations Law definition of "Arbitrage Transaction" would suggest that many transactions that have, in recent times, been marked as "Arbitrage" was in fact not. Most, apart from the interstate transactions, took place with either London or New York. The time difference alone would call into question the section **"or at as nearly the same time as practicable"**, and **"in the ordinary course of trading"**. Nearly all the transaction would not be **"quoted"** on another exchange as the Australian broker would be dealing with a broker of the overseas exchange and he may not be required to **"cross"** the stock through that exchange or deal on that exchange and on a number of occasions may hold a short position.

160. The ASX in its submission[34] to the ASC made the following recommendation:-

> "That the exemption from the Short Selling Business Rule (2.18) for arbitrage transactions be removed and that the Arbitrage Business Rule (2.2)

[32] For discussion refer to paragraphs <   > above.
[33] Refer to paragraghs 44 to 51 above.
[34] Policy Issue Paper on Arbitrage and Short Selling, ASX, 6 February 1992.

itself be deleted and that a submission be made to the Attorney-General suggesting similar amendments be made to the Corporations Law."

161. It is the ASC's view that there should be amendments to the legislation in particular to Section 846(3)(b), similar to that currently operating under the SEC's regime in the USA, to provide clarity, certainty and equal treatment in respect to Securities Transactions. These amendments are to provide clarity to the definition of arbitrage as contained in Section 9 of the Law. They are summarised below:-

- A facility enabling a short sale in Australia that is necessary to equalised the price of such security thereon with the current price of such security on another national securities exchange which is the principle exchange market for such security.

- A facility enabling a short sale in Australia, effected for a special international arbitrage account for the bona fide purpose of profiting from a current difference between the price of such security on an overseas securities market and the Australian securities market; provided the seller at the time of such sale knows or, by virtue of information currently received, has reasonable grounds to believe that an offer enabling the seller to cover such sale is available in a foreign securities market and intends to accept such offer.

- A facility enabling a short sale in a foreign security listed on a national securities exchange at the opening of trading on the national securities exchange, for the purpose of equalising the price of the security to or above the last reported price (adjusted for current exchange rate) in the principle foreign market for the security.

REGISTERED SPECIALISTS AND FACILITATION.

162. The ASX in its submission[35] to the ASC supported a widening of Approved Securities, and made the following recommendation:-

- "That the criteria for Approved Securities available for Short Selling in accordance with Business Rule 2.18, be broadened to cover all Securities traded on the ASX."

163. The ASC is not convinced that this should be allowed to happen as an Approved Security, but believes that some expansion can occur by way of Registered Specialists.

164. The ASC recognises that the semi restrictive delivery environment in the T + 5 fixed settlement regime will be an aid to the control of short selling; the growth and maturity of the market have been in the leading companies that would be covered by the "Approved Securities" status. In the argument it is said that

[35] Policy Issue Paper on Arbitrage and Short Selling, ASX, 6 February 1992

overseas investments are accounting for a larger part of the market along with local institutional investors, if this is the case these investors are only investing in the "leaders". It is said that Australian Securities are estimated to represent 25% of the world's sponsored ADR's (American Depository Receipts). Internal research shows that there are 160 Australian stocks of which 42 are leading companies like ANZ, BHP, etc. Of the balance of 118 nearly all are penny gold type stocks that would appear to trade infrequently. Again the major parts of the trades are in the leading securities.

165. The ASC earlier highlighted the fact that specialist (market makers) tended to add value to the market by providing price efficiency and thereby enhancing the depth of the market. To this end the ASC believes that recognised specialists should be allowed to short sell addition securities currently not approved for general short selling. In adopting this attitude it is believed that Australia will become compatible with other similar jurisdiction. ie. USA and the UK.

166. To this end the ASC believes that Registered Specialists should be allowed to short sell in the following circumstances:-

- A facility enabling a short sale when index arbitraging an index composed of securities that is subject of a financial future (or options on such futures) designated under Chapter 8 of the Law, or stock index warrants traded on a national securities exchange. Subject to the short position being maintained in the course of bona fide arbitrage, risk arbitrage, or bona fide hedge activities.

- A facility enabling a short sale by a registered specialist or registered exchange market maker, whilst acting in the capacity of a block positioner, even though the broker-dealer may not have a net long position to such security.

- A facility enabling a short sale by a registered specialist or registered exchange market maker, at price no lower than the last sale.

167. In recognising a Registered Specialist, consideration should be given to the capital adequacy requirements of the Registered Specialist to fulfil the contract, and Registered Specialist can only be recognised by those Approved Exchanges that have Business Rules to ensure adequate investor protection.

FIXED INTEREST SECURITIES.

168. As highlighted earlier[36] there currently appear to be two different regulatory treatments for fixed interest securities. Those that are traded on the ASX and those that are traded outside the ASX. The ASX regime appears to offer a less stringent set of Rules, whilst at the same maintaining a high level of investor protection by offering a transparent market.

36 For further detailed comments refer to paragraphs < > .

169. The ASC agrees with the proposal of the AFMPG as contained in its report recommending that a regulation be introduced which would allow unregulated shortselling in all fixed interest securities, under the following circumstances:-

- In respect of debentures or bonds issued by a non-governmental body corporate or an unincorporated body, there would be a pre-requirement that shortselling could not occur unless not less than $100 million of the relevant stocks, having the same maturity date, had been issued;

- That a short sale of Public Securities shall not be made with a settlement date more than 10 Trading Days after the date of sale;

- That there is some penalty imposed upon the seller for non-delivery.; and

- That there is some degree of transparency, in particular the size of the out-standing short sales are made available to market participants.

170. If implemented, this law reform proposal would remove the current need for fixed interest traders to comply with the exception to the shortselling prohibition in paragraph 846(3)(d), other than for the conditions set out above.

171. In arriving at this conclusion the ASC believes that the same regulatory treatment should be provided in all the securities of the same class, and that the new regime provides clarity, certainty and equal treatment to all fixed interest securities that are compatible to overseas jurisdictions.

SECTION 7: DEFINITIONS.

172. The following is a glossary of terms and their meaning as they are used throughout this report:-

COVER.

173. To buy back securities previously sold. Typically used to describe the closing of a short position in securities.

CORNER.

174. Arise when a buyer or buyers purchase more than the available supply of a security with the intention of forcing short sellers to settle on terms dictated by the purchaser or purchasers. Generally, such over-buying is possible only if there is unregulated short selling and the issuer of the security has a small issued capital.

ODD LOT.

175. Refer to a parcel of shares less than a marketable parcel, or a half parcel, traded on the exchanges. An odd lot dealer, who charges an additional fee, must deal in regular units or round lots and therefore he may sell round lots short either to anticipate or to offset odd lot orders of his clients.

SHORT SELLING.

176. "A device whereby the speculator sells stock which he does not own, anticipating that the price will decline and that he will thereby be enabled to 'cover', or make delivery of the stock sold, by purchasing it at the lower price. If the decline materialises, the short seller realises as a profit the differential between the sales price and the lower purchase or covering price." [37]

177. A short sale results from the sale of a security that the seller does not have ownership of or that the seller owns but does not deliver. Short selling is used to profit from an expected downward price movement or to hedge the risk of a long position in the same or related security.

DIFFERENT REGULATORY TREATMENT.

[37] 1934 Report of the U.S. Senate Investigation into Stock Exchange Practices.

178. The submission paper from AFMPG highlights the different regulatory treatment that currently exists for fixed interest products. Trading of these securities on the ASX would appear to have less strident rules than those traded off the ASX. For example, on the ASX:-

- There is no requirement for arrangements having to be made before the sale that will enable delivery of securities of the class sold to be made to the buyer within 3 business days after the date of the transaction effecting the sale as contained to section 846(3)(d)(ii). The ASX allows by Rule 2.18(11)(a) to have settlement dates up to 10 trading days after the date of the sale. However the ASX imposes a buy-in rule by Rule 4.4[38], which also imposes a penalty on the broker for non delivery. The penalty is currently $25 per trade and is not imposed until T+15.

38 Refer to paragraphs < > for further comments.

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Securities Lending of *Equity Securities* in Australia

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1 Introduction

1.1 Background

Both domestic and more recently cross border securities lending is a well established business transaction in most developed international securities markets. Domestic securities lending first appeared in the United Kingdom during the 1950s and 1960s and then rapidly developed in the United States (lead by the US custodian banks) in the 1970s and 1980s, before developing in most other developed domestic markets in the 1980s and later in many emerging markets. Securities lending practices in the US, the UK, Canada, the Netherlands, Germany and Japan have reached a sophisticated and mature level. Securities lending practices in Australia have likewise reached a sophisticated and mature level.

