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The Legal Structure and Regulation of Securities Lending

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Centre for International Finance and Regulation Project: Evaluating the Impact of Securities Loans on Shareholder Rights and the Governance of Listed Companies

RESEARCH REPORT 1: The Legal Structure and Regulation of Securities Lending

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Abstract

This paper examines the legal structure of securities lending in Australia, and also Europe, the United Kingdom and United States. It provides an analysis of the widely used industry documents, the *Australian Master Securities Lending Agreement* and the *Global Master Securities Lending Agreement* (GMSLA). It outlines the regulation of securities lending and short selling, including restrictions on short selling and the applicable disclosure requirements. It discusses the collapse of Opes Prime and the key Federal Court decision which considered the legal effect of the AMSLA. It also outlines the regulatory responses to securities lending and short selling taken by IOSCO, in Europe, the United States and the United Kingdom during the global financial crisis.

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I. INTRODUCTION

Securities lending is the temporary transfer of securities (mainly shares) from one party to another. At the conclusion of the loan, the borrower is required to deliver equivalent securities to the lender. Securities lending is an important and growing part of global market activity. While it is said to perform valid and useful functions such as increasing market liquidity, many – particularly during the global financial crisis – have expressed concerns that it also leads to market instability. Concerns with securities lending have focused primarily on its role in facilitating short selling. During the global financial crisis, markets and regulators were concerned about the potential destabilising effect of short selling on financial markets.¹ Regulators across the globe took action to ban naked and covered short selling.

This paper undertakes a comprehensive examination of the legal structure of securities loans in Australia. It examines securities lending in Australia and other major financial markets, namely Europe, the United Kingdom and United States. This paper examines the Australian and international industry standard form contracts and the current regulatory environment in those jurisdictions. It also considers the regulatory responses to short selling during the financial crisis.

II. WHAT IS SECURITIES LENDING?

Securities lending is where one party (the lender) transfers securities to another (the borrower), with the borrower obliged to redeliver to the lender securities which are equivalent in number and type at a later date.² Securities lending has become an increasingly important part of international financial markets;³ it is said to increase market liquidity, assist with price discovery and the efficient settlement of market trading, and potentially reduce the cost of capital.⁴ Reflecting this increased prominence, in recent years industry publications explaining securities lending have been released in the United Kingdom,⁵ and adapted in Australia⁶ and Canada.⁷

Perhaps the most important feature of securities lending is that it involves the absolute transfer of title to the securities to the borrower, so that the borrower is free to deal with those securities as it wishes (including without any obligation to vote the shares as instructed by the lender). The redelivery obligation is not to return the exact securities provided to the borrower, rather, it is to return securities of an equivalent number and type. Thus the legal nature of securities lending differs from its commercial or economic substance and the terminology of “lending” is inaccurate: at law, a “loan” of securities involves a transfer of title to the securities.⁸ Borrowed securities are very often sold or on-lent; indeed, in most cases this is the very purpose of borrowing the securities, and so it is essential for the borrower to obtain title to enable it to deal with the securities.

¹ On the global financial crisis, see Michael Legg and Jason Harris, ‘How the American Dream Became a Global Nightmare: An Analysis of the Causes of the Global Financial Crisis’ (2009) 32 *University of New South Wales Law Journal* 350.

² *Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Ltd* (2008) 246 ALR 361, 363 [4] (Finkelstein J).

³ Securities lending has been an important part of financial markets for some decades: see Technical Committee of the International Organization of Securities Commissions (IOSCO) and the Committee on Payment and Settlement Systems (CPSS), *Securities Lending Transactions: Market Development and Implications* (July 1999) 61.

⁴ Nadja Dreff, ‘The Role of Securities Lending in Market Liquidity’, *The Bank of Canada Financial System Review* (June 2010); Mark C Faulkner, *An Introduction to Securities Lending* (4th ed, Spitalfields, 2007), 13, 39.

⁵ Mark C Faulkner, *An Introduction to Securities Lending* (4th ed, Spitalfields, 2007).

⁶ John C King, *An Introduction to Securities Lending (Australia)* (Mallesons Stephen Jaques, 2005), and the shorter version: John C King, *Securities Lending of Equity Securities in Australia* (Mallesons Stephen Jaques, 2005).

⁷ Mark C Faulkner, *An Introduction to Securities Lending: First Canadian Edition* (Spitalfields, 2006).

⁸ Mark C Faulkner, *An Introduction to Securities Lending* (4th ed, Spitalfields, 2007), 13.

There are several motivations for borrowing and lending securities.⁹ Lenders have one motivation: to derive income.¹⁰ Typically, lenders of securities are institutional investors such as insurance companies, pension or superannuation funds and investment funds which lend out securities forming part of their asset portfolios in order to generate income in the form of lending fees.¹¹ For some lenders, securities lending contributes a significant proportion of their revenue from their investment portfolios.¹²

Borrowers are usually securities dealers and hedge funds who wish to use the borrowed securities as part of their trading strategies. The most common reason for borrowing securities is to cover a short position, especially to enable the borrower to fulfil a settlement obligation and to enable the borrower to engage in a short sale of the borrowed securities.¹³ Securities lending is also used by market makers, as part of arbitrage transactions,¹⁴ and to avoid withholding tax on dividends.¹⁵ Securities are also borrowed and lent for other reasons, such as the desire to borrow cash collateralised against the lent securities.¹⁶ In Australia, the principal type of transaction is a “securities-driven” one, where the borrower of the securities wishes to obtain temporary access to specific securities.¹⁷ Market makers are the largest borrowers of securities, and do so primarily for hedging related reasons and to cover settlement obligations, as well as short selling.¹⁸

Securities loans are normally collateralised with either cash or other securities. If collateral other than cash is provided, the borrower pays a fee as agreed between the parties, taking into account factors such as the quality of the security, market demand and the collateral accepted by the lender.¹⁹ If cash is provided as collateral, the lender pays interest on the cash at rates relative to market rates, less the fee payable by the borrower.²⁰ Any economic benefits related to ownership of the securities, including dividends and corporate actions, are “manufactured” back to the lender, with the borrower contractually obliged to make equivalent payments to the lender.²¹

Over US\$1.5 trillion in shares and bonds are on loan at any one time internationally, with a further US\$2 trillion on offer.²² In Australia, the value of equity securities on loan was approximately A\$16.7 billion as at end June 2013, with a further A\$226 billion available.²³ As at 30 September 2013, the Australian securities lending market was estimated to be worth between A\$15 billion to A\$25 billion.²⁴

It is not regarded as acceptable market practice to borrow securities for the specific purpose of influencing a shareholder vote. The *Securities Borrowing and Lending Code of Guidance* prepared by the Bank of England’s Securities Lending and Repo Committee states as follows:

⁹ See especially Mark C Faulkner, *An Introduction to Securities Lending* (4th ed, Spitalfields, 2007) and Financial Stability Board, *Securities Lending and Repos: Market Overview and Financial Stability Issues Interim Report of the FSB Workstream on Securities Lending and Repos* (27 April 2012).

¹⁰ International Securities Lending Association, *Securities Lending: Your Questions Answered* (April 2009), 6.

¹¹ Pension funds annually generate estimated revenue of US\$800m from securities lending: Sophia Grene, ‘Guide Issued on Securities Lending’, *Financial Times* (London), 13 September 2010, 4.

¹² Matthew Dive, Ronan Hodge, Catrin Jones and James Purchase, ‘Developments in the Global Securities Lending Market’ (2011) 51 *Bank of England Quarterly Bulletin* 224, 225.

