



RiskMetrics Group

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Corporations Amendment (Short Selling) Bill 2008
Corporations and Financial Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: shortsellingbill@treasury.gov.au

19 October 2008

Dear Sir

Thank you for the opportunity to comment on the Exposure Draft of the Corporations Amendment (Short Selling) Bill and on the issues raised in Treasury's Commentary on the Bill. RiskMetrics (formerly Institutional Shareholder Services) is the world's largest proxy voting advisory firm, providing governance research to more than 1700 institutional investors in Australia and around the world.

Objectives of the Bill

RiskMetrics supports this Bill whose purpose is to provide a new regulatory framework under which covered short sales can be implemented and which, if implemented, will, in contrast to the current regulatory framework, significantly improve the transparency of covered short sales in the Australian market. RiskMetrics notes that Treasury "is not seeking to prohibit or discourage covered short selling activity" and that Treasury recognises "that covered short selling activity, appropriately regulated, is beneficial to the operation of capital markets by increasing market liquidity and pricing efficiency".

These are views that RiskMetrics shares. As Treasury will be aware, there is a considerable body of empirical evidence that limiting the ability of investors to engage in short selling can lead to the over-valuation of shares with the consequence that share prices may adjust more slowly to unfavourable information: eg Chang, Cheng and Yu, 'Short-Sales Constraints and Price Discovery: Evidence from the Hong Kong Market' (2007) 62 Journal of Finance 2097 which contains a useful review of the academic literature on this particular point.

Naked short sales

RiskMetrics also notes that the Bill applies to only covered short sales, making no mention of short sales other than those covered by securities lending arrangements. This suggests that the ban on naked short sales implemented by the Australian Securities and Investments Commission in conjunction with the Australian Securities Exchange will not be affected by the enactment of the Bill. RiskMetrics supports making the ban on naked short sales permanent.

Such a step would not discourage or hinder covered short selling but would address the adverse consequences of permitting market participants to sell shares that they neither own nor have arranged to borrow at the time of sale. Treasury is no doubt aware of the views of the US Securities and Exchange Commission on naked short selling, in particular the potential of naked short selling for manipulative or abusive trading: see SEC, 'Amendments to Regulation SHO; Final Rule and

Proposed Rule' (2007) 72(156) Federal Register 45544; and SEC, 'Naked Short Selling Anti-Fraud Rule; Proposed Rule' (2008) 73(56) Federal Register 15376.

The SEC has observed that there is a high risk that a short seller may deliberately cause a naked short sale to fail to settle, in order to manipulate the price of the shares downwards. This can create considerable - deceptive - downward pressure on share prices, increasing of the volatility of share prices, destroying investor confidence in the issuer of the shares and impeding the ability of the issuer to raise funds. Naked short sales also carry a perverse incentive. The naked short seller may fail to settle simply because it is more profitable for the seller to pay the penalty for failing to settle than meet the costs of borrowing the shares or going into the market to buy the shares in time for settlement.

Draft sections 1020BA and 1020BB

RiskMetrics strongly supports these amendments which place beyond doubt the obligation of, first, a short seller to disclose to its broker that a sale order is for a covered short sale and, second, the broker to disclose covered short sales to the ASX.

This decisively addresses the definitional ambiguity in the current regulatory framework for short sales (under the Corporations Act and also under the ASX's Market Rules which mirrors the approach of the Act). As Treasury is well aware, it is possible, given the terms in which section 1020B(2) is expressed, for a short seller to take the view that a covered short sale is no different to a conventional sale of shares. This means that covered short sales can be transacted free of the disclosure and other requirements in section 1020B(4) that were meant to apply to them. This has led to the under-reporting of covered short sales in the Australian market and has had the effect of undermining the price discovery benefits of permitting covered short sales.

Reform options two and three - disclosure to brokers and the exchange

RiskMetrics notes that the Bill, in its current form, implements reform options two and three. RiskMetrics, as noted above, strongly supports this, as a minimum step towards facilitating a transparent and informed securities market. (RiskMetrics does not therefore support reform option one which would leave unaddressed the problems posed by the current regulatory framework for covered short sales.)

Reform option four - disclosure of securities lending arrangements

RiskMetrics also strongly supports reform option four. This step, however, can be implemented separately from reform options two and three and may, as Treasury indicates in reform option five, be more appropriately dealt with as part of a comprehensive review of short selling as well as securities lending in the Australian market. At this stage, in the context of the temporary bans on covered and naked short sales, a more urgent first step is to make covered short sales subject to the disclosure requirements of the Corporations Act (which the Bill does) and to ban naked short sales permanently (which is consistent with the approach of the Bill).

