



INDUSTRY NEWS

Member Newsletter – September 2010

From the Chair

After receiving such a positive response to the March newsletter, we have decided to make it a biannual event. It has been another busy year for the association with education very much still part of the wider ASLA initiatives, promoting the benefits stock loans bring through liquidity and supporting efficient financial markets.

Since the last newsletter, ASLA has been involved in speaking at various industry conferences, communicating with regulators, engaging with the media, participating in industry roundtables, hosting stock loan tutorials and holding securities lending forums.

Central banks and regulators globally have commented on the stability and liquidity stock loans provide financial markets, which is recognised as an essential component of any efficient market.

While there has been stability of on loan balances we have certainly not seen volumes return to historical levels. Given the low volumes of shares on loan one must assume this is detrimental to both the liquidity and the efficiency of the Australian market.

It is 16 months now since the short selling ban was lifted so the time is right to revisit the intentions when the regulations were communicated and adapt that to the current market environment.

The industry feels there should be additional exemptions to the current regulations, based on how they are applied. This edition of the newsletter discusses that in more detail.

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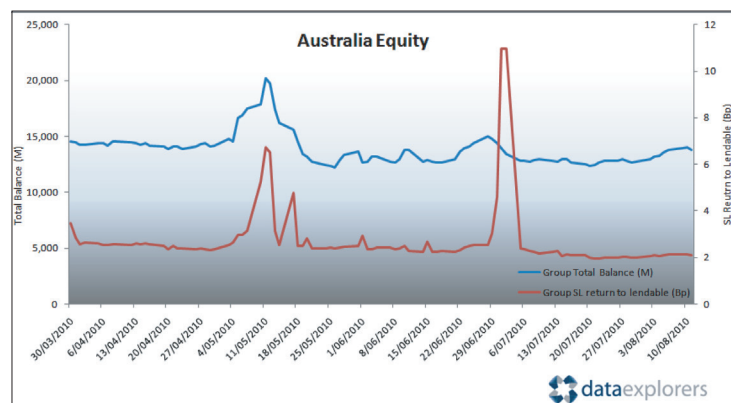
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Local market returns still strong but demand for securities still weak

Review of securities lending in Australia (March to September 2010)

Australia remains the third largest securities lending market in Asia with just shy of \$14 billion on loan as at mid August. It is on a par with the largest market, Japan, in terms of the return being made on the assets made available for lending. From March to present this is 2.9bps for Australia and 3bps for Japan. Hong Kong is first in terms of lending return and second by value borrowed.

In the previous six months, there have been two major spikes in demand for securities. In Mid May, ANZ bank paid out a large dividend creating lucrative demand. In early July there was an anomaly as Charter Hall Office Reit paid a large dividend leading to enormously high lending fees of up to 30% and boosted the overall securities lending return figure to 11bps at that time.



Collateral taken against loans in Australian equities is a 60:40 split in favour of non cash versus cash which shows a slightly higher popularity of non cash collateral against

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our aggregate information across all markets. As we know, the US remains biased heavily in favour of cash collateral with Europe the other way round. The amount of non cash collateral has remained steady over the period while cash collateral is lower but with a recent rebound in early August. Ninety three per cent of the securities lending revenue across Aussie equities is derived from the risk free lending fee with only 7% coming from cash re-investment.

Directional lending to meet the need of short sellers has been muted along with most other equity markets over this

period. As our graphic shows, the ratio of inventory to stock on loan ("Long Short Ratio") is close to an all time high signifying lower demand.

Investors are unlikely to have been short selling widely in a market like Australia given its bias towards resources and energy shares as the demand for these commodities remains robust. Of course, there are companies attracting short selling such as **Fairfax Media (FXJ)** although some of the borrowing here could be related to convertible bond delta hedging.

In mid caps, demand to borrow rural service provider **Elders Ltd (ELDDA)** is on the increase. Private wealth provider **Perpetual Ltd (PPT)** is also in strong demand. Both these securities have seen falling share prices after the increase in borrowing signifying that hedge funds are informed investors in Australia and it is a good idea to follow what they are doing.