¹³ Jonathan W Willson, ‘Securities Lending: An Overview and Update for Domestic and Cross-Border Transactions’, in *Report of Proceedings of Sixty-First Tax Conference* (Toronto: Canadian Tax Foundation, 2010), vol 9, 3.

¹⁴ Mark C Faulkner, *An Introduction to Securities Lending* (4th ed, Spitalfields, 2007), 39-47.

¹⁵ ‘Spring Break: Securities Lending’, *The Economist* (London), 11 May 2013, 74.

¹⁶ Mark C Faulkner, *An Introduction to Securities Lending* (4th ed, Spitalfields, 2007), 25.

¹⁷ John C King, *An Introduction to Securities Lending (Australia)* (Malleasons Stephen Jaques, 2005), 73.

¹⁸ John C King, *An Introduction to Securities Lending (Australia)* (Malleasons Stephen Jaques, 2005), 73.

¹⁹ Mark C Faulkner, *An Introduction to Securities Lending* (4th ed, Spitalfields, 2007), 23-5.

²⁰ Mark C Faulkner, *An Introduction to Securities Lending* (4th ed, Spitalfields, 2007), 26-8.

²¹ John C King, *An Introduction to Securities Lending (Australia)* (Malleasons Stephen Jaques, 2005), 13.

²² ‘Spring Break: Securities Lending’, *The Economist* (London), 11 May 2013, 74.

²³ Markit, *Resurging Arbitrage: Securities Finance Review*, Q2 2013 (2013), 11.

²⁴ Madeleine Heffernan, ‘Securities Lending on the Rise’, *Sydney Morning Herald* (Sydney), 30 September 2013.

A person could borrow shares in order to be able to exercise the voting rights and influence the voting decision at a particular meeting of the company concerned. There is a consensus, however, in the market that securities should not be borrowed solely for the purpose of exercising the voting rights at, for example, an AGM or EGM.²⁵

Closely related to securities lending is the practice of short selling, of which there are two main types. “Naked” short selling occurs where a seller does not own and has not arranged to borrow securities at the time of sale but intends to acquire securities by purchasing or borrowing them in order to meet the Australian three business day settlement obligation.²⁶ Naked short selling is perceived by some to have detrimental impacts on financial markets and was blamed for contributing to market instability during the financial crisis.²⁷ “Covered” short selling is where the seller has arranged to borrow the securities in order to meet their obligations to deliver prior to entering into the agreement to sell the securities.²⁸ Securities lending plays a key role in enabling sellers to fulfil their obligations under naked (where this is still permitted) and covered short sales. Industry bodies, such as the United States Conference Board, have expressed concerns about the use of securities loans to facilitate short sales: ‘[s]hare lending negatively impacts engagement between investors and companies, which do not know whether the investor will actually vote due to its active share lending strategy’.²⁹

III. INDUSTRY STANDARD SECURITIES LENDING AGREEMENTS

Standard securities lending agreements have been prepared for use in securities lending transactions. These include the *Global Master Securities Lending Agreement* which is widely used internationally and the *Australian Master Securities Lending Agreement* which is widely used in Australia. These are discussed in this Part.

A. *Australian Master Securities Lending Agreement*

The Australian Securities Lending Association has produced a standard document for use in securities lending arrangements, the *Australian Master Securities Lending Agreement* (AMSLA). This was prepared by the law firm Mallesons Stephen Jaques and adapted from the International Securities Lending Association’s *Overseas Securities Lender’s Agreement*.³⁰ It is the document typically used in Australian securities lending arrangements. The AMSLA sets up a framework for two parties to engage in securities lending transactions and specifies the legal effect of those transactions. The parties will agree from time to time on the terms of a loan of securities, relating to such matters as the number and type of securities to be lent, the fees to be paid and the amount and type of collateral to be provided to the lender.

The AMSLA makes clear that although the terminology of borrowing and lending is used in connection with securities lending, a “loan” of securities transfers ‘all right, title and interest in and to’ those securities, ‘free and clear of any liens, claims, charges or encumbrances or any other interest’ of the transferor.³¹ Upon delivery, the lender is required to deliver all documents necessary to vest title in the

²⁵ Bank of England Securities Lending and Repo Committee, *Securities Borrowing and Lending Code of Guidance* (July 2009), cl 7.4.

²⁶ *Explanatory Memorandum, Corporations Amendment (Short Selling) Bill 2008*, 15.

²⁷ Alexis Brown Stokes, ‘In Pursuit of the Naked Short’ (2009) 5 *New York University Journal of Law & Business* 1, 11–14; Emilius Avgouleas, ‘A New Framework for the Global Regulation of Short Sales: Why Prohibition Is Inefficient and Disclosure Insufficient’ (2009) 15 *Stanford Journal of Law, Business and Finance* 376. James W Christian, Robert Shapiro and John-Paul Whalen, ‘Naked Short Selling: How Exposed are Investors?’ (2006) 43 *Houston Law Review* 1033 discuss the harms associated with naked short selling.

²⁸ Commonwealth Treasury, *Short Selling Disclosure Regime – Regulation Impact Statement*, 1.

²⁹ The Conference Board, *Recommendations of the Task Force on Corporate/Investor Engagement* (March 2014), 13.

³⁰ The *User’s Guide to the Australian Master Securities Lending Agreement* (November 2003), 2-17 contains a clause by clause comparison of the AMSLA and the OSLA.

³¹ Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clause 1.4(b).

securities in the borrower.³² The lender is further required to warrant that it is absolutely entitled to pass full legal and beneficial ownership of the securities, free from any encumbrances.³³

Several clauses require the borrower to “manufacture” to the lender the economic benefits of ownership. The borrower is required to pay to the Lender any dividends or distributions received in relation to loaned securities after adjusting for tax liabilities³⁴ and the lender (whether of securities or collateral) may require the borrower to provide the lender with the benefits of any corporate conversion, subdivision, consolidation or other corporate action.³⁵ Clause 4.3 provides that the borrower must use its best endeavours to ensure that any voting rights attached to borrowed securities are exercised in accordance with the instructions of the lender;³⁶ however, according to the Australian Securities and Investments Commission (ASIC) this clause is often deleted.³⁷ There are detailed provisions relating to the tax treatment of the borrowed securities and any distributions received in relation to the borrowed securities.³⁸

The borrower must provide collateral to the lender in the type and amount agreed by the parties, and ensure that the value of the collateral remains at the agreed level; if it falls below the agreed level, the borrower is required to post additional collateral to make up the deficiency, and if the value of the collateral rises the lender is also required to pay back any excess to the borrower.³⁹ Where the collateral provided is cash, the lender (of securities) must pay a fee to the borrower (of securities) at a rate agreed by the parties; where there is no cash collateral, the borrower must pay a fee to the lender at the agreed rate.⁴⁰ The collateral is to be repaid or redelivered upon redelivery of the borrowed securities.⁴¹ The holder of collateral is required to manufacture to the borrower the value of any payments received in respect of the collateral, less any applicable taxes.⁴² Cash is the most common form of collateral.⁴³

Clause 7 of the AMSLA sets out the borrower’s redelivery obligations. The borrower is required to redeliver securities of ‘an identical type, nominal value, description and amount to particular Securities borrowed’, together with the benefit of any conversion, subdivision or other specified corporate action.⁴⁴ Thus, the borrower is not required to redeliver the exact securities which were transferred to it, but instead is required to redeliver equivalent securities. The lender may call for the redelivery of the borrowed securities at any time by giving notice to the borrower, requiring redelivery on a date which must not be less than the period in which trades are customarily settled.⁴⁵ If the borrower fails to redeliver the securities in accordance with the lender’s call, the lender may terminate the loan and apply the default provisions in relation to that loan.⁴⁶ The borrower may also terminate the loan and redeliver equivalent borrowed securities.⁴⁷

If the borrowed securities are suspended from trading or title to the borrowed securities is unable to be transferred (for example due to the insolvency of the issuer), the borrower or lender may give a

³² Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clauses 3 and 4.

