

Industry Release



Australian Securities Lending Association
website: www.asla.com.au

ASLA's Response to Securities Lending & Short Selling

ASLA, the Australian Securities Lending Association is an industry association established in 1991 to represent 32 member organisations with a common interest in the securities lending industry. ASLA works with Australian regulators and financial markets to agree to industry best practice and develop ways to improve the Australian Securities Lending industry.

This letter is ASLA's response to recent concerns and confusion surrounding Securities Lending, Short Selling and Margin Lending.

What is Securities Lending?

Securities Lending is the temporary transfer (loan) of securities (both Fixed Income and Equities) versus collateral. All loans are fully collateralised above the value of the lent securities. When the Lender requires securities the Borrower has an obligation to return the loan within the normal settlement cycle. Typical clients who lend their assets are large institutional investors, such as Superannuation Funds and Investment Managers both locally and offshore

Why do borrowers borrow?

Securities are borrowed for a number of reasons and although Lending does not of itself hedge, short or create an arbitrage position it provides the ability to do those things – eg:

- 1) Arbitrage. Securities loans make it possible to sell or buy hedges against futures, options, dual listed securities, convertible securities and other related instruments.
- 2) Market Making and settlement liquidity. Lending provides liquidity at two levels. It makes it possible for intermediaries to provide liquidity to the market when demand and supply may be imbalanced. It also facilitates liquidity in the settlement system and ensures Australia has a very low failed transaction rate.
- 3) Directional Short Selling, or unhedged short selling.

Finally, a borrower of securities may use the transaction solely as a means of swapping one collateral profile for another.

Do organisations borrow to influence the outcome of voting?

RiskMetrics has undertaken a specific study within the Australian Market and concluded that the possibility of borrowed shares influencing a vote is small. RiskMetrics proposed a series of recommendations in the form of a best practice document to further minimise this small possibility.

What is Securities Lending role within the Australian market?

Securities Lending provides the market with essential liquidity within the equity market. Regulators and academic analysis from around the globe (refer appendix) confirm Securities Lending not only adds liquidity which leads to price discovery and transparency it also reduces volatility. For this reason India and China are proposing to introduce securities lending within their markets.

Why would a Superannuation Fund lend their assets?

A lot of criticism has been directed towards Superannuation Funds for lending their assets. The argument that incremental income arising from Securities Lending is not sufficient to offset the devastating impact of short selling is not based on factual evidence. The fact is Superannuation Funds are required to invest significant cash inflows from the 9% compulsory contribution. This makes Super Funds substantial net buyers of assets. As a net buyer of all assets Superannuation Funds require liquidity and price discovery to ensure assets are fairly priced. Large Superannuation Funds typically have a well diversified portfolio and are long term investors, hence, the overall health and liquidity within the market is their primary concern.

Can Superannuation funds monitor what is happening on their portfolios?

Yes superannuation funds have a broad range of information available to them from their securities lending provider. As a result the superannuation fund is able to recall stock that they don't want to lend and can specify the amount of the portfolio available for lending and place limits on the maximum amount of any security in their portfolio that can be on loan.

What is Margin Lending?

Margin Lending is typically a mortgage finance facility. In such an arrangement the cash lender takes security over the asset being financed, while the owner usually retains legal or full beneficial ownership of the asset. The cash lender's economic and legal interest is usually limited to the recovery of the amount outstanding under the terms of the cash loan. The provision of credit is unilateral.

Confusion has arisen recently between Margin Lending and Securities Lending where certain margin lenders reportedly used a generic Australian Master Securities Lending Agreement. The agreement was designed for use between Institutional clients lending assets; it was never intended as a margin lending document for retail investors. The Association does not support the use of the Securities Lending Agreement for this purpose.

ASLA is concerned that Securities Lending is not well understood and its resulting benefits have been overlooked within the current market pessimism. We hope the attached literature addresses some of these knowledge gaps. In addition, ASLA acknowledges there are concerns regarding transparency of on loan positions and is working closely with regulators to address these concerns.

Natalie Floate
Chairman
The Australian Securities Lending Association

Securities Lending is NOT Margin Lending.

Securities Lending	Margin Lending
Securities Lending is the temporary transfer (loan) of a security to a borrower versus another security or cash collateral. So the owner of the securities is the lender. The loan is fully collateralised	Margin Lenders provide credit against securities collateral. So the owner of the securities is a borrower (exact opposite of securities lending).
The Securities Lender requires the borrower to pay additional margin when the price of the borrowed securities RISES.	The Margin Lender requires the borrower to pay a margin when the price of the securities FALLS.
A Securities Lender has the right to keep/sell collateral should the securities not be returned from loan.	A Margin Lender has the right to sell collateral on market should the margin call not be paid.

Is Short Selling Inherently Bad?

Prima facie, the answer is no. Prior to the recent controversies, short selling was considered a standard part of the market function. As part of ASX 6 March 2008 Media Release¹ in the wake of the recent controversies, the ASX commented that:

“Short selling plays a useful role in contributing to market efficiency in a developed financial economy.”