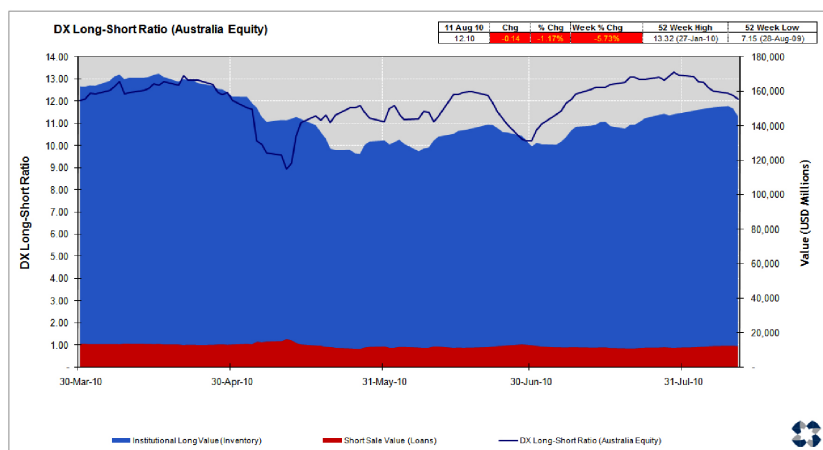
Looking ahead, it is hard to forecast a sudden uptick in the number of Australian listed securities being borrowed to support directional short selling. That said, there will be pockets of demand as there are now, especially if companies start taking risks in pursuit of growth as BHP Billiton recently did by trying to diversify into potash ownership.

Also encouraging is the volume of M&A activity with Australia experiencing the biggest proportion (even pre the BHP/Potash deal this was 41% according to dealReporter.com) of current takeovers by deal size as this drives risk arbitrage funds to borrow securities. M&A activity may well continue and even if it does not, firms may instead use the spare cash generated from balance sheet cleansing to pay out more dividends – another good thing for the securities lending market.

By Will Duff Gordon, Data Explorers

 dataexplorers

Select Asset Class: **Australia Equity**



Fighting for exemptions

The securities lending and short selling industry has undergone multiple changes over the past two years making it more difficult to borrow stocks and execute short positions. Stringent local regulation, especially when compared with other countries have resulted in weak demand for securities to be short sold. ASIC could assist with demand by allowing further exemptions such as defining liquidity to make it easier to operate in the Australian market.

The approved list of equities with sufficient liquidity was revoked in September 2008, when the short selling ban was imposed. In the current regulatory environment, an ASX 200 listed equity such as BHP is now treated in the same manner

as a small cap stock when it comes to requirements for initiating a short position.

"Many foreign investors just don't bother with the Australian market anymore"

However, even more surprisingly, the stringent liquidity restrictions only apply to equities and not other asset classes such as bonds. An ASIC Class Order [CO 09/1051] notes that there is no liquidity test for government bonds as long as the same issue bonds exceed \$100 million dollars. In this case, it is satisfactory if the seller believes on reasonable grounds that arrangements can be put in place for settlement at the relevant time.

The real issue here is around the criteria of liquidity. If short selling is a positive thing for the market and does not contravene ASIC's policies, then why are securities such as BHP so heavily regulated when it comes to initiating a short position when two separate class orders both refer to financial products in S&P/ASX 200 index as a measure of liquidity.

Professor Olan Henry research and that of his colleagues appears to show empirical evidence supporting the broad conclusion that short selling improves price discovery and does not increase volatility.

Anecdotal evidence strongly suggests that Australia's failure to have an approved list, coupled with onerous

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transactional and position reporting requirements, is a significant disincentive for past and potential foreign and local investors to invest in our financial products. Many foreign investors just do not bother with our markets anymore.

John King of Mallesons Stephen Jacques believes there is a need to bring back

a list of approved securities. This may involve establishing criteria acceptable to regulators while still achieving their objectives around short selling or an approved short sale financial products list (and related requirements). These exemptions aim to bring the equity markets more in line with other asset classes in Australia and with other

markets globally that Australia should be benchmarked against.

The introduction of exemptions and clarifying tax uncertainties would likely significantly increase foreign investment, improve the health of our market through increased liquidity without materially increasing settlement risk.