³³ Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clause 10.

³⁴ Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clause 4.2(a).

³⁵ Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clause 4.2(b).

³⁶ Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clause 4.3.

³⁷ Australian Securities and Investments Commission, Consultation Paper 107: *Securities Lending and Substantial Holding Disclosure* (July 2009), 10.

³⁸ Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clause 9.

³⁹ Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clauses 6.1, 6.2, 6.3.

⁴⁰ Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clause 5.

⁴¹ Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clause 6.6.

⁴² Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clause 6.7.

⁴³ Frank M. Keane, ‘Securities Loans Collateralized by Cash: Reinvestment Risk, Run Risk, and Incentive Issues’ (2013) 19:3 *Federal Reserve Bank of New York Current Issues in Economics and Finance* 1.

⁴⁴ Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clause 26 (definition of ‘Equivalent Securities’).

⁴⁵ Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clauses 7.1, 7.2.

⁴⁶ Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clause 7.3.

⁴⁷ Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clause 7.5.

suspension notice to the other, in which case the parties must negotiate in good faith to determine an agreed market value for the securities.⁴⁸ The AMSLA does not, however, specify the legal consequences of such an agreement as to market value. Accordingly, the remaining provisions of the agreement, including those relating to default and set-off, would apply. The User's Guide suggests that these problems are rare and that generally the parties will negotiate in good faith to resolve the issue.⁴⁹

The AMSLA provides for the conversion of any delivery obligations to an obligation to make payment in the event of default or insolvency. If an event of default⁵⁰ occurs in relation to a party, the parties' delivery and payment obligations are accelerated to the time of default and set-off against each other. The value of the securities is determined as the market value at the date of default.⁵¹ The obligations of the parties are netted off against each other, so that only the balance outstanding after netting-off remains owing by the relevant party. No obligation to deliver securities remains.

B. Global Master Securities Lending Agreement

The International Securities Lending Association (ISLA) has produced the *Global Master Securities Lending Agreement* (GMSLA), prepared by law firm Freshfields Bruckhaus Deringer. As with the AMSLA, the GMSLA establishes a framework for two parties to engage in securities lending transactions and specifies the legal effect of those transactions, contemplating that the parties will agree from time to time on the terms of a loan of securities. The terms of the GMSLA are similar to the AMSLA, and so only points of significance or departure from the AMSLA will be noted in this section.

The GMSLA provides, in terms very similar to the AMSLA, that notwithstanding the use of the terminology of borrowing and lending, a "loan" of securities transfers title to borrowed securities and the lender is required to transfer securities free from any security interests or encumbrances.⁵² The lender is required to warrant that it is absolutely entitled to pass full legal and beneficial ownership of the securities, free from any encumbrances.⁵³

As noted above, the AMSLA requires the borrower to use its best endeavours to ensure that any voting rights attached to borrowed securities are exercised in accordance with the instructions of the lender.⁵⁴ By contrast, the GMSLA provides that the borrower (whether of borrowed securities or collateral) has no obligation to exercise voting rights in accordance with the instructions of the lender, unless the parties have agreed otherwise.⁵⁵ Clause 14(e) requires each party to warrant that, when acting as borrower, 'it is not entering into a Loan for the primary purpose of obtaining or exercising voting rights in respect of the Loaned Securities'.⁵⁶ Thus, it would be a breach of the agreement for one party to borrow shares specifically for the purpose of exercising the votes attached to the borrowed shares.

IV. SECURITIES LENDING IN AUSTRALIA

A. Legislation and other regulation

Regulation of securities lending in Australia comes from several sources. First, the *Corporations Act 2001 (Cth)* contains provisions relating to naked and covered short selling, and separate provisions relating to the disclosure of interests in listed companies and managed investment schemes. These provisions are directly applicable to securities lending. Secondly, Chapter 7 of the *Corporations Act* regulates the provision of financial services. Thirdly, certain entities have specific requirements such as

⁴⁸ Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clause 7A.

⁴⁹ *User's Guide to the Australian Master Securities Lending Agreement* (November 2003), 21-3.

⁵⁰ Defined broadly in *Australian Master Securities Lending Agreement*, clause 12.

⁵¹ *Primebroker Securities Ltd (recs and mgrs apptd) (in liq) v Fortis Clearing Sydney Pty Ltd* (2009) 28 VR 479.

⁵² International Securities Lending Association, *Global Master Securities Lending Agreement* (January 2010), clauses 2.3 and 4.2.

⁵³ International Securities Lending Association, *Global Master Securities Lending Agreement*, clause 13.

⁵⁴ Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clause 4.3.

⁵⁵ International Securities Lending Association, *Global Master Securities Lending Agreement*, clause 6.6.

⁵⁶ International Securities Lending Association, *Global Master Securities Lending Agreement*, clause 14(e).

prudential requirements which apply where those entities borrow or lend securities. This section discusses each of these in turn.

1. Legislative provisions relating to short selling

Many jurisdictions regulate naked and covered short selling; this section discusses the Australian regulation relating to short selling. Securities lending and short selling are closely related given that one of the main reasons for borrowing shares is to facilitate short selling. Under a typical short sale, the short seller will borrow shares to cover its settlement obligations, whether prior to entering into the agreement to sell the security (in which case the short sale is “covered”), or otherwise (known as a “naked” short sale). Given the key role securities lending plays in enabling sellers to fulfil their short selling obligations, the regulation applicable to short selling is highly relevant to securities lending. Naked short selling is prohibited in Australia; covered short selling is permitted where the seller has ‘a presently exercisable and unconditional right to vest the products in the buyer’.

Section 1020B (which is situated in Part 7.9) is one of the key provisions of the *Corporations Act* which relates to securities lending. This provision was enacted into the *Corporations Act* by the *Financial Services Reform Act 2001 (Cth)* (FSR Act). As enacted by the FSR Act, s 1020B largely replicated s 846 of the previous *Corporations Law* as in force prior to the commencement of the *Corporations Act* on 15 July 2001.⁵⁷ Section 846 had been a part of the *Corporations Law* for many years.⁵⁸ The main substantive change wrought by the FSR Act was to extend the coverage of the prohibition (which applied only to securities)⁵⁹ to other types of financial products. Presumably because they were largely replicating the existing law, the short selling provisions received no treatment in the explanatory documents accompanying the FSR Bill.⁶⁰ These provisions remained in the same form until amended by the *Corporations Amendment (Short Selling) Act 2008 (Cth)* (*Short Selling Amendment Act*).

Prior to the *Short Selling Amendment Act*, s 1020B applied to the following classes of financial products, defined as “section 1020B products”:

- (a) securities;⁶¹
- (b) managed investment products;
- (c) a debenture, stock or bond issued by a government;⁶² or
- (d) any financial products prescribed by regulations.⁶³

Section 1020B(2) provided that a person may only sell “section 1020B products” if, at the time of sale, the person has, or believes on reasonable grounds that the person has, ‘a presently exercisable and unconditional right to vest the products in the buyer’. If the person making the sale is selling the product on behalf of another person, the other person must have, or the person making the sale must believe on reasonable grounds that the other person has a presently exercisable and unconditional right to vest the products in the buyer.⁶⁴

⁵⁷ Section 846 was criticised in Vivien R Goldwasser, ‘Short Selling Revisited – The Need for a New Direction’ (1994) 12 *Company and Securities Law Journal* 277.