In July 1999 the Technical Committee of the International Organisation of Securities Commissions ("**IOSC**") prepared a comprehensive report (the "**IOSC/CPSS Report**") entitled "Securities Lending Transactions: Market Developments and Implications" jointly for the IOSC and the Committee on Payments and Settlements Systems of the central banks of the Group of Ten countries ("**CPSS**"). The IOSC/CPSS Report noted in its Foreword that -

> "The growth in securities lending transactions, such as securities loans and repurchase agreements, has been such in recent years that they now represent a substantial part of the daily settlement value in many settlement systems and play an important role in facilitating market liquidity".

The IOSC/CPSS Report concluded that securities lending activity was expected to increase and become an even more integral component of financial markets in the future.

For the institutional investor (such as a pension or superannuation fund, an insurance company, public unit trust or other kind of mutual fund, and some government bodies), securities lending is widely viewed as a natural adjunct and value-added service to the custody service provided by custody banks. Although the incremental income is typically relatively small (though it can be significant in absolute terms), it offers the opportunity to the investor, *with limited risk*, to earn some incremental income and thereby effectively reduce their net custody fees This is particularly relevant for a large portfolio, because it enables the institution to effectively provide a greater return for its clients. As the IOSCO/CPSS Report noted (page 19), this can be important in a field as highly competitive as funds management, where very small differences in performance can significantly affect performance ranking.

1.2 Focus of this paper

While parts 1-4 of this paper apply generally to the lending of both equity and debt securities, the principal focus of this paper is on the lending by an institutional investor of its *Australian equity* securities, which typically must be executed in Australia. (Different legal, practical, documentary and tax issues are involved in the "lending" of debt securities. These are dealt with in a parallel paper focused solely on debt securities.) (However, several observations will be made in passing regarding the lending by Australian owners of *overseas* equity securities.)

Accordingly, the tax comments in part 5 of the paper are confined to equity securities.

The paper also tries to highlight the differences between a principal and an agency programme operated by a custodian bank.

Unless otherwise indicated, the paper assumes:

- that the transaction will take place under a common form master securities lending agreement, governed by Australian or English law (in particular, this paper does not deal with transactions under reciprocal purchase agreements); and

- that the transaction is securities-driven, not cash-driven (see 1.3(b) below).

1.3 What is "securities lending"?

(a) the "loan"

As the IOSC/CPSS Report observed (page 5), "in today's capital markets, securities seldom lie idle".

Securities lending arrangements arise when a longer term holder of securities agrees to provide them to a borrower for a period. The borrower is contractually obliged to return, at the end of the period, replacement securities which are equivalent in number and type to the original securities. Consequently, at the end of the period, after the return of the replacement securities, the lender retains exactly the same portfolio as before. For that reason, the arrangement is viewed in substance, or economically, as a "loan" of the relevant securities, even though, legally (where the agreement is governed by Australian or English law), the lender actually transfers absolute ownership of the original securities to the borrower and is only entitled to receive identical or equivalent securities in return. (This transfer of absolute ownership enables the borrower to sell or otherwise deal with the securities as it thinks fit.)

During the period of the "loan", the lender has contractual rights similar to those that it would have had if it had retained ownership of the original securities, namely the right to receive from the borrower the equivalent of all dividends (or, in the case of debt securities, interest), other distributions or rights (if any) in respect of the securities which are paid or arise during the period of the loan.

However, in the case of equity securities, the lender does **not** retain any voting rights. Generally, if the lender wishes to exercise voting rights, it must recall the stock.

(b) two distinct markets

In practice, there can be two distinct drivers for a securities lending transaction:

(i) The principal type of transaction is a *"securities-driven"* one. This is where the borrower of the securities wants to effectively obtain temporary access to the specific securities.

These types of transactions are highly intermediated, as the securities lenders usually must rely only on the intermediary to source the demand for the securities. The leading intermediaries for institutional investors, in terms of market share, have traditionally been the custodian banks,.

This paper focuses solely on these types of transactions.

(ii) Another, much less common, type of transaction is a *"cash-driven"* one. This is where the securities lender simply wants effectively to borrow cash and to use the relevant securities as collateral for the transaction. The securities borrower is *not* seeking to obtain access to any particular securities and, within certain defined categories, will generally permit the securities lender to choose the securities to be provided.

The potential advantage to the securities lender is that it may be able to effectively borrow cash at a cheaper rate than under a conventional secured loan facility.

This paper does not deal with any particular issues connected with this type of transaction.

(c) types of Australian securities lending programmes; role of intermediaries

A lender can run its own programme, provided it can itself source sufficient demand. Several of the biggest institutions in Australia do so. However, most institutions in Australia use an intermediary, to avoid the expense, the administrative and operational difficulties, and the credit and other risks of running their own programmes. As indicated above, the leading intermediaries for institutional investors, in terms of market share, have traditionally been the custodian banks.

There are two types of securities lending programmes offered by custodians:

(i) A *principal* programme.

Many institutions find it convenient to lend securities to an intermediary principal (eg a custodian bank), which then onlends to many more counterparties. This saves administration and, importantly (as will be seen), limits credit risks to the principal.

However, in Australia, if the principal is a custodian bank, that risk is usually uncollateralised.

(ii) An *agency* programme (with or without indemnification).

Many other institutions choose to enter into an agency programme with an intermediary (usually a custodian), which then deals directly with a large but limited number of end borrowers. This involves extra administration and wider credit and other risks. On the other hand, most (but not all) of these risks are collateralised and some may be the subject of indemnification by the agent.

The main differences between the two types of programmes are described in some detail in part 2 below.

(d) collateral

In any *principal* programme with a custodian bank in Australia, normally collateral is not provided by the custodian bank.

In any *agency* programme, the borrower provides the lender (or the lender's agent) with collateral (usually cash) for the term of the loan, to secure the performance of its obligation to return the replacement securities. The three main types of collateral are:

- cash (usually in the same currency in which the borrowed securities are traded on the principal stock exchange on which they are quoted, or in which they are denominated),
- securities (such as bonds or equities), and
- occasionally, standby letters of credit ("**L/Cs**").

The administrative burdens involved in a direct lender receiving collateral have lead to the development of tri-party arrangements, in which a third party takes on the effective back-office role. However, they are still in their embryonic stages in Australia.

(e) fees

The lender effectively earns a fee for the use of the borrowed securities.

In an *agency* programme:

(i) Where cash collateral is provided by the borrower under a "borrow vs cash" ("**BvC**") arrangement, usually, no separate fee is payable. Instead, the interest rate which the lender of the securities pays to the borrower on the cash collateral put up by the borrower (generally called the "**rebate**") is a normal market rate less an agreed spread. The spread is equivalent to the fee which the lender would otherwise earn (see (ii) and (iii) below).

(ii) Where cash collateral is provided by the borrower under a so-called "pool" arrangement (either under a "borrow vs cash pool" ("**BvCP**") arrangement, where only cash collateral can be provided, or under a "borrow vs pool" ("**BvP**") arrangement, where cash and/or agreed securities can be provided), a separate borrow fee, calculated usually on a daily basis by reference to the market value of the borrowed securities, is payable by the borrower to the lender.

(iii) Similarly, where an irrevocable standby letter of credit is provided, a separate fee, calculated usually on a daily basis by reference to the market value of the borrowed securities, is payable by the borrower to the lender.

In a *principal* programme in Australia (where normally collateral is not provided by the borrower custodian bank), the borrower normally just pays a separate agreed fee to the lender (similar to (iii) above).

(f) distributions and other entitlements

The borrower also compensates the lender for distributions (for example, dividends or, in the case of debt securities, interest) and other rights (if any) which may accrue on the borrowed securities during the term of the loan. The compensation payments are often called "manufactured" payments (being the term originally used in the UK). The tax attributes of the manufactured payments are explained in part 5 below.

(g) benefits to lenders

Thus, as explained in the "Background" in 1.1 above, lenders obtain an additional return in the form of the fees earned (or equivalent interest rate spread), on top of the distributions and other returns (if any) normally derived from the security itself.

(h) true legal character of the transaction

The terms "lending" and "borrowing" describe the substance of the arrangement, but incorrectly describe its legal effect under the terms of a typical master agreement governed by Australian (or English) law:

(i) The first leg involves an outright disposition of absolute ownership of the securities by the lender.

(ii) Contemporaneously, the borrower in effect enters into a deferred forward sale agreement for *equivalent* (but not necessarily the original) securities.

Thus, there is no "lending" of the original securities by the lender. (Despite this, market terminology continues to use lending terminology, which is likewise adopted and used in this paper.) In technical legal parlance, most arrangements are *mutuums*.

(i) true legal character of provision of collateral securities

Likewise, in the case of the provision of collateral securities under a typical master agreement governed by Australian (or English) law, effectively, there is a separate securities lending transaction in respect of those collateral securities, contemporaneous with the loan of the principal securities. The main differences are:

(i) The provider of the collateral securities cannot recall them unless it provides substitute collateral.

