Chapter 2

Background to the bill

What is 'short selling'?

2.1 A share owner who believes that a share is likely to fall in price may sell it in the hope of buying it back later at a lower price. This is a relatively low-risk activity, although of course if the investor is wrong she will miss out on the subsequent increase in the value of the share, and if she wishes to be a long-term investor in the stock would then be buying it back at a higher price.

2.2 To make markets more liquid and to aid in 'price discovery', it can be desirable to allow other traders who regard a share as overvalued to take a position where they can profit if their judgment is correct. One way of doing this is by 'short selling'.[1]

2.3 In a '*covered* short sale' a trader 'borrows' a share, sells it, and must later buy an equivalent share to return to the lender.[2] The difference from the earlier scenario is that the trader is now *obliged* to buy an equivalent share at a later date. If the share price has risen a large amount, a large loss will result. As there are no limits to how high share prices can go, there is correspondingly no limit to the risk being borne by the trader.

2.4 In an 'uncovered', or '*naked*' short sale, the seller neither owns nor has borrowed the stock, but plans to buy or borrow it in time to meet settlement obligations. This practice is not only risky for the seller but raises the possibility of settlement risk for the buyer.

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1 Another way would be by buying a 'put option'.

2 The precise legal form through which the share is 'borrowed' varies. The seller can be described as 'covered' if, at the time of contracting to sell, the seller has a 'presently exercisable and unconditional right to vest the products in the buyer' - that is, a legal title; *Corporations Act*,s1020B(2). ASIC, Regulatory Guide 196: *Short Selling: Overview of s1020B*, par. 8. Typical stock 'borrowing' agreements actually involve the so-called 'borrower' purchasing the stock from the lender subject to a contractual obligation to sell back to the lender at an agreed time or on demand. Shares are usually borrowed, for a premium, from fund managers or custodial managers holding shares on behalf of institutions.

The market impact of short selling

2.5 As noted above, short selling can allow more traders to enter the market and so potentially can allow prices to reflect available information more readily. This should in principle make the market more efficient and have a stabilising influence on prices.[3]

2.6 Short selling is argued to serve a number of legitimate purposes:

- arbitrage: it helps remove price anomalies in a timely way;
- market making: it facilitates trades between clients to provide continuous liquidity;
- risk management: it enables investors to hedge against price volatility in shares they own;
- capital raising: it facilitates underwriting of capital raisings; and
- funds management: it increases the range of investment strategies.[4]

2.7 However, short selling also raises some concerns. It creates an incentive for certain investors to try to drive down the price of a share, if only temporarily. This may be done by spreading unfounded rumours; a practice now known as 'rumourtrage'.[5] It may involve collusion. In these cases, rather than being a stabilising force making the market more efficient, short selling may make share prices more volatile. This is of particular concern at times like the present when the market is very skittish. Even a temporary fall in the share price caused by short sellers may prevent companies rolling over debt or push them into forced sales of assets.

2.8 There are also concerns about the lack of transparency and monitoring of short selling. Conflicts of interest may also arise with brokers producing research, and hedge funds being major clients of the same brokers.[6]

2.9 The *Explanatory Memorandum* expands on these concerns:

> Currently, when a security experiences a significant decline in price, it is unclear whether this is attributed to short selling activity or other factors, which is resulting in considerable rumour and speculation regarding short selling activity and potentially adding to price volatility. Speculation regarding the level of short selling activity in Australian securities is also having broader market implications. Confidence in the market, particularly among retail investors, is likely to be damaged as investors express concern

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3 The only quantitative evidence the committee received on this was analysis by Dr Hamson of IFSA who claimed that when short selling was banned, 'the spread went up by about eight basis points'; *Proof Committee Hansard*, 24 November 2008, p. 3.

4 Australian Bankers' Association, *Submission 12*, p. 2.

5 Australian Bankers' Association, *Submission 10*, p. 2.

6 Australian Bankers' Association, *Submission 12*, p. 2.

> about the perceived activity of short sellers in the market. A fall in market activity, and investor confidence about the integrity of Australian capital markets, will make it more difficult for companies to raise additional capital leading to an increase in the companies' overall cost of capital and a fall in investment activity.[7]

Rules governing short selling before the crisis

2.10 Prior to the crisis, naked short selling was restricted to a range of transactions by section 1020B of the *Corporations Act*. In particular naked short selling was allowed for a limited range of securities subject to conditions imposed by the Australian Securities Exchange (ASX).[8] There were far fewer restrictions on covered short selling.

2.11 As short selling was not controlled, there was no disclosure of it, although it is believed that covered short sales were much more common than naked short sales.[9] The Reserve Bank of Australia has reported that the value of stock loans outstanding was around $60 billion at the end of 2007, but this only provides an upper bound to the amount of short selling as borrowed stock can be used for purposes other than short selling.[10]

2.12 IFSA's opinion of the size of short selling was:

> …it has averaged round about 15 per cent of the volume. I think that overseas studies have put the line of shorting at somewhere between 10 and 20 per cent. Typically, the amount of short interest is of the order of four or five per cent.[11]

ASIC's recent actions

2.13 On 19 September 2008 the Australian Securities and Investments Commission (ASIC) introduced reporting requirements for covered short selling. Its stated reason was 'to maintain confidence in our markets in the face of current international turmoil and to complement moves made by other regulatory agencies'. At the same time the ASX removed all securities from its Approved Product List for naked short sales. This effectively banned naked short sales.[12]

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7 *Explanatory Memorandum*¸ p.25.

8 *Explanatory Memorandum*, p.25

9 *Explanatory Memorandum*, p.26. The Securities and Derivatives Industry Association argues that 'contrary to belief in some quarters, the volume of naked short sales is not significant'; *Submission 14*, p.4

10 *Explanatory Memorandum*, p.26. Discussion with a market participant suggested that short selling typically accounts for the majority of equity loans outstanding, but the proportion fluctuates over time.

11 Dr Justin Wood, IFSA, *Proof Committee Hansard*, 24 November 2008, p. 4.

12 ASIC announcement AD 08-204; Class Order 08/751.

2.14 On 21 September ASIC extended the ban to most covered short selling following overseas bans which, without an Australian ban, would have 'intensified the risk of unwarranted activity on the Australian market'.[13]

2.15 On 21 October ASIC extended the ban on covered short selling until 18 November for non-financial stocks and 21 January 2009 for financial stocks.[14]

2.16 On 19 November ASIC lifted the ban on covered short selling of non-financial stocks, subject to reporting and disclosure requirements which had been announced on 12 November.[15]

2.17 ASIC implemented these measures by issuing declarations, known as 'class orders', modifying the operation of the *Corporations Act*. Class orders are published on ASIC's website and the Federal Register of Legislative Instruments; and market participants are informed through the Australian Securities Exchange (ASX).

Related inquiry

2.18 On 19 November 2008 the Minister for Superannuation and Corporate Law, Senator the Hon. Nick Sherry, announced that the Corporations and Markets Advisory Committee (CAMAC) would inquire into the following market practices by 30 June 2009:

- margin lending by company directors;
- 'blackout' trading by company directors;
- spreading of false rumours; and
- potential disclosure of market sensitive information at analysts' briefings.[16]

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13 ASIC announcement AD 08-205; Class Order 08/752.

14 ASIC announcement AD 08-210.

15 ASIC announcement AD 080-65; Class Order 08/824.

16 Senator the Hon, Nick Sherry, Minister for Superannuation and Corporate Law, *Action to Further Enhance Market Integrity*, press release 19 November 2008.