⁵⁸ For the early history of short selling in Australia see Andrew Kedzior, ‘Short Selling in Australia’ (1988) 11 *Adelaide Law Review* 327.

⁵⁹ *Corporations Law (Cth)* s 846(1).

⁶⁰ Revised Explanatory Memorandum, *Financial Services Reform Bill (Cth)*; Commonwealth Treasury, *Financial Services Reform Bill: Commentary on the Draft Provisions* (February 2000).

⁶¹ See further Benjamin B Saunders, ‘Has the Financial Services Reform Act Fixed the Problems with the Regulation of Securities and Derivatives?’ (2010) 21 *Journal of Banking and Finance Law and Practice* 33 regarding the definition of securities.

⁶² As defined in *Corporations Act 2001 (Cth)* s 764A(1)(j).

⁶³ *Corporations Regulations 2001 (Cth)* reg 7.9.80B prescribed 3 classes of financial products for the purpose of s 1020B.

⁶⁴ *Corporations Act 2001 (Cth)* s 1020B(2).

The critical question for determining compliance with this prohibition was therefore whether the seller had ‘a presently exercisable and unconditional right to vest the products’. Section 1020B(3) provided some un-illuminating guidance⁶⁵ on what constituted such a right:

- (a) a person who ... has a presently exercisable and unconditional right to have section 1020B products vested in the person, or in accordance with the directions of the person, has at that time a presently exercisable and unconditional right to vest the products in another person; and
- (b) a right of a person to vest section 1020B products in another person is not conditional merely because the products are charged or pledged in favour of another person to secure the repayment of money.

The interpretation of s 1020B remains important because only minor changes have been made to ss 1020B(1), (2) and (3). ASIC’s view is that, in order to have a presently exercisable and unconditional right to vest, ‘a person must, at the time of the sale, have power to direct a transfer of the product, that is, the person must have the absolute ability to give the buyer title to the product’.⁶⁶ Holding legal title to the product would amount to a presently exercisable and unconditional right to vest for the purposes of s1020B.⁶⁷ Thus, the requirement appears to be concerned with whether a seller holds a proprietary interest in the securities.⁶⁸

Various exceptions to the general rule were set out, permitting short selling where the seller did not have a presently exercisable and unconditional right to vest in 5 situations:

- (a) as part of an ‘odd lot’ transaction;⁶⁹
- (b) as part of an arbitrage transaction;⁷⁰
- (c) where the seller enters into a contract to buy the products before the time of sale and has a right to have those products vested in the person, conditional only on payment of the consideration, or receipt of an instrument of transfer or documents of title to the products;⁷¹
- (d) where the seller makes arrangements before the time of sale that will enable delivery of products of the class sold to the buyer within 3 business days after the date of sale;⁷²
- (e) where a declaration is in force in relation to a class of financial products made by the operator of the relevant financial market.⁷³

These exceptions permitted naked short selling where the requirements could be satisfied. Where a transaction was undertaken under s 1020B(4)(b), (d) or (e) and through a financial services licensee, the seller was required to inform the licensee, and the seller was required to inform the buyer where a transaction was undertaken under s 1020B(4)(d).⁷⁴

The *Short Selling Amendment Act* was enacted in December 2008, in the wake of the global financial crisis, and was designed to ‘enhance the integrity, fairness and transparency of our markets’.⁷⁵ It made 3 sets of amendments to the *Corporations Act*. First, it confirmed that ASIC had power to modify the

⁶⁵ An opinion shared by Andrew Kedzior, ‘Short Selling in Australia’ (1988) 11 *Adelaide Law Review* 327, 337.

⁶⁶ Australian Securities and Investments Commission, Regulatory Guide 196: *Short Selling* (April 2011), [196.28].

⁶⁷ Australian Securities and Investments Commission, Regulatory Guide 196: *Short Selling* (April 2011), [196.29].

⁶⁸ Andrew Kedzior, ‘Short Selling in Australia’ (1988) 11 *Adelaide Law Review* 327, 337.

⁶⁹ *Corporations Act 2001 (Cth)* s 1020B(4)(a). ‘Odd lot’ was not defined, but is defined by the *Macquarie Dictionary* to mean ‘a number of shares which is not a marketable parcel’, typically less than 100 securities.

⁷⁰ *Corporations Act 2001 (Cth)* s 1020B(4)(b). ‘Arbitrage transaction’ was defined in s 9 as ‘a purchase or sale of financial products effected in the ordinary course of trading on a financial market together with an offsetting sale or purchase of those financial products effected at the same time, or at as nearly the same time as practicable, in the ordinary course of trading on another financial market for the purpose of obtaining a profit from the difference between the prices of those financial products in the 2 financial markets’.

⁷¹ *Corporations Act 2001 (Cth)* s 1020B(4)(c).

⁷² *Corporations Act 2001 (Cth)* s 1020B(4)(d).

⁷³ *Corporations Act 2001 (Cth)* s 1020B(4)(e).

⁷⁴ *Corporations Act 2001 (Cth)* s 1020B(5) and (6).

⁷⁵ Commonwealth, *Parliamentary Debates*, House of Representatives, 13 November 2008, 10881 (Chris Bowen).

operation of the *Corporations Act* in relation to short selling. This was to validate the numerous class orders issued by ASIC. During the height of the crisis, ASIC had issued class orders modifying the *Corporations Act* in relation to short selling, which are examined further below. Prior to the *Short Selling Amendment Act*, ASIC had a general power to exempt persons or financial products from all or specified provisions of Part 7.9 and modify Part 7.9 of the *Corporations Act*,⁷⁶ which includes the short selling provisions. Where a market operator had issued a declaration in relation to a class of financial products permitting naked short selling,⁷⁷ ASIC also had a further power to override that declaration and prohibit short selling of those products.⁷⁸ There was concern that the scope of these powers was uncertain, and that they did not extend to responding to emergency situations.⁷⁹ The *Short Selling Amendment Act* thus amended s 1020F to specifically confirm that ASIC has the power to prohibit or limit the short selling of financial products and vary the provisions of Part 7.9 relating to short selling.⁸⁰ Transitional provisions were inserted to confirm the validity of class orders made by ASIC prior to the passing of the *Short Selling Amendment Act*.⁸¹

Secondly, the *Short Selling Amendment Act* prohibited naked short selling, or more precisely, confirmed in the *Corporations Act* the ban on naked short selling imposed by ASIC, by removing the exceptions to the prohibition contained in s 1020B.⁸² The exception permitting short sales where the seller had entered into a prior purchase agreement in respect of the securities, such that the seller had the right to have the securities vested in itself, conditional only on payment of the consideration, or receipt of an instrument of transfer or documents of title,⁸³ was retained.⁸⁴ Transactions of this type were considered not to be a true naked short sale, because of the prior purchase agreement.⁸⁵ As a result, there are now fewer exceptions to the rule set out in s 1020B that in order to sell securities (or other products), the seller is required to have a presently exercisable and unconditional right to vest.⁸⁶

Thirdly, the *Short Selling Amendment Act* amended the *Corporations Act* to require the disclosure of covered short sales.⁸⁷ Before entering into a covered short sale through a financial services licensee, a seller is now required to make disclosure of prescribed information⁸⁸ to the financial services licensee,⁸⁹

⁷⁶ *Corporations Act 2001 (Cth)*, s 1020F.