(ii) In certain circumstance, the recipient of the collateral securities may not be obliged to gross up any manufactured payments for any tax payable in respect of that manufactured payment while the collateral securities are held by that recipient (see, for example, clause 6.7 of the AMSLA; contrast clause 9.7(a) of the AMSLA in relation to manufactured payments in respect of the lent securities).

1.4 What securities are typically lent in Australia?

- The top 200 Australian equities and those securities with an associated derivative instrument.

- Government, Semi-Government and corporate bonds and inscribed stock. (For largely historical and also systems reasons, such securities are also often dealt with by reciprocal purchase agreements, or "repos" (and similar transactions known as buy/sell agreements), typically under as the BMA/ISMA Global Master Repurchase Agreement ("**GMRA**"), whose legal effect is different from a securities lending agreement.)

1.5 Who are typical borrowers and why do they borrow?

Borrowing currently occurs for one or more of several purposes.

(a) Margin requirements

There are borrowers who need to meet margin requirements and can do this more cheaply by borrowing securities, rather than by depositing cash. This type of transaction typically occurs in the Australian equity options market, where lodging certain transferable securities is an accepted alternative to deposits of cash margins.

(b) Market making/trading

Market makers (such as investment banks and broker-dealers, including prime brokers) are the largest borrowers of securities in Australia and are responsible for the majority of securities lending transactions in this country. These traders sell securities for a variety of reasons, most of which are hedging related, for example index/physical arbitrage, option or warrant hedging, other derivatives, as well as outright short selling.

Securities loans drawn down by market makers and traders are typically larger in volume and, in the case of equity securities, can be of longer duration than other loans. For lenders, these loans represent the greatest opportunity to maximise profit, by minimising associated administrative costs.

(c) To exercise equity voting rights

There have been several instances overseas where a borrower apparently just wanted to be able to exercise the voting rights referable to the borrowed equity securities at an important general meeting of the relevant company. The best known of these involved the UK company British Land in June 2002: see the article entitled "Getting the Vote Out" in the International Securities Finance magazine, June 2003, at pages 34-36. An analogous situation occurred in Australia in relation to the 2002 election for directors of Coles Myer Limited and in 2005 in relation to the control of General Property Trust.

1.6 Who are typical lenders and why do they lend?

Generally, institutions lend their securities to increase gross portfolio returns, or to effectively reduce their net custody costs. However, it is necessary to distinguish the different circumstances of:

- Overseas institutions (for whom interest (and, in the case of equity securities, dividend) withholding tax are, or may be, relevant).

- Australian institutions (for whom, in the case of equity securities, franking credits are relevant).

- Local nominees and custodians, either as a principal or as an agent for local and overseas clients.

1.7 Size of the market

The size of the securities lending market in Australia is uncertain. This is principally because (as will be seen in part 6 below) in practice securities lending transactions are presently not reported in Australia, irrespective of the purpose of the borrowing.

The demand for equity securities dropped substantially after the May 1997 Federal Budget effectively removed the opportunity for franking credit tax arbitrage (see further part 5 below), but in 1999 the IOSC/CPSS Report estimated that the daily turnover in equities securities lending in Australia was A$550+ million.

1.8 Standard documentation

Regulatory changes in the United Kingdom, coupled with the efforts of the International Securities Lending Association and the Money Brokers' Association, brought a degree of standardisation to the forms of agreement used by overseas lenders. One such form of standard agreement is the UK Overseas Securities Lender's Agreement ("**OSLA**"). Another is the US Bond Market Association Master Securities Loan Agreement.

In 1997 the Australian Securities Lending Association ("**ASLA**") decided to attempt to standardise the securities lending documentation in use in Australia, by adapting the OSLA for use in Australia for loans of Australian securities. In April 1997, a specimen Australian Master Securities Lending Agreement ("**AMSLA**") and accompanying User's Guide, prepared by the writer, were publicly released. The AMSLA quickly gained a high degree of market acceptance.

An updated version of the AMSLA and supplementary User's Guide, prepared by the writer, were released in December 2002. A further very minor list of suggested amendments was subsequently released. A consolidated version of the AMSLA and User's Guide were released and published by the Australian Financial Markets Association ("**AFMA**") in its 28 November 2003 Update 8 to its On-Line Guide to OTC Documents.

As a consequence of the widespread acceptance of the AMSLA, potential new participants in the Australian securities lending market face a lower barrier to entry, because of, among other things, a lessening of concerns about relevant legal issues, the perceived cost of getting appropriate legal advice and developing their own form of agreement. (The cost of the development of appropriate systems (or, alternatively, the cost of a standard software package) is now a more important issue.)

(As was mentioned above, for various reasons debt securities are more typically "lent" under the BMA/ISMA GMRA.)

1.9 Summary

In summary, in Australia:

- The level of securities lending is primarily "securities" (or demand) driven.
- This demand varies because of different market characteristics.
- Those market characteristics include:
  - the efficiency of the relevant settlement system,
  - the presence and nature of the derivatives market,
  - the fundamentals of the underlying relevant physical market, and
  - the tax and regulatory environment.
- The efficiency of the Australian securities markets and their settlement systems is dependant on the availability of securities lending.

2 Agency vs Principal Programmes

2.1 Principal programme

In a *principal* programme:

(a) The custodian bank will borrow securities from the client as a principal and, accordingly, will have a personal obligation and liability to return equivalent securities, as well as to perform its other obligations under the agreement.

(b) Accordingly, the client has counterparty credit risk exposure to the custodian bank.

(c) In Australia, the custodian bank typically does not provide any collateral to the client (which the client would then have to manage, or which the custodian would have to manage on behalf of the client). Instead, the exposure of the client to the custodian bank appears similar to that arising if the client had deposited cash (or, perhaps more relevantly, foreign currency) with the custodian, subject only to the priority afforded to deposit liabilities of the bank (under section 13A(3) of the Banking Act 1959).

(d) However, when the custodian on-lends the securities as principal to a third party, it will invariably only do so to a select number of counterparties of requisite credit-worthiness, subject to credit limits and on terms which involve the third party providing collateral and variation margin, as described below under the heading "Common Features".

2.2 Agency programme

In an *agency* programme:

(a) As the primary legal relationship in relation to the securities lending transaction is with each of the borrowers (and not with the agent), the lender has counterparty credit exposure to each borrower. Accordingly, as indicated in more detail below, the lender has to initially consider and periodically review the credit worthiness of each potential borrower on the agent's list and set any exposure limits.

(b) For similar reasons, the lender has to consider and periodically review acceptable collateral and, in particular, its re-investment of cash collateral risk (which is invariably not indemnified by the agent). The collateral risks are described in more detail below.

(c) The lender must also:

   (i) assess, perhaps with the help of an external rating agency, (or rely on the agent's assessment of) the creditworthiness of any bank whose letter of credit is permitted as acceptable collateral by the agent, unless the lender indicates otherwise; and

   (ii) consider the lending institution's other exposures (if any) to every permitted issuing bank and whether the institution wishes to impose limits on the L/C exposure to any such bank and, if so, advise the agent accordingly.

   (The agent will normally only accept an L/C issued by a bank with a certain minimum credit rating and require the issue of a substitute L/C by another approved issuing bank if the rating of the first issuing bank is downgraded to below the minimum level. The agent also normally has in place other procedures to try to avoid an over-concentration with, or an excessive exposure to, any individual issuing bank.)

(d) An agency programme may also be a partly indemnified one. The IOSCO/CPPS Report (page 56) says that "market participants acting as agents need to clearly specify the risks covered by any such [indemnification] provisions". Therefore, the lender needs to clearly understand who will ultimately bear all the risks and, in particular, what risks are not covered by any indemnification.

2.3 Common features of principal and agency programmes

Typically, the custodian will:

(a) prior to transacting:

- (i) review potential borrowers and determine acceptable borrowers and any applicable credit or other limits;
- (ii) negotiate a master agreement with each acceptable borrower;
- (iii) identify and agree available securities; and
- (iv) identify acceptable collateral and (in the case where the collateral can take the form of an L/C) determine acceptable issuing banks and any applicable credit or other limits;

(b) periodically:

- (i) review and update acceptability of borrowers and any applicable credit or other limits;
- (ii) review and update available securities; and
- (iii) review and update acceptable collateral and acceptable L/C issuing banks and relevant limits; and

(c) in transactions:

- (i) arrange trades;
- (ii) issue instructions to settle;
- (iii) (if applicable) provide collateral management services (including receiving, investing and returning collateral; mark-to-market valuation of securities on loan and (if applicable) collateral; and (if applicable) calling for, receiving and returning variation margin);
- (iv) collection and crediting of income equivalent, or "manufactured" income, payments;
- (v) (if applicable) collection and whole or partial remittance of income on collateral;

(vi) in the case of equity securities, monitoring other corporate actions.

