



S Y N S T R A T
M A N A G E M E N T

GM:AR

16 October 2008

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

Email: shortsellingbill@treasury.gov.au

Synstrat Management Pty Ltd
ABN 57 006 295 325

660 Doncaster Road
PO Box 14
Doncaster Victoria 3108

Tel: (03) 9843 7777
Fax: (03) 9843 7799
Internet: www.synstrat.com.au
Email: office@synstrat.com.au

Dear Sir

RE: SHORT SELLING BILL – DRAFT LEGISLATION

I refer to the draft legislation and to ASIC's response.

The proposed legislation overlooks the rights of the beneficial owners of shares.

The proposed legislation overlooks the rights of individual shareholders to be fully informed about market processes.

The proposed legislation is drawn heavily in favour of both stock lenders and stock borrowers by limiting full disclosure.

The proposed legislation is seriously flawed and will lead to further scandalous activity.

Background

The situation which has existed in Australian share markets preceding the recent temporary ban has been scandalous. The laxity of regulation and supervision effectively made the Australian market a magnet for manipulative hedge funds from abroad, probably acting in tandem with local short sellers.

The proposed Bill does not adequately address the issues.

Political Damage

There is a significant political danger. If the proposed legislation does not cure the disease, then the government will be held responsible as the new legislation will have been promulgated on its watch.

Disclosure Weakness

There is a significant weakness in the area of disclosure. If this weakness is not addressed there is a high risk that the savings of Australians will again be subjected to a sustained short selling attack.

Whilst there are laws against collaborative manipulation: in practice, there is enormous difficulty in proving that this is occurring. If, hypothetically, a group of North American hedge funds each borrow several percent of "Company X's" stock, nobody in Australia can tell that they are acting jointly and may have a position in that company which far exceeds a disclosable interest of five percent. If, again hypothetically, they wait until there are a couple of negative days on the stock market, preferably coinciding with a fall below the normal amount of orders on the buy side of the stock, and then act in concert, they can plant significant sell orders in the market with a multitude of brokers, each accompanied by some negative comment about the stock. They can easily initiate a flood of rumours around the market. They can then attack the company in question by repeated bursts of short selling through multiple brokers, each extinguishing any buying activity in the company. Almost immediately the brokers begin asking each other:

"What's wrong with Company X?"

This will be followed by an ASX Ltd request to the company to:

"Please advise whether you know any reason why your share price has fallen."

Inevitably the company under attack will reply:

"We know of no reason why our share price has fallen."

...or words to that effect.

However in the public's mind, significant doubt has been created. Inevitably the press will report the sustained selling of the company and the fall in the company's share price, probably accompanied by a story as to how much shareholder capital has been wiped out. This causes other innocent shareholders to believe that there is something seriously amiss. They then sell, thus facilitating the market manipulation.

The short sellers maintain their pressure and if their intelligence is really good they can force the price to a point at which the company's banking covenants are breached. Along the way they may have also triggered some margin loans. An innocent company can be put to the sword in this way.

If the hedge funds are successful in creating a panic in the market they can ultimately buy back the shares at a distressed price and return them to the lenders of the stock. The hedge funds have made huge amounts of money shorting the stock whilst simultaneously Australian share investors and members of superannuation funds have lost significant amounts of wealth. In some cases the company's reputation may have been wrecked, its bankers will have exerted strong control, and its customers prefer to deal elsewhere on the grounds that they can't be sure that the company will be able to honour its contracts.

This type of event is not negated by the proposed legislation.

It is all too easy for a group of hedge funds placing separate sell orders for a large number of brokers and dropping negative comments around the market to create a virtual inferno of bad rumours and panic short selling.

Back to inadequate disclosure.

The proposal that:

"The disclosure regime would only result in the reporting of aggregated data, so individual trades cannot be identified."

is nice in theory. In practice it will allow market manipulation, illegal collaboration and other market rigging activities to occur.

It is apparent that those associated with stock lending and short selling activities who have had their activities curtailed have had significant impact on the proposed legislation. They are not long-term investors.

The primary purpose of the stock market seems to have been overlooked. It is to provide a mechanism for raising capital for business. Market manipulation through inadequately regulated short selling and stock lending inhibits capital raising rather than assists it because it destroys faith in the market.

The recommended option of:

"Disclosure of covered short sales by investors to brokers;"

is wholly inadequate. If a pool of short sellers are holding a massive amount of borrowed stock in reserve, their control of that stock and its carefully timed short sales into the market at strategic intervals gives them a degree of control over the market and knowledge as to that control not apparent to either brokers or to the public at large. In other words, the legislation institutionalises a poorly informed market.

It is easy to understand why the next sustained burst of manipulative short selling under the proposed legislation will have significant political fallout. This should be avoided at all costs.

Fixing the Problem

Not only should notification of short sales by brokers occur, but public notification by stock lenders is essential in order to have a properly informed market. That public notification must identify to whom they have lent the stock.

Protecting the privacy of borrowers at the expense of protecting the assets of the investing public, including members of superannuation funds, is a bizarre way to regulate a market.

Additionally there must be stiff penalties for non disclosure.

The Custodial Problem

Where a custodian/trustee service holds shares in Company X for a number of separate superannuation funds and/or managed funds, the individual members of such funds have no way of determining whether their stock is being loaned.

The One Sided Incentive

A custodian receives a fee and therefore has a vested interest in lending stock regardless as to whether the loan to short sellers is against the interests of members of superannuation funds for whom the custodian acts. In other words the custodian, by acting against the interests of its clients, can and does breach a duty of care.

It also raises the question as to which of the custodian's client shares are being loaned out. If, for example, a custodian holds Company X shares on behalf of superannuation funds A, B, C, D, E and F and lends the shares of Company X to hedge funds, it may not only be

acting against the interests of the members of funds A and B but also be acting against the interests of funds C, D, E and F even though theoretically it may not be lending their stock. Of course it also raises the issue as to how anybody knows which fund's shares are being loaned.

The ethical and legal problems in this area abound and are not addressed in the legislation.

The information concerning and defences of short selling as listed in the financial press have a heavy bias towards protecting the identities of borrowers and lenders and of the extent of borrowing and lending in real terms. Hedge funds, other short sellers, stock lenders including custodial services, and large stockbrokers who arrange stock loans and trade for hedge funds have a vested interest in keeping the public, the regulators and the drafters of the legislation ill informed. It is clear that the persons who have worked diligently in preparation of the proposed legislation have not been adequately informed.

It's not only the knowledge that Company X's shares have been short sold to the tune of six percent of its capital which is relevant to the market, but is it not also relevant to a fully informed market that the hedge funds who sold Company X's shares are holding another fifteen or twenty percent of the stock collectively and may also use that stock to drive down the price further and induce panic.

It is essential that the lender's identity be clearly established. If individual members of superannuation funds A and B know that their fund manager is party to lending of shares in their fund which are being driven down by short sellers, they may bring pressure to bear on their fund to discontinue this practice under threat of moving their superannuation to another fund. That too is part of the market.

Only by having full disclosure of both stock lending and short selling can shareholders in Australian listed companies be assured that there is a fully informed market. The legislation as proposed legitimises an uninformed market.



Graham Middleton
Director
Synstrat Management Pty Ltd
PO Box 14
Doncaster Vic. 3108
Telephone: 03 9843 7777
Tel Home: 03 9497 5181