Short selling reports commence

ASIC started reporting short selling positions on 21 June 2010 in a bid to increase the level of transparency in the market. What has been the market reaction to the reports and has it improved the transparency in the short selling markets?

When the reports were first published by ASIC, the volume of short selling reported was much lower than most in the market had anticipated. The numbers so far suggest speculative short selling was not the culprit during the GFC for falling stock prices but may have been the scapegoat.

Other fears including short sellers retreating from the market due to

adverse reactions from companies and investment firms which could affect liquidity has not eventuated. If anything, numbers have shown that supply is plentiful but demand is weak.

“Supply is plentiful but demand is weak”

The reports so far have not radically changed the short selling market for lenders or borrowers. Although analysis is yet to be done on whether the reporting is effective, meets the objectives outlined by ASIC and improved the current system, the way the market has reacted to the reports suggests there will be marginal gains.

This is not to say the exercise is without merit. The reports have shown the role of short selling in the market as a hedging tool and provider of liquidity to the market compared with the perception of short sellers being speculative and manipulating the market.

As with the Securities Lending disclosure via the [ASX website](#) the main benefit is this brings the transparency that the regulators were looking for. How much the broader market utilises this information now it is available remains to be seen.

ASLA engages with the media

ASLA has continued to engage with journalists on current issues in securities lending and aims to further educate the broader market on the role of securities lending. As demand for securities lending is still weak, ASLA has been actively promoting the need to increase exemptions to reduce barriers to entry to the market.

Below is a series of articles of interest to the industry. Please contact **Honner Media** to request the articles which do not contain a link:

March 2010	Global Investor: ASLA statement on global crisis
April 2010	Global Investor: ASLA seeks easier short-selling rules
14 April 2010	Investor Daily: ASLA calls for exemptions on short selling
July 2010	Superfunds Magazine: Stock Lending: Back in favour
July/ August 2010	Global Investor: Making headway – The global financial crisis hobbled many securities lending markets, but Australia seems to have fared well, attracting new business
August 2010	Securities Lending Times: In Association (interview with Peter Martin)

For co-ordination of media enquiries please contact ASLA's PR consultants Yolanda Beattie or Suk Hee Lee at **Honner Media** on +612 8248 3752.

Engaging ASIC on substantial holding disclosures

ASLA met with ASIC on 3 August 2010 to discuss potential exemptions to substantial holding disclosure requirements. ASLA and ACSA submitted a joint response for the Consultation Paper 107 "Securities lending and substantial holding disclosures" in August 2009.

In June 2010, ASIC responded requesting further feedback on the August 2009 submission around relief for prime brokers, matching of borrowing and loan transactions for securities lending intermediaries which ASLA responded to in July 2010.

ASLA's view is that prime brokers should be granted a class order relief to allow a prime broker to disregard its relevant interest arising from its borrowing rights unless there is physical borrowing of the securities from its clients.

Although a securities intermediary such as a prime broker may have a right to borrow securities it holds on behalf of a client, the client retains all rights including voting and the ability to deal in those securities.

A prime broker should not be required to recognise a relevant interest in a client's securities merely because they are made available to borrow

under a securities lending programme. A relevant interest should only be recognised when the right to borrow is exercised and the securities are transferred into the name of the prime broker. However, any relevant interest should be recognised only on a net basis and on-lent securities should be disregarded.

"Relevant interest should be recognised only on a net basis"

ASLA believes a strict application of the relevant interest provisions on this issue raises significant practical compliance difficulties for securities lending participants which are also likely to result in figures being distorted due to double counting. The relief proposed by ASIC will help to address the practical difficulties with compliance under the existing relevant interest legislation.

Also under consideration by ASIC is a class order relief to allow relevant interests to be disregarded where the relevant interest arises from a 'matched' securities lending transaction occurring within the same day.

ASLA members have expressed particular concern about ASIC's view that a lender will generally continue to have a relevant interest in securities

where they are on-lent, as a strict application of this view will lead to significant multiple reporting of relevant interests in the same securities.

At best, a strict application of ASIC's view is likely to result in the market being less informed. Further, ASLA members consider there is a real likelihood that multiple substantial holding reports in respect of the same securities may be misunderstood by market participants and the financial press, potentially leading to unsubstantiated rumours that adversely affect market efficiency and ultimately investor confidence.