The choice between a principal and an agency programme depends on who the lender's custodian bank is (and its preference or willingness to offer one kind of programme rather than the other) and the lender's level of comfort with the programme offered by that custodian.

2.4 Comparison: principal v agency

Uncollateralised lending to a custodian as a principal intermediary does involve the concentration of credit risk in a sole counterparty. However, it thereby avoids the need for the lender to:

(a) evaluate and rely on (or at least on the agent's assessment of) the creditworthiness of all the counterparties on the agent's list of potential counterparties (many, or at least some, of whom may not be well known to the lender) and set appropriate exposure limits (if any);

(b) determine (or at least rely on the agent's assessment of) acceptable collateral;

(c) evaluate and rely on (or at least rely on the agent's assessment of) the credit worthiness of any L/C issuing bank and set any exposure limits;

(d) investigate and comprehend the extent of its re-investment of its unindemnified cash collateral risk and the extent of any indemnification by the agent of other risks.

3 Risks in Securities Lending

The risks inherent in lending securities are not always readily apparent, but must be considered when entering into a securities lending programme.

Broadly, as stated in the IOSCO/CPPS Report (page 39), securities lending transactions are in substance similar to a deposit (by the securities lender) with the counterparty (securities borrower), in that there is a creditor's agreement to advance value (securities in this case, instead of cash), in exchange for a promise by the counterparty (securities borrower) to pay at a later date.

However, there are some differences. The comments below seek to highlight the main differences. (A fuller explanation, also covering repos and buy/sell agreements, is contained in the IOSC/CPSS Report.)

3.1 Counterparty credit risk

As in the case of a cash deposit, the greatest risk in a securities lending transaction or programme is that of counterparty (ie borrower) default (whether or not due to insolvency).

Counterparty (ie borrower) default can arise in respect of any one or more of a number of obligations/situations:

(a) the failure of the borrower to return equivalent securities on the due date (a settlement or a market risk);

(b) the failure of the borrower to pay or provide manufactured income or equivalent other rights or entitlements on the due date;

(c) (if applicable) the failure of the borrower to pay margin calls as and when obliged to do so;

(d) another situation is either where the transaction is uncollateralised or where the proceeds of the realisation of any collateral held by or on behalf of the lender are insufficient to purchase replacement securities or any equivalent other rights or entitlements. (The latter risk is sometimes separately called the replacement cost risk.)

Apparently, in a non-insolvency situation, such defaults rarely occur and, when they do, it is almost invariably because of operational problems.

Accordingly, in practice, it is the insolvency of the counterparty which is likely to pose the greatest risk to a lender.

In a *principal* programme with a custodian bank, the lender is only concerned with the credit worthiness and the insolvency risk of the custodian and may consider the custodian a good credit risk and be comfortable with the level of its exposure to the custodian. (As indicated in 3.4 below, where there are other relationships between the institutional lender and the custodian, the lender's exposure can also be minimised by an appropriate set-off or close out netting provision with the custodian.) If so, the client would only need to monitor and regularly review the custodian's credit rating and the limit(s) and actual exposure applicable to it.

In an *agency* programme:

(a) The legal relationship is between the lender and the person to whom the agent has lent the securities. Accordingly, it is the borrower (and not the agent) who is the counterparty. In other words, the client cannot automatically look to the agent to make good the borrower's default. Also, collateral exposure lies with the lender.

(b) Accordingly, the lender is vitally interested in the credit worthiness of each of those borrowers and must therefore:

    (i) come to its own view, perhaps with the help of an external rating agency, of the appropriateness of the borrower for inclusion on the agent's list of potential borrowers;

    (ii) if it wishes to do so (eg having regard to other exposures to any borrower on the agent's list and to the rating given to those borrowers by external rating agencies), set any limits on the level of exposure that it is willing to have to particular borrowers on the agent's list;

    (iii) monitor and regularly review permissible borrowers and limits;

(iv) having regard to the above, determine acceptable collateral (or agree with, or differ from, the agent's list of acceptable collateral).

(c) Invariably, the lender will also have recourse to the collateral provided by the borrower. The sole purpose of the collateral is to minimise the exposure of the lender to counterparty credit risk.

The collateral is subject to the various risks associated with collateral described below.

Normally, in a properly managed collateral management programme, the risk should be limited to an intra-day or overnight risk of an adverse market movement in the value of the lent securities or the collateral, and then only when the extent of the aggregate adverse movements exceeded the normal margin or buffer. But, as will be seen below, there are other risks.

(d) Sometimes (subject to a cap) the agent will offer one or more indemnities to the lending customer (eg against an inadequacy of collateral due to an overnight increase in the value of the loaned securities or an overnight decrease in the value of collateral held or for the failure of the borrower to return equivalent securities on the due date). These indemnities require the lender to assess the credit worthiness of the agent.

3.2 Collateral risks

As the IOSCO/CPSS Report noted (page 51), "while collateral reduces credit risk, it can add to other risks, such as legal, operational, liquidity and market risk".

The main risks in an *agency* programme, where collateral is provided, are outlined below.

At the outset, it is important to again note that, in an agency programme, collateral exposure lies with the lender, except to the extent (if at all) expressly indemnified by the agent.

(a) Delivery (versus payment or versus delivery) risk (if applicable)

Delivery risk occurs when collateral is received or is to be received.

This issue is not so important in practice in Australia nowadays, because:

(i) Transactions involving equity securities can now be settled through CHESS on a dvp basis (so that cash collateral can be credited contemporaneously with the delivery of the relevant securities), as well as on a free of payment basis.

(ii) Transactions involving debt securities such as Government Bonds and inscribed stock and semi-government and corporate bonds can also effectively be settled on a dvp basis through Austraclear.

(iii) The majority of securities loans for which the collateral is cash are now settled on a dvp basis in these ways, both on the initial and on the return leg.

The same issue arises where non-cash collateral (other than a L/C) is to be provided - a delivery versus delivery ("**dvd**") risk.

Where for any reason there cannot be dvp or dvd, the normal practice of an agent is to require the provision of collateral before delivery of the lent securities is made (and likewise, on the return leg, to require the provision of equivalent securities before redelivery of the collateral or equivalent collateral).

However, variation margin payments and refunds cannot be settled in this way.

(b) Collateral title risk (if applicable)

A lender should always ensure that there is clear title to any collateral received.

In practice, this is not a problem where the borrower is a bank. But the issue needs to be addressed in the course of a credit assessment of every non-bank borrower.

(c) Adequacy of collateral risk (if applicable)

This is the main collateral risk. Where the lender is relying on the adequacy of the collateral, as well as the credit-worthiness of the potential counterparties:

(i) The margin above market value must cover market fluctuations. This is particularly important in a rising market. This risk is normally minimised by the agent continually monitoring collateral levels and making timely margin calls.

(ii) Current market practice in Australia generally is that the collateral should be maintained within the range of:

(A) at least 102-105% for equities (and sometimes substantially higher (eg 110%-130%) in the case of non-cash collateral); and

(B) 0-2% for debt securities such as Government and semi-government bonds and inscribed stock

of the daily marked-to-market value of the borrowed securities. The value of the borrowed securities is marked to market daily. The agent has sophisticated software to assist in making these calculations.

(iii) The making of timely margin calls could still leave an intra-day or overnight exposure if there is a sudden substantial increase in the market price of the borrowed securities.

All these operational activities are often called “loan maintenance”.

(d) Re-investment of cash collateral risk

This is probably the second most important collateral risk.

In keeping with the legal position that collateral exposure lies with the lender, the lender is exposed to a market risk of incurring losses on re-invested cash collateral. In other words, if the cash collateral received is so invested that, on the return of equivalent securities by the borrower to the lender, there is insufficient cash to repay the borrower, then the lender is legally obliged to make good the shortfall. This exposure exists because, to obtain the desired incremental yields on the cash reinvestment, a lender (or the lender’s agent) will typically match only part of the term of the securities loan with the term of the cash investment: eg pay the rebate based on a 24-hour call rate, while investing in a 30 day money market instrument.

This kind of exposure actually materialised in the US in 1994 (see the IOSCO/CPSS Report, page 42), due to a sudden and unforeseen increase in US short-term interest rates (even though many custodian banks operating the relevant agency programme voluntarily compensated their customers). A similar thing may have happened more recently in one case in the US: see International Securities Finance magazine, June 2003, pages 4 and 6.

Any indemnification provided by an agent will typically *never* extend to any devaluation of collateral due to market movements or issuer default.