⁷⁷ Pursuant to *Corporations Act 2001 (Cth)*, s 1020B(4)(e).

⁷⁸ *Corporations Act 2001 (Cth)*, s 1020C, as repealed by the *Corporations Amendment (Short Selling) Act 2008 (Cth)*, sch 2 item 3.

⁷⁹ *Explanatory Memorandum, Corporations Amendment (Short Selling) Bill 2008*, 7.

⁸⁰ *Corporations Act 2001 (Cth)*, s 1020F(8), as inserted by the *Corporations Amendment (Short Selling) Act 2008 (Cth)*, sch 1 item 1.

⁸¹ *Corporations Act 2001 (Cth)*, Part 10.10, as inserted by the *Corporations Amendment (Short Selling) Act 2008 (Cth)*, sch 1 item 2.

⁸² *Corporations Amendment (Short Selling) Act 2008 (Cth)*, sch 2 item 2, repealing ss 1020B(4), (5) and (6).

⁸³ Former *Corporations Act 2001 (Cth)* s 1020B(4)(c).

⁸⁴ Now *Corporations Act 2001 (Cth)* s 1020B(4).

⁸⁵ *Explanatory Memorandum, Corporations Amendment (Short Selling) Bill 2008*, 13.

⁸⁶ Note that ASIC has exempted certain entities and products: see below.

⁸⁷ The purpose of the disclosure requirements is identified in Commonwealth Treasury, *Short Selling Disclosure Regime – Regulation Impact Statement*, 3. This issue was also considered in Parliamentary Joint Committee on Corporations and Financial Services, *Better Shareholders – Better Company: Shareholder Engagement and Participation in Australia* (June 2008), 37–41. The ASX was critical of the government's failure to include disclosure of securities lending data: ASX, *Transparency of Short Selling and Securities Lending*, Position Paper (2 October 2008), 10.

⁸⁸ *Corporations Regulations 2001 (Cth)* reg 7.9.100:

- (a) the number of section 1020B products that the seller will vest in the buyer under the arrangement;
- (b) a description of the product;
- (c) the name of the entity that issued the product;
- (d) the seller's short position as at the close of business 3 reporting days before the day the particulars must be given under subregulation (4).

These regulations replicated the reporting requirements set by ASIC in Class Order 08/751 (19 September 2008).

⁸⁹ *Corporations Act 2001 (Cth)* s 1020AB, as inserted by the *Corporations Amendment (Short Selling) Act 2008 (Cth)*, sch 3 item 3.

who is in turn required to disclose that information to the operator of the licensed market.⁹⁰ Section 1020AB applies in the situation where a seller relies on a securities lending arrangement⁹¹ to ensure that it will be entitled to vest the relevant products in the buyer.⁹² Before a financial services licensee enters into a covered short sale on its own behalf, it is required to make disclosure of the prescribed information in relation to the transaction to the operator of the licensed market.⁹³ The operator of the financial market is required to make public disclosure of the total number of each kind of “section 1020B product” that has been sold on a particular day and disclosed to the market.⁹⁴ Financial services licensees are required to ask their clients whether a sale is a covered short sale.⁹⁵

These provisions are a form of transactional reporting; namely, the requirement to make disclosure is triggered when a short sale transaction is entered into.⁹⁶ In contrast, positional reporting requires investors to report their overall short position. According to the Treasury Consultation Paper *Short Selling Disclosure Regime*, this type of reporting may provide a more accurate indication of market sentiment in relation to a particular stock at any point in time.⁹⁷ In 2009 the *Corporations Regulations* were amended to introduce positional reporting requirements.⁹⁸ Sellers are required to disclose their short positions – where their holding of a product is less than the quantity of the product which the person has an obligation to deliver – on a daily basis.⁹⁹

In summary, naked short selling is not permitted under s 1020B, which requires sellers to have ‘a presently exercisable and unconditional right to vest the products’, which is analogous to the US ‘locate’ requirement.¹⁰⁰ There are some exceptions to this basic rule under various exemptions issued by ASIC.¹⁰¹ Covered short selling, where sellers have the right to vest the relevant products, is permitted. Holding legal title to securities would satisfy the condition set out in s 1020B, as would a binding commitment to have securities transferred pursuant to an AMSLA. For covered short sales, reporting of both the number of s 1020B products sold and overall short positions held is required.

2. Disclosure of substantial holding of securities

A loan of securities can also trigger substantial holding disclosure obligations for both the lender and borrower. In addition to the specific short selling disclosure requirements outlined above, the *Corporations Act* requires disclosure of interests in listed companies and listed managed investment schemes (MIS) in certain circumstances. Section 671B provides that a person must make disclosure upon acquiring or ceasing to have a “substantial holding” in a listed company or a listed MIS.¹⁰² Disclosure is also required where a person has a substantial holding and there is a movement of at least 1% in their holding.¹⁰³ The purpose of these provisions is to ‘maintain an informed market for listed shares’.¹⁰⁴ Simplifying slightly, a person has a substantial holding in a body corporate or a listed MIS if the person

⁹⁰ *Corporations Act 2001 (Cth)* s 1020AC.

⁹¹ Defined in *Corporations Act 2001 (Cth)* s 1020AA.

⁹² *Corporations Act 2001 (Cth)* s 1020AB(1)(b)&(c).

⁹³ *Corporations Act 2001 (Cth)* s 1020AB.

⁹⁴ *Corporations Act 2001 (Cth)* s 1020AD; *Corporations Regulations 2001 (Cth)* reg 7.9.102.

⁹⁵ *Corporations Act 2001 (Cth)* s 1020AE.

⁹⁶ ASIC, *Short Selling: Post Implementation Review* (Report 302, September 2012), noted that industry feedback ‘has been almost universally critical of the transactional reporting regime’: 25.

⁹⁷ Commonwealth Treasury, *Short Selling Disclosure Regime – Consultation Paper* (6 March 2009), 2.

⁹⁸ *Corporations Amendment Regulations 2009 (No 8) (Cth)*, sch 2.

⁹⁹ *Corporations Regulations 2001 (Cth)*, regs 7.9.99, 7.9.100. For discussion see Australian Securities and Investments Commission, Regulatory Guide 196: *Short Selling* (19 September 2008), [196.115]-[196.155].

¹⁰⁰ Securities and Exchange Commission, *Short Sales: Final Rule and Notice*, 69 Fed Reg 48008, 48013–9 (6 August 2004).

¹⁰¹ These are conveniently summarised in Australian Securities and Investments Commission, Regulatory Guide 196: *Short Selling* (19 September 2008), [196.42].

¹⁰² *Corporations Act 2001 (Cth)*, s 671B(1)(a).

¹⁰³ *Corporations Act 2001 (Cth)*, s 671B(1)(b).