RiskMetrics is aware that the level of securities lending in the Australian market (as well as in other markets) does not directly correspond to the level of short selling in the market. Apart from covered short sales, securities loans are used for hedging purposes, dividend arbitrage, to raise funds on a secured basis and, most controversially of all, to gain access to the voting rights that follow ownership of shares: eg D'Avolio, 'The Market for Borrowing Stock' (2002) 66 Journal of Financial Economics 271; and Duffie, Garleanu and Pedersen, 'Securities Lending, Shorting, and Pricing' (2002) 66 Journal of Financial Economics 307.

The disclosure of securities lending activity will, as with rectifying the problems with the current disclosure regime for covered short sales, contribute positively to price discovery and market

liquidity. Moreover, as securities loans are not used exclusively for covered short sales, the disclosure of information about the former will provide valuable information about the shares being lent that cannot be obtained by investors and issuers from only information about short selling activity.

An associated issue concerns the interrelationship of securities lending with on-market settlement risk. Australia experienced CHES settlement delays on 29 January, 2008, with settlement delayed by several hours as a result of one market participant (Tricom Securities) being unable to fulfill its settlement obligations following an unspecified error with an associated securities lending programme. The Reserve Bank of Australia subsequently recommended improved disclosure of stock lending volumes as a means of better understanding the interrelationship between off-market transactions (such as securities lending) and on-market settlement risk.¹ RiskMetrics strongly shares the view expressed by the Reserve Bank, ASX² and the Australian Securities Lending Association³, that transparency around securities lending would be best enhanced by appropriate modifications to CHES that captures this data at the trade capture stage and is reported nightly to market.

By having available information about both short sales and securities loans, investors and issuers will be better equipped to gauge correctly market sentiment about shares and the extent to which, for example, shares are being borrowed to create an inventory for future short sales, to protect against a recall of borrowed shares or for dividend arbitrage. Perhaps, most important of all, investors and issuers will be able to assess the extent to which shares are being borrowed, on or about the announced cut-off date for the determination by an issuer of voting entitlements at that issuer's upcoming general meeting, for the purpose of obtaining votes to cast at that meeting: eg Hu and Black, 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership' (2006) 79 Southern California Law Review 811; Christoffersen, Geczy, Musto and Reed, 'Vote Trading and Information Aggregation' (2007) 62 Journal of Finance 2897; and Hu and Black, 'Equity and Debt Decoupling and Empty Voting II: Importance and Extensions' (2008) 156 University of Pennsylvania Law Review 625.

Securities loans can be used to distort the results of shareholder voting and may even determine the outcome of a meeting where the matter under consideration is controversial or one on which the views of shareholders are finely balanced. A voting result that has been secured using votes attaching to shares, that have been borrowed for the purpose of gaining access to those votes, may not necessarily reflect the views of the majority of the company's other shareholders. This is of particular concern in the context of matters that affect the control of Australian companies. Securities loans, when used to obtain access to votes, can also have an effect beyond the shares actually borrowed. Even if not voted, those shares are no longer available to the lender (unless recalled) nor do they form part of the free float of shares of the company. This has the potential to influence the outcome of a close contest by withdrawing votes from, for example, the opposition to a proposed transaction with control implications. Moreover, where the borrowed shares are actually voted in favour of a change of control transaction, the impact on the opposition is effectively doubled (the votes are not available to them or their potential supporters and have, instead, been voted against them).

¹ Reserve Bank of Australia, REVIEW OF SETTLEMENT PRACTICES FOR AUSTRALIAN EQUITIES – MAY 2008. Available at: http://www.rba.gov.au/PaymentsSystem/StdClearingSettlement/RevSetPracAusEquities/trans_disclosure_sec_lend.html

² http://www.asx.com.au/about/pdf/transparency_of_short_selling_and_securities_lending.pdf

³

<http://www.asla.com.au/info/26.09.08%20Positive%20action%20welcomed%20by%20the%20Securities%20Lending%20sector.pdf>

RiskMetrics therefore believes that the comprehensive review of short sales proposed in reform option five - which will necessarily involve an examination of the role played by securities loans - should be accompanied by a comprehensive review of securities lending arrangements and the uses to which those arrangements are put.

Please do not hesitate to contact us if you would like to discuss any aspect of our submission in more detail. Thank you once again for the opportunity to comment on the draft Bill and the issues raised in your Commentary.

Yours sincerely

A handwritten signature in blue ink that reads "Dean Paatsch".

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