Agents typically manage this risk exposure by maintaining a short asset/liability mismatch window and a short weighted average portfolio maturity, by investing in a portfolio of liquid assets of high-quality issuers and by investing in highly correlated indices.

(e) Default by LC bank

In keeping with the legal position that collateral exposure lies with the lender, if a lender in an agency programme agrees to accept a letter of credit from an approved issuing bank, then the lender may find itself under collateralised in the event of borrower and then L/C issuer default.

3.3 Accrued benefits risk

The lender must be able to accurately determine the benefits to which it is entitled and to be satisfied that the borrower is able to remit them on the due date.

In this regard:

(i) Where collateral is provided (as in an agency programme), the accrued benefit up to the relevant record date is normally taken into account in calculating margin requirements, because it is reflected in the market price of the relevant security.

(ii) There is an exposure between the record date and the payment date. In practice, this is not taken into account in calculating margin requirements in an ongoing relationship. Only in an exceptional case would a lender wish to ensure that, if securities are on loan over a books' closing date for a distribution, but returned before the distribution payable date, the benefit due is also secured.

(iii) In practice, the only accrued benefits which are captured and adjusted for are non-cash entitlements such as entitlement to participate in a dividend re-investment plan or a rights issue.

3.4 Set-off/Netting

Where collateral is provided (and subject to the adequacy of the collateral) or (in the case of a principal programme) where there are other relationships between the institutional lender and the custodian bank, a lender's risk exposure can be minimised by an appropriately drafted set-off or close-out "netting" provision if the borrower defaults, both before and after insolvency. The set-off provisions in the AMSLA are contained in clause 8.2.

4 Stamp Taxes and GST

4.1 No transfer stamp duty

Since 1 July 2001, no Australian jurisdiction has imposed stamp duty on the transfer of shares quoted on the ASX (and other approved exchanges).

There is also no stamp duty on the transfer of debt, fixed interest or other money market securities.

4.2 No mortgage duty

The securities lending agreement itself should not be liable to mortgage duty in any State, because securities lending does not involve a mortgage or charge over either the securities or any collateral.

4.3 Goods and Services Tax ("GST")

No GST is imposed on securities lending (ie the transaction between the securities "lender" and the securities "borrower"). Rather, securities lending is an input taxed supply (unless it qualifies for GST-free treatment, for example under the "export" provisions in section 38-190 of the GST Act).

However, where, for example, a custodian is lending securities under an agency programme on behalf of its custody client, GST will be imposed on the custodian by reference to the consideration that the client provides for the custodian's services (ie typically a share of the "spread" where cash collateral is provided, or a share of the fee where non-cash collateral is provided). Likewise, where a custodian bank is the borrower under an uncollateralised principal programme, GST will be imposed on the fee that the custodian bank pays to the lender custody client.

5 Income Tax Issues re Equity Securities

In addition to residency rules and permanent establishment and source type issues, lenders must be aware of the application of:

- Ordinary income tax, and
- if applicable:
    - Capital gains tax (“**CGT**”),
    - Dividend imputation, and
    - Interest and dividend withholding tax,

to any securities lending transaction involving *equity* securities into which they enter.

This part 5 is focused on the lending of *equity* securities.

In this part 5:

- the **ITAA 1936** means the Income Tax Assessment Act 1936;
- the **ITAA 1997** means the Income Tax Assessment Act 1997; and
- the **TAA 1953** means Taxation Administration Act 1953;

5.1 Ordinary income and capital gains tax (“CGT”) re lending and re-delivery legs of transaction

As was mentioned in 1.3(h) above, securities lending involves a **sale** of securities and the subsequent **repurchase** of identical (but not necessarily the same) securities, even though the securities industry treats the transactions as if they involved a **loan** of securities.

This sale and repurchase view was adopted by the Australian Taxation Office when it first became aware of securities lending arrangements. Securities lending could therefore crystallise a liability to ordinary income tax or CGT, because it involves the realisation of an asset, namely the securities being “lent”. For capital gains tax purposes, the consideration for the initial disposal of the securities would be regarded as their market value at the time of disposal. (However, it should be noted at the outset that under current law (as affected by an announcement in the May 2005 Federal Budget), broadly, a non-resident of Australia is normally not liable to capital gains tax in respect of the disposal of shares in an Australian listed company unless it and its associates have beneficially owned at least 10% by value of the issued shares in the company (except preference shares) at any time during the five years before the relevant disposal. Different considerations apply if that 10% limit is exceeded or if the non-resident holds the shares on revenue account (rather than on capital account).)

However, (where otherwise applicable) any such tax liability can now be avoided if certain conditions are fulfilled. Broadly, under section 26BC of the ITAA 1936, a lender is not subject to any tax consequences (other than those arising from being paid a fee) if, among other things:

- the securities lending agreement is in writing;
- the borrowed security (or an identical security) is in fact returned within twelve months after it is lent;
- the borrower and lender deal at arm's length in relation to the transaction;
- the consideration paid by the borrower (including any fee) is specifically identified; and
- the lender retains the total consideration due under the agreement.

In addition, there are specific requirements if a distribution, or the issue of a right or option, in respect of the borrowed security occurs during the borrowing period.

It is generally easy for a lender to meet all these requirements, if it wishes to do so. Likewise, it is generally easy for parties to avoid meeting these requirements, if (usually for tax reasons) one of them wishes to do so. A loan under an overseas master securities lending agreement will generally **not** comply with all the requirements of section 26BC. A transaction which fails to meet the requirements is generally referred to as a "non-complying" (as distinct from a "complying") loan. An Australian borrower may be largely indifferent as to whether the loan is a complying one, because (apart from possible debt/equity and transfer of shareholder status considerations) the tax consequences for it may be the same.

5.2 No debt/equity issues re complying securities lending transactions

Section 974-130(4)(b) of the ITAA 1997 effectively explicitly provides that a securities lending arrangement under section 26BC of the ITAA 1936 is not a "financing arrangement" for the purposes of the debt/equity rules in the ITAA 1997.

Accordingly, provided that the relevant transaction meets the requirements of section 26BC, then, irrespective of whether the transaction is securities driven or cash driven, the transaction itself should not qualify as either debt or equity for tax purposes. This is relevant to the treatment of manufactured payments for both domestic and withholding tax purposes.

(Note that section 26BC does not refer to collateral. Thus, in my opinion, in the case of an agency programme, a rebate paid to a securities borrower in respect of any cash collateral can still be characterised for tax purposes as interest on a debt interest held by the securities borrower in the securities lender.)

5.3 Distributions

(a) Franking credits

Australian resident shareholders receiving distributions from a company must gross up the distribution received (by the amount of tax paid by the distribution paying company on the profits out of which the dividend was paid), but are then generally entitled to a tax credit (or "offset") for the amount of the gross up (the franking credit). This franking credit can be applied against tax payable on the distribution or other income of the recipient of the distribution.

(b) Possible transfer of shareholder status for tax purposes re fully or partly franked (but not totally unfranked) distributions under a complying securities lending transaction

Under the general rules relating to franked distributions, any franking credit that attaches to a distribution is normally only able to be utilised (if at all) by the registered security holder.

This rule is altered for securities lending arrangements that comply with Division 216 of the ITAA 1997, which is headed "The effect of a cum dividend sale or securities lending arrangement under the simplified imputation system". That Division provides for the transfer of shareholder status for franking credit purposes in certain circumstances.

Division 216 generally deems a fully or partly franked distribution (but **not** a totally unfranked distribution) paid directly by an issuer to a borrower under a securities lending arrangement which falls within section 26BC of the ITAA 1936 (or which is deemed to have been paid directly by the issuer to the borrower as a result of one or more previous applications of section 216-10) to have been paid to the lender. The legislation (section 216-30) also requires the borrower to issue a statement in an approved form to the lender.

An important limitation on the operation of Division 216 is that franking credits referable to franked distributions are only transferable under section 216-10 if the transferor can transfer a genuine distribution. Thus, if the borrower is not entitled to a genuine franked distribution, for example because it has on-sold the securities (and consequently cannot transfer any franking credit to the lender), Division 216 does not apply. Instead, both parties must ensure that the contractual arrangements between them specify exactly what compensation will be due. Well drawn documentation for any complying loan will require that the distribution equivalent amount or "manufactured" income payment be grossed-up (by a compensatory payment) for any loss of the franking credit to the lender (see, for example, clause 9.2 of the AMSLA, as amended to date).

In practice, unless otherwise agreed, if a loan on behalf of an Australian lender would extend over a distribution record date, most custodian banks will contact the borrower and confirm whether or not the borrower will give a section 216-30 statement. Unless it is certain that the borrower will do so, the custodian bank will generally recall the securities. Where there is no recall but the borrower fails to give a section 216-30 statement, the gross-up compensatory payment referred to in the preceding paragraph adequately compensates the lender.