¹⁰⁴ *Australian Securities Commission v Bank Leumi Le-Israel (Switzerland)* (1996) 21 ACSR 474; *ASIC v Terra Industries Inc* (1999) 31 ACSR 186.

and their associates have “relevant interests” in 5% or more of the total number of votes attached to the voting shares in the body or interests in the scheme.¹⁰⁵

The term “relevant interest” is defined in ss 608 and 609, which contain complicated extensions and carve-outs. The basic rule is that a person has a relevant interest in securities if they:

- (a) are the holder of the securities; or
- (b) have power to exercise, or control the exercise of, a right to vote attached to the securities; or
- (c) have power to dispose of, or control the exercise of a power to dispose of, the securities.¹⁰⁶

The information required to be disclosed is set out in s 671B(3). Disclosure is made using forms prescribed by ASIC and released to the relevant financial market.¹⁰⁷ If the transaction does not take place on a prescribed financial market, the terms of any agreement that contributed to the transaction giving rise to the need to make disclosure must also be disclosed.¹⁰⁸

It would seem to be beyond doubt that s 671B has the effect of requiring borrowers under a securities lending arrangement to make disclosure of their holdings.¹⁰⁹ As discussed elsewhere in this paper, a loan of securities involves the transfer of legal title to those securities, including all voting and other rights attached to those securities. Accordingly, a loan of securities – certainly a loan pursuant to an *Australian Master Securities Lending Agreement* (AMSLA) – confers a relevant interest in those securities on the borrower. Further, securities lending is a common method of meeting the requirement in s 1020B(2) that “section 1020B products” may only be sold if the person has ‘a presently exercisable and unconditional right to vest the products in the buyer’. This requirement is very similar to the criterion in s 608(1)(c). It would be contradictory to argue that a person had a presently exercisable and unconditional right to vest the products, thereby complying with s 1020B(2), but did not have a relevant interest as defined in ss 608 and 609. In *Re BioProspect Ltd* the Takeovers Panel held that the acquisition of securities pursuant to an AMSLA triggered the requirement to make disclosure under s 671B of the *Corporations Act*.¹¹⁰

This view is supported by ASIC. In addition, ASIC considers that under a securities lending transaction, *both* the lender and the borrower will have a relevant interest in the borrowed securities. In ASIC’s view, a standard securities lending transaction ‘will usually result in both parties having a relevant interest in the securities under s608’, because:

- (a) the borrower will have a relevant interest in the securities under s608(1) when it has a legally binding commitment to borrow particular securities; and
- (b) the lender will continue to have a relevant interest in the securities through its right to recall the securities from the borrower, which, when accelerated by s608(8), amounts to a right to control disposal of the securities.¹¹¹

This is difficult to reconcile with the fact that the lender’s right under a securities loan is to recall securities of an equivalent number and type, and not to recall the specific securities that were lent to the borrower.¹¹² It will be impossible to point to a parcel of securities in which the lender has a relevant interest; and it is not clear if a person can have a relevant interest in unspecified securities, a point not considered by ASIC. Nevertheless, ASIC has confirmed its view in Class Order 11/272, which provides

¹⁰⁵ *Corporations Act 2001 (Cth)*, s 9, definition of ‘substantial holding’.

¹⁰⁶ *Corporations Act 2001 (Cth)*, s 608(1).

¹⁰⁷ Form 603 *Notice of Initial Substantial Holder* and form 604 *Notice of Change of Interests of Substantial Holder*.

¹⁰⁸ *Corporations Act 2001 (Cth)*, s 671B(4)&(5).

¹⁰⁹ ANZ has, however, denied that it was obliged to lodge substantial holding notices in relation to interests acquired by it under certain AMSLAs: *Securities Lending Review* (22 August 2008), 6.

¹¹⁰ *Re BioProspect Ltd* (2008) 26 ACLC 356 at [65].

¹¹¹ Australian Securities and Investments Commission, Regulatory Guide 122: *Substantial Holding Disclosure: Securities Lending and Prime Broking* (April 2011), [222.27].

¹¹² Note also Australian Custodial Services Association, Submission No 2 to Australian Securities and Investments Commission, *Consultation Paper 107: Securities Lending and Substantial Holding Disclosure* (4 August 2009), [6.2].

that the lender under a securities lending arrangement is taken to have a relevant interest in the securities.¹¹³ A consequence of ASIC's position is that where shares are loaned, multiple parties may be required to lodge substantial holding notices in relation to the same parcel of shares, a consequence acknowledged by ASIC.¹¹⁴ This would include where a borrower sells or transfers shares to a third party.¹¹⁵

Borrowers are obliged to make disclosure, by lodging the required notice together with a copy or summary of the AMSLA with the ASX. Mere entry into an AMSLA will not trigger the disclosure requirement because the AMSLA sets up the framework for entry into securities lending transactions but does not of itself commit either party to transfer securities until a binding commitment is made. The borrower's interest arises once the commitment to transfer the securities has been agreed.¹¹⁶

3. *Other applicable regulation*

Securities lending may require borrowers and lenders to obtain an Australian financial services licence (AFSL). Chapter 7 of the *Corporations Act* regulates the provision of financial services. A person is required to obtain an AFSL if the person carries on a business of providing financial services.¹¹⁷ Section 1020B products¹¹⁸ are all "financial products" for the purposes of Chapter 7.¹¹⁹ A securities lending transaction may also amount to a "derivative" for the purposes of s 761D of the *Corporations Act*.¹²⁰ "Dealing" in a financial product is the provision of a financial service,¹²¹ and dealing includes issuing, acquiring or disposing of a financial product.¹²² However, dealing in a product on one's own behalf is not taken to be dealing.¹²³ In any case, many parties to securities lending arrangements, especially lenders, would hold an AFSL due to the nature of their business. The *Corporations Act* was also amended in 2009¹²⁴ so that margin loans, including those which use a securities lending agreement to achieve a similar economic outcome as a standard margin loan, are now financial products and subject to the various requirements of Chapter 7.¹²⁵

Special requirements also apply to particular entities.¹²⁶ The Australian Prudential Regulation Authority (APRA) has set prudential standards which contain rules relating to securities lending for different entities that it supervises.¹²⁷ This is important for entities such as superannuation funds and insurance companies

¹¹³ Australian Securities and Investments Commission, Class Order 11/272 (8 April 2011), which inserts new subs (8A) into s 608.

¹¹⁴ Australian Securities and Investments Commission, *Response to Submissions on CP 107: Securities Lending and Substantial Holding Disclosure*, Report 235 (April 2011), 19.

¹¹⁵ This view is taken in ASIC, Consultation Paper 107: *Securities Lending and Substantial Holding Disclosure* (July 2009), 11, which states: '[w]hen a borrower on-lends the securities to a third party, provided the borrower retains a relevant interest in the securities, the lender will continue to have a relevant interest in the securities under s608(8). In this way, a number of securities lending transactions will result in a chain of people having a relevant interest in the same securities'.

¹¹⁶ Australian Securities and Investments Commission, Report 235: *Response to submissions on CP 107 Securities Lending and Substantial Holding Disclosure* (April 2011), 19-20.

¹¹⁷ *Corporations Act 2001 (Cth)*, s 911A.

¹¹⁸ Defined in s 1020B(1) to mean securities, managed investment products, financial products referred to in paragraph 764A(1)(j) and financial products of any other kind prescribed by regulations.

¹¹⁹ "Financial product" is defined in Pt 7.1 Div 3 of the *Corporations Act*.

¹²⁰ John C King, *An Introduction to Securities Lending (Australia)* (Mallesons Stephen Jaques, 2005), 85-6.

¹²¹ *Corporations Act 2001 (Cth)*, s 766A(1).

¹²² *Corporations Act 2001 (Cth)*, s 766C(1)(a) and (e).

¹²³ *Corporations Act 2001 (Cth)*, s 766C(3)

¹²⁴ *Corporations Legislation Amendment (Financial Services Modernisation) Act 2009 (Cth)*.

¹²⁵ Explanatory Memorandum, *Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009 (Cth)*, [1.51]. The *Corporations Act* also has specific requirements relating to margin loans: Part 7.8 Div 4A.

¹²⁶ Note also, in the United States, Securities and Exchange Commission, *The Brinson Funds et al. SEC No-Action Letter*, 1997 SEC No-Act. LEXIS 1024 (25 November 1997), in relation to the lending of shares by mutual funds.