Numerous academic studies and regulatory bodies have studied the practise of short selling. The results are often not always understood immediately as they seem counter-intuitive. After similar market ructions post the tech bubble bust in the UK throughout 2002, the UK Financial Services Authority (FSA) published a discussion paper on short selling in October 2002, with the responses received and published² in April 2003. Comments by the FSA were as follows:

- *“short selling is a legitimate investment activity that plays an important role in supporting financial markets”*
- *“we saw no case for introducing artificial constraints on short selling”*
- *“publication of data on securities lending ...[would be] welcome and [we] do not see the case for proceeding with any other general transparency measures at present”*

¹ http://www.asx.com.au/about/pdf/mr20080306_short_selling%20.pdf

² “Short Selling: Feedback on DP17”, FSA, April 2003.

- *“we are now satisfied that short positions held by directors in the securities of the companies on whose boards they sit must be disclosed”*

In addition, the US Securities and Exchange Commission (SEC) notes³ that:

“Short selling provides the market with two important benefits: market liquidity and pricing efficiency. 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 short sales are effected in the market by securities professionals, such short sale activities, in effect, 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 a temporary contraction of supply.

Short selling also can contribute to the pricing efficiency of the equities markets. Efficient markets require that prices fully reflect all buy and sell interest. When a short seller speculates on a downward movement in a security, his 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 strategies primarily differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security. Arbitrageurs also contribute to pricing efficiency by utilizing 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 arbitrageur may purchase a convertible security and sell the underlying stock short to profit from a current price differential between two economically similar positions.”

In essence the support for short selling is based on the theory that markets rely on “price discovery” to function efficiently. In practice this means that a stock’s price should readily reflect both positive and negative news, and that market participants should have the ability to fully reflect such views. If only positive news could be readily reflected

³ <http://www.sec.gov/rules/concept/34-42037.htm>

then the risks are of Ponzi Schemes⁴ developing (similar to what might be happening in the Chinese “A” share market at the moment, where short selling is not permitted). Indeed there is some evidence that markets that allow short selling are less volatile than markets that do not, for the reason mentioned above.

It is also instructive to note that *short selling promotes superior risk management practices for investment managers*. Indeed the ability to better manage risk via short sales is a primary reason for their use within hedge funds (indeed short sales are primarily used to “hedge” long positions). However such efficiency in risk management via the use of short sales is no longer only the domain of hedge funds.

An example is the “130/30”-type mandates, which allow up to 30% of the mandate to be shorted. In practice this shorting is utilised to hedge risks within the portfolio such that a better risk-return outcome can be obtained. Hence the shorting provides for a more efficient portfolio structure, rather than being used merely for speculative purposes.

Another example of risk mitigation is where investors invest in convertible securities for their yield, rather than for the share the convertible will ultimately convert into. Indeed for these managers the equity exposure represents a risk, hence to remove it such managers can short the stock to offset the “long” position that will result at the conversion date.

How is Securities Lending related to Short Selling?

While Securities Lending originally grew out of brokers’ needs to borrow stock to complete transactions, there is little doubt now that the majority of securities are being borrowed by prime brokers on behalf of hedge funds and other market participants, on the basis of their being able to then short the stock. Hence, Securities Lending is intimately tied in with the ability to short a stock, a point conceded by the FSA which considers securities lending utilisation rates as a good proxy for short selling. Hence a removal of the securities lending market would cripple the growing short selling industry but would also, according to the views of the regulators in Section 2, weaken the efficiency of the markets.

Did Short Selling Cause Recent Market Turmoil?

Market actions, including short and default selling, do not change the intrinsic value of a company, as represented by that company’s balance sheet and financial statements. It is these ‘fundamentals’ that ultimately lead to both short selling and long investors selling their positions e.g. a company taking on too much leverage and being unable to service it’s debt. On this basis it is difficult to believe that short selling alone is sufficient to destroy a company. It’s possible short selling could accelerate price discovery distress and even be seen to increase short term volatility of the price of a distressed stock, but other external/internal factors must also be at play.

⁴ Pyramid-type schemes based on the “rob-Peter-to-pay-Paul” principle. See <http://www.sec.gov/answers/ponzi.htm>

Indeed assuming a company with sound intrinsic value was targeted for short selling, this should provide a great buying opportunity as stock could be bought at a discount on the basis that the intrinsic worth would emerge after the short-term pricing action of the short seller had abated.

Perversely it is sometimes the short sellers who provide the floor to precipitous falls, as they are required at some stage to repurchase the shares they had previously sold in order to return them to the lenders (a process called “short covering”).

In essence though, the task of market participants is ultimately one of optimising their capital allocation. In an efficient market funds are preferentially directed towards the better companies, and away from those with flawed business models and strategies, even if this results in their liquidation (although more likely it means they are taken over). Long only equity holders will ultimately see to this outcome by reducing/removing their capital.

However, while significant opacity regarding the actions of short sellers in markets exists, there will always be questions about their motives. The UK FSA considered this transparency issue and several suggestions were made regarding how this might be improved. It was agreed that a reporting regime that reported significant short positions in a company, commensurate with the required reporting of significant (>3% in the UK, >5% in Australia) “long” positions, was not supportable for two main reasons. Firstly, reporting long positions is done to reflect the degree of control investors have in a company; given that shorting does not involve control at all (i.e. no voting capability) this is irrelevant. Secondly, such information could readily be used against the short sellers by other market participants, in that by driving pricing upwards (i.e. purchasing the stock) short sellers would be forced to cover their positions by purchasing the stock, likely at substantial losses (called a “short squeeze”). For these reasons the FSA supported the production of an indirect measure, being the publication of securities lending data. This is currently being performed via CrestCo⁵ on a daily basis (lagged three days).

END.

⁵ <https://www.euroclear.co.uk/sld/>