(c) Application of the 45 day holding period rule and the related payments rule (re claiming franking credits) to a complying securities lending transaction

The “45 day holding period rule” and the “related payments rule” (as contained in sections 160APHC to 160APHU of the ITAA 1936, to be re-enacted in the ITAA 1997) do not affect the ability of an Australian resident lender to utilise franking credits under securities lending arrangements that fall within section 26BC of the ITAA 1936.

The “45 day holding period rule” and the “related payments rule” both require an Australian resident taxpayer, subject to certain exceptions, to hold shares at-risk for not less than 45 days (or 90 days in the case of preference shares) in a certain qualification period. The qualification period differs for each rule, with the qualification period for the related payments rule being more onerous. Both rules are intended to prevent certain forms of franking credit trading, with effect from the date of the May 1997 Federal Budget.

Complying securities lending arrangements are specifically excluded from the application of these rules. Section 160APHH(8) provides that, if a taxpayer disposes of shares or interests under a securities lending arrangement that satisfies section 26BC(4) of the ITAA 1936 (and therefore is deemed not to have disposed of the shares or interests for the purposes of the ordinary income or capital gains provisions of the ITAA 1936), then the taxpayer is also treated as not having disposed of the shares for the purposes of section 160APHO. In such a case, the lender will still be taken to hold the shares for the purpose of determining whether the lender has satisfied the holding period rule in relation to dividends paid on the shares.

The “45 day holding period rule” and the “related payments rule” will apply to deny access to franking credits for non-complying securities lending arrangements, being arrangements that do not fall within section 26BC and in respect of which section 216-10 does not operate. Prior to the introduction of the holding period rule, deliberately non-complying arrangements were entered into by **non-resident lenders** and Australian borrowers. This is because non-resident holders of Australian equities effectively obtain less value than would a resident holder from any franking credits referable to distributions which they receive. By making the lending arrangement non-complying, prima facie, the Australian resident borrower obtained the benefit of the franking credit, rather than the non-resident lender. This practice is overcome by the holding period and related payments rules because:

(i) at all times, the borrower is under an obligation to re-transfer identical securities to the lender, and so will fail the 45 day rule (unless the borrower is an eligible institutional investor (such as a complying superannuation fund) which has opted out of that test);

(ii) even if the borrower is an investor which has elected not to apply the 45 day rule, the limit imposed under the formula approach for such an institution will effectively preclude the institution from accessing franking credits not referrable to its actual net equity exposure;

(iii) the borrower will usually be required to make related payments to the lender and therefore be required to satisfy the related payments rule; or

(iv) the borrower may fall foul of the anti-avoidance rules in section 160AQCBA or section 177EA if one of the purposes (other than an incidental purpose) of the arrangement is to obtain a tax advantage in relation to franking credits.

(d) Application of dividend withholding tax to distribution equivalent (or "manufactured") amounts

Broadly, withholding tax must generally be withheld and remitted to the Australian Taxation Office on Australian sourced unfranked dividends paid or credited to non-residents. (There are some exceptions under the Australia/US and Australia/UK double tax agreements and under section 23(jb) of the ITAA 1936.)

If applicable, withholding tax on unfranked **dividends** is generally imposed at a flat rate of 30%, but the rate is reduced to 15% for dividends paid to residents of countries with which Australia has concluded a comprehensive double tax agreement and to as low as 0% in the case of some US and UK residents, under the current US and UK agreements. Importantly, tax need not be withheld on that part of a distribution which is fully franked (i.e. where the company has borne full Australian tax on the profits out of which the distribution is paid).

The transfer of shareholder status provisions do not apply for dividend withholding tax purposes. An issue therefore arises as to whether, in any circumstances (for example, if, or to the extent to which, the underlying distribution is unfranked), a distribution equivalent amount paid by a resident borrower to a non-resident lender can be liable to dividend withholding tax.

This issue is also affected by anti-avoidance rules in Part IVA of the ITAA 1936.

(i) Ordinary position

Apart from the possible application of Part IVA (discussed below), the ordinary position is as follows:

(A) The dividend withholding tax provisions can only apply to dividends in the strict legal sense of that word (other than on non-equity shares (as defined in section 995-1 of the ITAA 1997)), and to non-share distributions (as defined in section 974-115 of the ITAA 1997) made in relation to "non-share equity interests" (as defined in section 995-1 of the ITAA 1997): see section 128AAA of the ITAA 1936.

(B) A distribution equivalent amount or manufactured payment is not a dividend in the strict legal sense. As discussed above, the securities lender under a section 26BC complying transaction should not hold an equity interest in the borrower, Therefore, in such a case the distribution equivalent amount paid by the securities borrower to a non-resident securities lender cannot be treated as a non-share distribution so as to come within the dividend withholding tax provisions.

(C) Accordingly, in such a case the distribution equivalent amount paid to a non-resident lender is not liable to dividend withholding tax, even if in lieu of unfranked or partly franked dividends which the non-resident lender would otherwise receive. (However, a corollary is that, if the borrower simply pays the non-resident lender the net amount the lender would have received after the deduction of any dividend withholding tax, the lender will not have any foreign tax credit which it can claim in its home jurisdiction.)

(D) However, where a comprehensive double tax agreement with Australia does not apply to the distribution equivalent amount, there may be a risk (depending on the circumstances) that the amount is Australian source income of the non-resident recipient, which is assessable to it as ordinary income at the corporate rate (30%) in the case of a corporation, under section 6-5(3)(a) of the ITAA 1997. (The position may be especially complicated where (as is often the case) the lender is a nominee or custodian for other non-residents (be they institutions, trusts or corporate entities).)

(ii) Application of Part IVA

Since 20 August 1996, Part IVA (which contains the general anti-avoidance provisions in the ITAA 1936) has applied to schemes or arrangements involving the avoidance of dividend, interest or royalty withholding tax: see section 177CA of the ITAA 1936.

Where Part IVA applies to a distribution equivalent amount, the recipient of that amount is made retrospectively liable to pay the avoided withholding tax: see sections 177F(2A) to (2G) of the ITAA 1997 and related provisions in Schedule 1 of the TAA 1953.

Thus, where:

- a non-resident owns a share (including non-share equity) in an Australian company which pays unfranked or only partly franked dividends,
- prior to the books' closing date for payment of the distribution, it lent the share to an Australian resident in an attempt to avoid the distribution being subject to dividend withholding tax, with redelivery occurring after the books' closing date, and
- the borrower agrees to pay the lender, say, an amount greater than the net amount (after deduction of any normal withholding tax) that the lender would otherwise have received,

it is quite possible that the anti-avoidance provisions would apply, so that the Australian borrower would be liable to pay to the Australian Taxation Office the amount of withholding tax avoided and a penalty relating to that amount.

For that reason, as far as I am aware, informed lenders and borrowers generally ceased entering into arrangements such as those just described, as from 20 August 1996, being the date that the amendments introducing the withholding tax avoidance provisions to Part IVA became effective.

5.4 Income tax issues re a securities borrowing fee

Broadly, Australian source interest, and any amount in the nature of interest, derived by a non-resident is subject to withholding tax at a flat rate of 10% on the gross amount. There are exceptions in sections 23(jb) and 128F of the ITAA 1936. The rate is now also reduced in certain instances by Australia's double tax agreements with the US and the UK.

This is an issue as to whether interest withholding tax can apply to any fee paid by an Australian securities borrower to a non-resident securities lender.

5.5 Income tax issues re the provision of cash collateral

As was mentioned in 1.3(d) and (e) above, in an agency programme in Australia cash collateral (instead of, for example, an irrevocable standby letter of credit) is generally provided to the lender to secure the obligation of the borrower to deliver equivalent securities. In those circumstances, no fee may be payable by the borrower to the lender in connection with the transaction (and so no question arises as to the application of withholding tax to any such fee). Instead, in such a case the lender makes a profit which comprises the spread between the yield which it makes on investing the cash collateral and the lower yield which is passed back to the borrower of the securities.

However, lenders and borrowers alike should be conscious of the possible impact not only of Australian, but also of foreign, interest withholding tax on this interest (or "rebate" as it is generally called in the context of securities lending) which the lender pays to the borrower. In my view, the rebate is interest within the ordinary meaning of that term.

Since Australian residents are usually net borrowers of Australian securities from non-residents (and not the lenders of securities to them), the rebates will flow from offshore to Australia, and not vice versa. Accordingly, the possible impact of overseas (rather than Australian) interest withholding tax on any rebates received by Australian residents is likely to be more relevant for them.

However, increasingly, Australian residents are lending their overseas equities to non-resident broker/dealers. In that situation, if the Australian resident lender receives cash collateral (whether directly or through a custodian operating an agency programme, and whether in Australian currency or (more usually) in a foreign currency, which may be invested offshore at all times), the potential application of Australian interest withholding tax to any rebate paid to the offshore borrower needs to be carefully considered.