¹²⁷ For example, Australian Prudential Regulation Authority, *Capital Adequacy: Internal Ratings-based Approach to Credit Risk*, Prudential Standard APS 113 (January 2013), Attachment B, [39]; Australian Prudential Regulation

which are key participants in the securities lending industry. The Reserve Bank of Australia also has set various standards for Securities Settlement Facilities which contain rules relating to securities lending.¹²⁸ Tax issues relating to securities lending, which will be specific to the individual circumstances of the lender and borrower, are not discussed in this paper.¹²⁹

Finally, it is worth noting the potential impact of the *Personal Property Securities Act 2009 (Cth)* (PPSA). The PPSA commenced operation on 30 January 2012 and has retrospective effect on security interests and security agreements arising before that time.¹³⁰ The purpose of the PPSA was to ‘establish a single national law governing security interests in personal property’,¹³¹ and regulates security interests with respect to their substance, not their legal form. There is equivalent legislation to the PPSA in the United States, Canada and New Zealand.¹³²

“Personal property” as defined by the PPSA includes shares.¹³³ Thus, the PPSA governs security interests in relation to shares. A “security interest” is an interest in personal property that secures payment or performance of an obligation.¹³⁴ As will be discussed below, the AMSLA provides that a transfer of securities pursuant to that agreement transfers “all right, title and interest in” those securities, “free and clear of any liens, claims, charges or encumbrances or any other interest” of the transferor.¹³⁵ As a general rule, therefore, a transfer of securities pursuant to an AMSLA will exclude any security interests in relation to those securities. Of course, in a particular case, and depending on the terms of any relevant agreement, a security interest may exist.¹³⁶ In such a case, the registration, priority and other rules in the PPSA would apply.

The Australian Securities Lending Association has also produced a *Code of Guidance* for securities lending.¹³⁷ In summary, this Code provides that securities loan transactions should be documented by a written legal agreement between the parties; the agreement should provide that each party’s claims may be offset immediately against the claims of their counterparty in the event of default; there should be appropriate authority for the securities to be lent; parties should be clear in what capacity the counterparty enters into the agreement; parties should monitor their exposure to counterparties; securities loans are normally secured against collateral acceptable to the lender; the loan and the collateral should be marked to market daily or as agreed; the collateral should be adjusted to maintain the appropriate margin; the economic benefits of ownership should be manufactured back to the lender; the rights and obligations of each party in relation to the recall of securities should be clearly established; there should be prompt notification of any intention to return or recall securities on loan; clearly specified procedures should be followed in the event of failed deals in all markets in which securities are lent; confirmation of each deal should be issued; and appropriate management controls such as exposure limits should be maintained. Many of these recommendations are implemented in the AMSLA.

Authority, *Capital Adequacy: Asset Risk Charge*, Prudential Standard LPS 114 (January 2013), [24]; Australian Prudential Regulation Authority, *Capital Adequacy*, Prudential Standard GPS 110 (January 2013), [24].

¹²⁸ Reserve Bank of Australia, *Financial Stability Standards for Securities Settlement Facilities* (December 2012).

¹²⁹ On the tax issues see John C King, *An Introduction to Securities Lending (Australia)* (Mallesons Stephen Jaques, 2005), 93-103; Jonathan W Willson, ‘Securities Lending: An Overview and Update for Domestic and Cross-Border Transactions’, in *Report of Proceedings of Sixty-First Tax Conference* (Toronto: Canadian Tax Foundation, 2010), vol 9, 1.

¹³⁰ *Personal Property Securities Act 2009 (Cth)* ch 9.

¹³¹ Explanatory Memorandum, *Personal Property Securities Bill 2009 (Cth)*.

¹³² United States: Article 9 of the *Uniform Commercial Code*; the Canadian provinces and territories have each passed a *Personal Property Security Act*; for New Zealand: *Personal Property Securities Act 1999 (NZ)*.

¹³³ *Personal Property Securities Act 2009 (Cth)* s 10 (definition of ‘personal property’); Explanatory Memorandum, *Personal Property Securities Bill 2009 (Cth)*.

¹³⁴ *Personal Property Securities Act 2009 (Cth)* s 12.

¹³⁵ Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clauses 1.4(b), 4.1.

¹³⁶ *Lift Capital Partners Pty Ltd v Merrill Lynch International* (2009) 73 NSWLR 404.

¹³⁷ Australian Securities Lending Association, *Code of Guidance* (December 1997).

B. The Opes Prime Affair and its Consequences

This section discusses the role of securities lending in connection with the collapse of Opes Prime and the Federal Court decision which considered the legal effect of securities lending. The Opes Prime affair has been discussed separately from other cases relating to securities lending (which are discussed below) because the collapse provoked huge controversy regarding the role of securities lending and was the first judicial examination of the issue in Australia.¹³⁸

Opes Prime operated a business of providing margin loans to its clients for the purpose of investing in shares, but the structure of the arrangement differed from traditional margin lending facilities. Margin lending has been the focus of separate attention,¹³⁹ including the concerns arising where directors hold securities in their company using margin loans to fund their holdings.¹⁴⁰ Rather than Opes Prime taking security over the purchased shares to secure repayment of the loan,¹⁴¹ Opes Prime entered into securities lending arrangements with its clients, whereby the shares purchased by the clients with the funds lent by Opes Prime were transferred to Opes Prime, which in turn transferred those shares to its financiers as security for the loans which financed Opes Prime's business.¹⁴² The client transferred legal and beneficial title to Opes Prime, which therefore was able to deal with the shares as principal.¹⁴³ Utilising this model, Opes Prime allowed clients to borrow funds to invest at higher loan to valuation ratios than permitted under traditional margin lending¹⁴⁴ and also allowed its clients to invest in risky and speculative stock which other lenders would not provide funding for, although at very low loan to valuation ratios (LVRs).¹⁴⁵

This model presented greater risks to Opes Prime clients, for in the event of Opes Prime's insolvency, clients would be only unsecured creditors in respect of Opes Prime's obligation to redeliver securities, whereas under traditional margin lending arrangements, clients retain ownership of the securities, subject to the security interest of the lender. The risks inherent in this model materialised when Opes Prime experienced financial difficulties;¹⁴⁶ on 27 March 2008 administrators were appointed and ANZ Bank also appointed receivers over the assets of the companies in the Opes Prime group. The creditors resolved that the companies in the group should be wound up, and they were ultimately placed into liquidation.¹⁴⁷

Opes Prime's collapse gave rise to a spate of litigation. The legal effect of the securities lending agreement was tested in *Beconwood Securities Pty Ltd v ANZ*,¹⁴⁸ a test case for the implications of the Opes Prime collapse. The plaintiff, Beconwood Securities, had entered into a "Securities Lending and Borrowing Agreement" (SLA) with Opes Prime Stockbroking Ltd. The SLA was largely based on the AMSLA, with some modifications. Under that agreement Beconwood transferred shares to the value of approximately \$7m to a related entity of Opes Prime in return for cash (approximately \$1.35m). The

¹³⁸ See the useful discussion in Stacey Steele, 'Lessons (to be) Learnt from the Opes Prime Insolvency' (2008) 32 *Melbourne University Law Review* 1127.

¹³⁹ For example, Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into Financial Products and Services in Australia* (November 2009), ch 3; Winifred Murray, 'Regulation of Margin Loans – Before and After the New Amendments to the Corporations Act 2001 (Cth)' (2011) 26 *Australian Journal of Corporate Law* 299.