In general, the ultimate lender and ultimate borrower of securities subject to a securities lending arrangement are the parties that should be required to recognise and, if applicable, report a relevant interest in the relevant securities, as they ultimately control the rights attaching to the securities.

ASLA expects to consult with ASIC soon on a range of other exemptions shortly and we will keep you updated with the progress.

ASLA welcomes no change to securities lending rules for superannuation trustees

The government released its final report of the Cooper Review into superannuation on 5 July 2010. Although ASLA's submission to the Cooper Review was around only one issue, ASLA is pleased the government has decided not to regulate superannuation trustees around securities lending or hedging.

ASLA believes it should be left to trustees to decide if it is in the interests of super fund members to have equity investments owned by the fund made available for the purposes of short selling or hedging.

Securities lending is an investment activity for a fund. As the trustees of a fund have responsibility for the investment strategy of the Fund, it follows that the Trustees should also be responsible for deciding whether the fund enrolls in a securities lending program.

For a full copy of the submission, please click [here](#)

Tax changes to reflect commercial substance of arrangement

On 29 June 2010, Senator Nick Sherry, Assistant Treasurer sent out a media release detailing upcoming changes to the tax treatment of certain securities lending transactions to better reflect the commercial substance of the arrangement. ASLA made a submission in February 2009 noting the tax and economic treatments were not consistent for certain transactions. Although regulation changes are not final, regulators are aware of the issue and final amendments to legislation will be developed in consultation with the industry and the ATO.

The amendments proposed are below.

No.	Proposed amendments	Explanation
12	<p>Repurchase / securities lending arrangements</p> <p>To amend Division 230 so that: where the risks and rewards in respect of a financial benefit (a 'security') under a financial arrangement have not been transferred under that financial arrangement (a loan), the security is disregarded for the purposes of determining what constitutes the loan financial arrangement and the gain or loss from that arrangement; and the party that is exposed to the risks and rewards in respect of a financial benefit under a financial arrangement would be treated as having the security and the party that is not exposed to the risks and rewards would be treated as not having it.</p>	The tax law should recognise the economic and commercial substance of repurchase/ securities lending arrangements over a financial arrangement as a loan, rather than as a disposal of that arrangement and its separate (re)purchase (or purchase of an equivalent financial arrangement).
13	<p>Short sale arrangements</p> <p>To amend Division 230 so that the gain or loss from a short sale of a financial arrangement is to be determined by reference to the short sale and its close out, having regard to commercially appropriate ordering rules.</p>	This outcome would reflect the commercial recognition of the gain or loss from the short sale.

Members speak up on the health of the industry

The local securities lending market is weak with demand for securities depressed. ASLA surveyed its members in August to discuss some of the issues facing the securities lending industry and possible sources of future demand.

Current state of play

The prevalent theme among all the members surveyed was the supply was plentiful but the demand is weak in the securities lending market. A member described the series of events as "the perfect storm" with multiple factors such as the GFC and the short selling ban all happening in quick succession.

Although the market has bounced back from all time lows, the market is still far away from the highs of the first half of 2008, with supply levels still lower than pre GFC.

One of the biggest factors mentioned by everyone interviewed was the need

for a more efficient process. Market participants are required to allocate resources to reporting requirements which make it too costly for certain types of funds to operate locally.

Onerous taxation laws which local market participants must adhere to are also a barrier to entry for overseas investors. The local tax system is complicated and there are genuine risks such as participants being labelled "permanent establishments" which has the potential to drag overseas operations into Australian tax jurisdiction without proper planning. All these factors add costs to the process.

The major issue outside of the control of the securities lending markets was the GFC. Although Australia weathered the storm better than most nations, global players have repatriated capital back home with no sign of inflows post the GFC.

So with this background in mind, the short selling ban in September 2008 did not do any favours for the securities lending industry. The members surveyed noted although there was greater activity in the securities lending market with the lifting of the short selling ban in May 2009, the damage had already been done.

One respondent went as far as to say, when the market was increasing, no one complained about hedge funds or speculative traders. However, only when the prices fall do people start making noise.

Alternatives to securities lending

With demand low, it was worth investigating if the market was using an alternative for securities lending. Although alternative products such as swaps are being used, these arrangements still involve securities lending.