6 Regulatory and compliance issues affecting the lending of equity securities or the provision or receipt of collateral (including issues specifically affecting superannuation funds, ADFs, PSTs, some statutory authorities and insurance companies)

6.1 Substantial shareholdings etc

Lenders and borrowers need to ensure (as far as possible) that they either avoid or comply with any restrictions on, or reporting requirements relating to, the percentage of shareholdings or relevant interests in shares which can be acquired or are disposed of.

Broadly, under the Corporations Act, a substantial shareholder in an Australian incorporated publicly listed company must give notice of the acquisition of a substantial shareholding or a 1% or more change in a substantial shareholding.

A person is defined as a substantial shareholder in a company if entitled to more than 5% of the voting shares of the company or 5% of the voting shares in any class of shares in the company. The statutory requirements take no account of the possible consequences of a securities lending transaction, especially if the borrowed securities are used to settle a short sale. Professional opinion as to the theoretical position under the existing law and market practice may not coincide. The ASIC and its predecessor bodies have refrained from publicly entering the debate, though the NCSC (a predecessor to the ASIC) previously made declarations under the now superseded Companies Code regarding one major institution.

Similar issues could in theory arise with the 15% threshold under the Foreign Acquisitions and Takeovers Act 1975 (Cth), and the thresholds applicable under the Broadcasting Act and various other Federal and State Acts regulating particular industries or companies.

6.2 Reporting of securities lending transactions involving equity securities

Currently brokers (now called “market participants”) and non-broker participants (now called “non-market participants”) in CHESS do not treat equity securities lending transactions in which they are a borrower or a lender as reportable transactions under the ASX Business Rules. This is so whether or not the relevant borrowing is to settle an underlying trade (eg, in the case of a broker, to settle a sale on behalf of a client or, in the case of a market maker, to settle a short sale). To date the ASX has taken the same view.

The immediate predecessor to the ASIC, the ASC, spent some time reviewing the regulation of short selling in Australia. (Presently, if a person wishes to short sell securities but has arranged to borrow equivalent securities in order to settle the sale, market practice is that the seller does not regard itself as under an obligation (under Corporations Act section 1020B) to expressly disclose the sale as a short sale. This gave rise to particular problems prior to the introduction of ASX Business Rule 4.10A (which was subsequently deleted in October 1999). In May 1994 the ASC released a Discussion Paper on short selling. The ASC subsequently had intensive discussions with a range of industry bodies with a view to formulating a recommendation to the federal Attorney-General.

However, as far as I am aware, no action resulted. And it seems that the finalisation of any recommendation by the ASIC regarding securities lending still has a low priority.

It is possible that the eventual outcome will be that short sales of equity securities which are to be settled by the delivery of borrowed securities will have to be specifically disclosed as short sales, in contrast to the view which is currently taken of the operation of section 1020B of the Corporations Act. (If so, the ASX would presumably also have to change to its Business Rules to require similar disclosure.) However, it is likely to be some time before (if at all) current practice might change and a distinction might be drawn between the different purposes to which borrowed securities may be put.

6.3 FSRA issues

The Financial Services Reform Act 2001 ("**FSRA**") introduced a licensing regime that may apply to both lenders and borrowers who enter into securities lending arrangements. The licensing requirements apply where a person "carries on a financial services business" "in this jurisdiction".

Unless it is required to be licensed on some other basis, the lender and the borrower would be required to obtain an Australian financial services licence (and satisfy other obligations such as maintaining adequate resources and risk management systems and training for its staff) if it is carrying on a business of dealing in financial products. It could do so by entering into securities lending arrangements, if such arrangements constitute financial products under section 766C of the Corporations Act.

(a) Is there a financial product?

The financial products involved in a securities lending transaction involve:

(i) shares in companies (a security within s 761A of the Corporations Act and therefore a financial product under s 764A(1)(a));

(ii) corporate debentures (as for shares in a company);

(iii) government bonds (a financial product under s 764A(1)(j)); and

(iv) the securities lending transaction itself, if it is a derivative (a financial product under s 764A(1)(c)) [see (b) below].

Accordingly, by entering into securities lending arrangements, both counterparties could be carrying on a business of dealing in financial products if such arrangements constitute a dealing under section 766C of the Corporations Act.

(b) Is a securities lending transaction a "derivative" for the purposes of the Corporations Act?

In general, it is possible to view a securities lending transaction as being a financial product on the grounds that it is a derivative, as defined, even though it might not traditionally be thought of as a derivative. "Derivative" is defined in section 761D of the Corporations Act as an arrangement in relation to which the following requirements are satisfied:

- a party to the arrangement must, or may be required to, provide consideration at some future time (being generally not less than 1 business day); and

- the amount of consideration or the value of the arrangement is ultimately determined, derived from or varies by reference to, the value or amount of something else (such as an asset, a rate, an index or a commodity).

The term is intended to embrace financial contracts such as futures, options, warrants, swaps, share ratios and other composites (though this list is not exhaustive) and exotics (in other words complex variations of standard derivatives).

It is arguable that the securities lending transaction satisfies both of the above requirements, on the basis that:

- the borrower is required to provide consideration at a future time (in other words equivalent securities and, importantly, manufactured payments and any non-cash rights); and

- the amount of consideration for the initial lending leg (ie the promise to redeliver equivalent securities and also to make manufactured payments and provide the value of non-cash rights), or value of the arrangement, may vary by reference to something else: at the very least, the value of the manufactured payments and any non-cash rights varies by reference to the distributions and non-cash rights that arise in respect of identical securities to the lent securities.

On the other hand, unlike options and futures contracts, it is arguable that the "loan" or retransfer under a securities lending transaction takes it outside the statutory definition. The argument is that, if the "consideration to be provided in the future" is the delivery of the equivalent securities at the end of the borrowing, the "amount of consideration" provided in the future is fixed, not variable (it is the equivalent number of borrowed securities) and that, depending on the structure of the securities lending arrangement, the "value of the arrangement" is the fee or the margin achieved by the lender above the interest rate on the cash collateral, neither of which is "determined, derived from or varies by reference to the value or amount of something else".

However, irrespective of the generally understood meaning of a "derivative" or of the parties' understanding of a securities lending transaction, the agreement of the borrower to make manufactured income payments and also (in the case of equity securities) to compensate the lender for any non-cash rights would seem to drag any securities lending transaction within the statutory definition.

Accordingly, even though the legal position may not be clear cut, it may be prudent to assume that a securities lending transaction constitutes a "derivative" as defined in the Corporations Act and therefore a "financial product" for FSRA purposes.

(c) Dealing in financial products

Dealing in a financial product is defined to mean applying for, acquiring, issuing, varying or disposing of a financial product or, in relation to securities or managed investments, underwriting the securities or interests (section 766C(1)). Arranging for a person to engage in such conduct is also 'dealing', unless the actions amount to providing financial product advice (section 766C(2)).

Entering into a derivative transaction involves the "issue of a derivative, which is a dealing service (s 76IE(5) and s 766C(1)(b)). Accordingly, if a securities lending transaction is a financial product (on the grounds that it is a derivative), then it is likely that a party to the transaction will fall within the above definition of dealing. In that event, a person "lending" or "borrowing" shares under a master securities lending agreement would be likely to be "dealing" in the securities lending arrangement for the purposes of Chapter 7 of the Corporations Act.

There is an exception in the legislation that provides that a person is taken not to deal in a financial product if the person deals in the product on their own behalf (whether directly or through an agent or other representative) unless the person is an issuer of financial products and the dealing is in relation to one or more of those financial products (section 766C(3)). However, importantly, the effect of section 761E(5) is that the lender and the borrower are both taken to be an issuer of a derivative not entered into or acquired on a financial market. Therefore, the section 766C(3) exception will not apply.

Consequently, if a securities lending transaction is a derivative, it is likely that securities lending will involve dealing in financial products under section 766C of the Corporations Act.

However, some likely securities lenders, such as some superannuation trustees or other persons regulated by the Superannuation Industry (Supervision) Act 1993, may be exempt from FSRA licence requirements under regulation 7.6.01 or other provisions.

6.4 Receipt of cash collateral, and provision of non-cash collateral, by special entities

(a) Cash, Superfunds, ADFs and PSTs

In October 1992, the Insurance and Superannuation Commission ("**ISC**"), the predecessor of the Australian Prudential Regulating Authority ("**APRA**"), was asked to consider whether the acceptance of cash collateral by a superannuation fund in connection with a securities **loan** by the fund might technically constitute a "borrowing" of money by the fund for the purposes of the predecessor to the current Superannuation Industry (Supervision) legislation. The same issue is relevant to ADFs and PSTs.