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As an example, a hedge fund will ask its prime broker to write an equity swap for the downside performance of a certain stock. The obligation now falls on the prime broker to borrow the stock either internally or through third party lenders while the hedge fund still gains the relevant exposure.

Future demand

So without a major alternative to securities lending and the demand for the market being depressed, what can be done to encourage demand? The overarching theme from all respondents was the need to make it easier to deal in Australia.

With greater levels of regulatory and compliance needs in Australia compared to countries in Asia, overseas investors are placing Australia in the too hard basket. More incentives need to be provided for demand to return to Australia such as clarity on tax issues, simplifying the tax regime, further market maker exemptions and an approved list of liquid stocks which are allowed to be short sold.

“More incentives need to be provided for demand to return”

Macroeconomic factors such as markets losing credit driven volatility should also increase demand for

securities lending. This could have flow on effects to other sectors such as superannuation funds increasing allocations to hedge funds driving demand for securities lending.

The demand for securities lending is currently depressed. Although credit driven volatility is curbing demand, the major factor contributing to the ill health of the securities lending market is the need for regulatory and compliance change to drive efficiency. Until this occurs, Australia will lag behind other more efficient markets such as Asia.

28 July 2010 – Securities Lending Industry Event

Hosted by Dedication Group and endorsed by ASLA this event brought together a cross section of participants in the securities lending industry. As well as providing networking opportunities and a chance for ASLA members to connect with peers there were also two excellent presentations by Professor Olan Henry and John King of Maleson Stephen Jacques.

Professor Henry discussed what has been learnt from recent research on short selling. The empirical evidence based on the analysis performed demonstrates the detrimental effect on the efficiency of financial markets when we see a decline in either the supply or demand for shorting and securities lending.

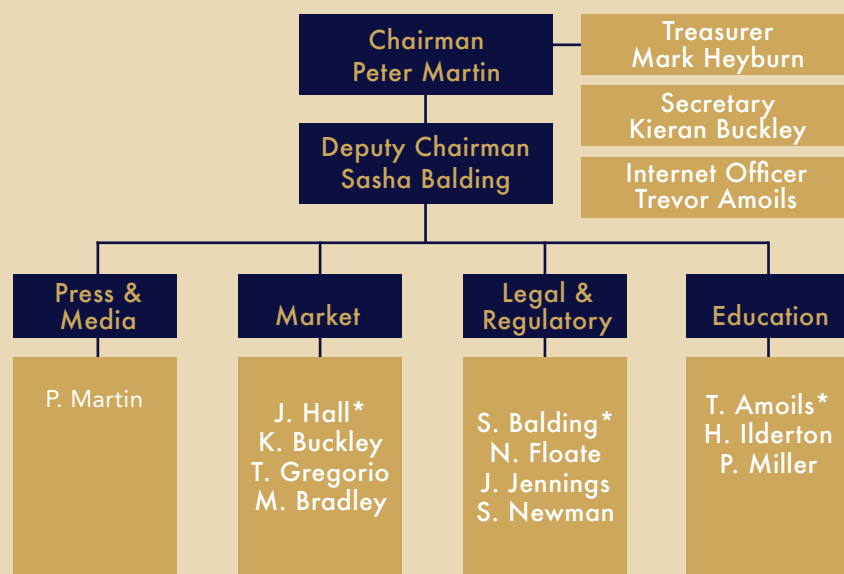
John King proposed ideas which could be adopted by ASIC to better account for liquidity such as bringing back an approved securities list.

We were grateful to have representatives from both Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA) in attendance and the success of the evening should see the event being repeated in the near future. Keep posted on the ASLA website for further details.

About ASLA

The Australian Securities Lending Association was formed in 1991 to give securities lending industry participants a unified representation in regulatory and other issues relevant to its members. In addition to ASLA's role of assisting regulatory development, the Association also promotes standardisation through the industry in terms of documentation and market practice. ASLA currently represents 33 organisations across the spectrum of investment banks, custodian and commercial banks, brokers, legal firms and information technology providers. Further information can be found at www.asla.com.au

ASLA COMMITTEE STRUCTURE



* Sub Committee Chair