In its written submission dated 2 August 1993 to the Senate Select Committee on Superannuation, and in subsequent oral testimony before the Committee, Mallesons Stephen Jaques, on behalf of the Superannuation Committee of the Law Council of Australia, requested legislative clarification of the issue. Subsequently, on 27 October 1993 ASLA put in a further written submission, also prepared by Mallesons Stephen Jaques, to the same effect.

Unfortunately, the Superannuation Industry (Supervision) Act 1993 is completely silent on the point. This is despite the fact that the SIS Act imposes a civil penalty (which provides for civil and criminal consequences) on fund trustees for breach of the relevant statutory prohibition on the borrowing of money (see sections 67, 93 and 97).

However, by letter dated 18 February 1994 to ASLA, the ISC advised that, in its view, the acceptance and holding of cash as security in the course of a securities lending transaction of the kind described in the ASLA submission, to be repaid when the transaction is completed, would not amount to the "borrowing" of the cash. (The letter however did go on to say that this conclusion was dependent on:

- the purpose of the transaction being restricted to the lending of securities [ie being a securities driven transaction - see 1.3(b)(i) above] and not extending to the borrowing of money [ie being a cash driven transaction - see 1.3(b)(ii) above];

- the terms of the securities lending agreement being consistent with the character of the cash as security [ie with the transaction only being a securities driven transaction]; and

- the transaction being bona fide.)

An additional issue arises for any superannuation entity that **borrows** securities. Subject to certain limited exceptions, a regulated superannuation fund and an ADF are not permitted to give a charge over, or in relation to, an asset of the fund. If such a fund provided non-cash collateral, in the form of say bonds or equities, in connection with a securities borrowing by the fund, could that constitute the granting of a charge over that collateral? In my view, at least under the AMSLA, the answer is a definite "No". It is plain under that Agreement that the recipient of the collateral acquires absolute title to the collateral and is only obliged to redeliver equivalent collateral (see clause 1.4(b)). In other words, in effect the collateral is itself the subject of a securities lending type arrangement (see now also new clause 6.12). There is no mortgage, charge or other encumbrance over any such collateral received by the lender.

(b) Statutory authorities

A similar issue to the "borrowing" of money issue discussed above also arises for any statutory authorities which manage equity or bond portfolios and which are subject to restrictions on their power to "borrow" money.

Likewise, if the statutory authority is not permitted to charge or otherwise encumber its assets.

(c) Life insurance companies

Similar issues arises for life insurance companies. The Life Insurance Act 1995 requires a life company to have at least one statutory fund. It also prohibits a life company from borrowing money for the purposes of the business of a statutory fund unless certain exceptions are satisfied (see section 38). I am not aware of APRA's view regarding securities **lending** by life companies and, in particular, regarding the receipt of cash collateral by them. I presume that, if it takes the view expressed in the ISC's 18 February 1994 letter in relation to superannuation entities, it takes the same view in relation to life companies, namely that a receipt of cash collateral in a securities driven transaction does not involve the borrowing of money for the purposes of the Life Insurance Act.

One additional issue arises for any life company that **borrows** securities. The assets of one statutory fund cannot be used as collateral for the borrowing of securities on behalf of another statutory fund (section 38).

6.5 APRA issues for superannuation entities and insurance companies

Finally, for both superannuation entities and insurance companies, an issue arises as to:

- Whether the lender's rights under a securities lending agreement come within the concept of a "derivative" for the purposes of relevant APRA Prudential Standards and Guidance Notes. (The same issue arises if a superannuation entity or insurance company was a borrower of securities.)

- If so, the consequences thereof.

(a) Regulatory background for an insurance company

An authorised insurer is required to maintain a certain minimum capital base.

(b) Special category for "derivatives"

In particular, insurers are required to set aside capital to cover the investment risk of derivative transactions. For this purpose, a "derivative" is not defined. However, for example, paragraph 23 of Guidance Note GGN 110.4 Investment Risk Capital Charge states:

> "Derivatives include forwards, futures, swaps, options and other similar contracts."

See also a similar statement in paragraph 14 of Guidance Note GGN 220.3 (quoted below).

The principal concern about derivatives is that they expose the investor to kinds of risk which are not associated with an ordinary investment in a physical asset, such as basis risk (as well as the ordinary market risk associated with any physical investment), and facilitate speculation. This concern has prompted the requirements for the separate assessment and reporting of derivative exposures.

(c) Is a securities lending transaction a "derivative" for APRA purposes?

There are several arguments as to why a securities lending transaction might not be a derivative for the purposes of relevant APRA Prudential Standards and Guidance Notes.

Further, in the absence of a relevant definition of the kind found in the Corporations Act, it is not clear what significance (if any) ought to be attached to the fact that, under a securities lending agreement, the borrower is obliged to make manufactured income payments and also (in the case of equity securities) to compensate the lender for any non-cash rights.

However, paragraph 23 of Guidance Note GGN 110.4 (quoted above) and paragraph 14 of Guidance Note GGN 220.3 (quoted below) both state that a "derivative" is taken to include a "forward" contract, which would include a forward purchase contract (which is akin to the second leg of a securities lending transaction).

Accordingly, while the position may not be clear cut, it may be prudent for any authorised insurer to assume that a securities lending transaction constitutes a derivative for the purposes of APRA Prudential Standards and Guidance Notes.

(d) Consequence of being a derivative: Capital Charges for derivatives

A Capital Charge must be calculated for any securities lending transaction, if it is regarded as a derivative for APRA purposes.

(e) Risk Management Strategy Document

Insurers are also required by Prudential Standards and Guidance Notes to have a Risk Management Strategy Document which has been approved by the Board of the Insurer and to provide a copy of that document to APRA.

Each year (at the time the insurer lodges its statutory accounts with APRA) the Board of the insurer is also required to provide APRA with a Board Declaration which, among other things, states that:

- the Board and senior management have identified the key risks facing the insurer and have a Risk Management Strategy ("**RMS**") in place to manage and monitor those risks;
- the insurer has substantially complied with its Risk Management Strategy ; and
- the copy of its Risk Management Strategy Document provided to APRA is accurate and current.

The use of derivatives by the insurer is something which its RMS must specifically address. For example, Guidance Note GGN 220.3 Balance Sheet and Market Risk states that an insurer's RMS must include certain minimum policies and procedures in relation to the insurer's use of derivatives. For these purposes, paragraph 14 of that Guidance Note states:

> "Derivative transactions are financial contracts and include a wide assortment of instruments such as forwards, futures, swaps, options and other similar transactions."

Whether or not securities lending is a derivative for those purposes, engaging in securities lending transactions is in any event something which an insurer's RMS should probably address:

- For example, regard should be had to the obligations assumed under (what is effectively) a deferred forward purchase agreement.

- A decision to enter into securities lending transactions is also likely to be directly relevant to the insurer's investment decision making policies and procedures - which are matters an insurer's RMS should also include in its ambit.

- An insurer's current RMS may also, in accordance with its terms, require that new risks - such as those which would be assumed under a securities lending arrangement - be incorporated into the insurer's RMS.

If the change might be regarded as material to the RMS, an insurer would, as a matter of practice, normally first discuss the proposed change with APRA, before implementing it.

7 Miscellaneous

7.1 Clarification of unresolved tax issues?

Some securities lending transactions involving equities are documented as repos. (The principal difference involves the character of any cash which passes from the borrower to the lender at the time that the securities are lent. Under a securities lending agreement, the cash is in the nature of a security deposit. Under a repo, it is in the nature of purchase money.)

However, it is uncertain whether or not a repo qualifies as a "securities lending arrangement" for the purposes of section 26BC of the Income Tax Assessment Act.

An industry submission by the Australian Financial Markets Association (settled by Mallesons Stephen Jaques) in January 1993 asked the Australian Taxation Office for clarification on this and several other related issues. However, the ATO did not formally respond to the submission.

7.2 Clarification of effect of securities lending transactions on "relevant interests"?

As was noted in 6.1 above, the effect of securities lending transactions on "relevant interests", for the purposes of the substantial shareholder provisions in the Corporations Act, is also uncertain, and possibly dependant on the position of a borrower (about which a lender of securities may be ignorant). There may be some clarification of the attitude of the ASIC to this issue in time.

7.3 The future

The increasing array and volume of options, futures and other derivative products, and the continued existence of arbitrage opportunities, should help ensure continued substantial demand for securities lending of equity securities in Australia.

John C. King
1 August 2005

This is the fourth edition of this paper (previous versions were published in 1993, 1995 and 1997). The paper is not a definitive statement of the law or practice, or of the risks, relating to securities lending of equity securities in Australia. Readers should seek appropriate professional advice about their own circumstances before lending or borrowing securities.