¹⁴⁰ Corporations and Markets Advisory Committee, *Aspects of Market Integrity*, Report (June 2009), ch 2.

¹⁴¹ Cf the definition of 'standard margin lending facility' in *Corporations Act* s 761EA(2).

¹⁴² *Eric Preston Pty Ltd v Euroz Securities Ltd* (2011) 274 ALR 705, 707 [4].

¹⁴³ ANZ, Submission No 379 to Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into Financial Products and Services in Australia*, 18 August 2009, 22.

¹⁴⁴ ANZ, *Securities Lending Review* (22 August 2008), 11; Reserve Bank of Australia, *Statement on Monetary Policy* (9 May 2008), 51.

¹⁴⁵ Andrew Main, 'Logic of Assessment Turned on Its Head', *The Australian* (Sydney), 11 April 2008, 6. ANZ later acknowledged deficiencies with the LVR models: ANZ, *Securities Lending Review* (22 August 2008), 13.

¹⁴⁶ For the reasons for these difficulties, cf Michael West, 'Bank Was Warned of Fraud Risk', *Sydney Morning Herald Weekend Edition* (Sydney), 31 May – 1 June 2008, 1.

¹⁴⁷ *Re Opes Prime Stockbroking Ltd (No 2)* (2009) 179 FCR 20, 24-5.

¹⁴⁸ *Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Ltd* (2008) 246 ALR 361; (2008) 66 ACSR 116.

shares were transferred to ANZ, which had provided the funds which were advanced to Beconwood by Opes Prime. ANZ and Opes Prime had entered into an AMSLA.¹⁴⁹

When Opes Prime became insolvent, the question was which party had title to those securities. Finkelstein J commenced his judgment by analysing the function of securities lending in modern financial markets. In an important and often-quoted statement, Finkelstein J held:

The term “securities lending” under these agreements is factually incorrect. The transaction that is referred to as “lending” is in terms an outright disposal of the securities lent, linked to a subsequent acquisition of equivalent securities. In other words the agreements provide that title to the securities on loan, as well as to any collateral that is received by the lender, passes from one party to the other. On the other hand, the economic benefits of ownership are “manufactured” back to the lender by the terms of the securities loan agreements.¹⁵⁰

The express terms of the SLA, mirroring those of the AMSLA,¹⁵¹ provided that where any securities were “borrowed” or “lent”, title would pass absolutely to the other party, free from any security interests.¹⁵² His Honour held that the substance of the transaction is to be determined in the language of the contract, that is, ‘the character of a transaction is to be determined by reference to its legal nature, not to its economic effect’. In addition, his Honour applied the principle that ‘a commercial contract should be construed having regard to its purpose, which requires an understanding of the genesis of the transaction, its background, its context, and the market in which the parties are operating’.¹⁵³ The purposes for which market participants enter into securities lending transactions depend for their efficacy on title to the borrowed securities transferring to the borrower. If title did not transfer, the purpose of the transaction would be defeated.¹⁵⁴ Further, the provision for netting in the event of default would not operate effectively unless title passed to the other party.¹⁵⁵

It was therefore impossible to conclude that, instead of an absolute transfer of title, the agreement should be characterised as a mortgage of the purchased shares in favour of Opes Prime. First, the express terms of the SLA provided that unencumbered title in lent securities and collateral passes on delivery. Secondly, when the transaction comes to an end, the borrower is obliged to deliver the same number and type of securities, not to deliver the securities initially lent. Thirdly, the netting and set off provisions that come into effect on default, which converted redelivery obligations into payment obligations, were inconsistent with any equitable property rights over lent securities or collateral.¹⁵⁶ The decision was widely seen as vindicating the intended operation of the AMSLA (on which the SLA was modelled).¹⁵⁷ Although *Beconwood* sits uncomfortably with other cases which emphasised the economic substance of the transaction (and which are consistent with the approach taken by the PPSA),¹⁵⁸ subsequent decisions have upheld the approach adopted by Finkelstein J and have given effect to the contractual provisions.¹⁵⁹

¹⁴⁹ *Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Ltd* (2008) 246 ALR 361, 366-7 [15]-[18].

¹⁵⁰ *Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Ltd* (2008) 246 ALR 361, 366 [14].

¹⁵¹ Australian Securities Lending Association, *Australian Master Securities Lending Agreement*, clause 1.4(b).

¹⁵² *Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Ltd* (2008) 246 ALR 361, 367 [25].

¹⁵³ *Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Ltd* (2008) 246 ALR 361, 371 [42]-[43].

¹⁵⁴ *Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Ltd* (2008) 246 ALR 361, 371 [45].

¹⁵⁵ *Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Ltd* (2008) 246 ALR 361, 371 [45].

¹⁵⁶ *Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Ltd* (2008) 246 ALR 361, 373 [50].

¹⁵⁷ Jeremy Walter and Julia Smithers Excell, ‘Securities Lending: Title Transfer Upheld Down Under’ (2008) 2 *Law and Financial Markets Review* 348; Michael Legg, ‘The Opes Prime Litigation: Securities “Lending” Transfers Legal Title to Securities’ (2008) 26 *Company and Securities Law Journal* 407; GJ Tolhurst, ‘Securities Lending in Australia’ (2009) 2 *Corporate Rescue and Insolvency*, 22; Leonie Wood and Vanessa Burrow, ‘Opes clients left in the cold’, *The Age* (Melbourne), 3 May 2008.

¹⁵⁸ Paul Ali, ‘Short Selling and Securities Lending in the Midst of Falling and Volatile Markets’ (2009) 24 *Journal of International Banking Law & Regulation* 1, 11.

¹⁵⁹ *Melewar Steel Ventures Ltd v ANZ Nominees Ltd* [2008] NSWCA 68 (on appeal from Windeyer J, *Melewar Steel Ventures Ltd v ANZ Nominees Ltd* [2008] NSWSC 345); see also *Melewar Steel Ventures Ltd v ANZ Nominees Ltd*

In *Re Opes Prime Stockbroking Ltd*¹⁶⁰ the administrators of Opes Prime sought directions from the court concerning the operation and the effectiveness of the netting provisions of the AMSLA. The set-off provisions are triggered by an event of default, defined to include an act of insolvency. Under these provisions, default pursuant to an act of insolvency occurs automatically where a liquidator or analogous officer is appointed, otherwise the non-defaulting party is given a choice whether to invoke the default provisions and close out the outstanding transactions.¹⁶¹ Finkelstein J held that a liquidator is not analogous to an administrator or a receiver, whose functions were quite different, and that accordingly, the netting and close-out provisions of the SLA were not engaged unless a creditor made a call for delivery of the lent securities.¹⁶²

Following the collapse of Opes Prime, numerous claims were initiated against Opes Prime and its financiers, ANZ and Merrill Lynch, and there was also extensive media scrutiny of Opes Prime's business model and the role of its financiers. ANZ and Merrill Lynch agreed to make a payment to settle any further claims against it. Opes Prime's liquidators proposed a scheme of arrangement under s 411 of the *Corporations Act*, to be approved by the court. Under the scheme ANZ and Merrill Lynch agreed to pay \$226 million into a fund to be distributed to creditors. Assets to the value of approximately \$27 million were to be returned to the liquidators for distribution. The banks were to be released from all claims by the Opes Prime companies, liquidators and Opes clients. This was to provide a return to Opes creditors of approximately 37 cents in the dollar. Finkelstein J granted leave to convene meetings of the companies' creditors to vote on the scheme on 1 July 2009¹⁶³ and subsequently approved the scheme on 4 August 2009.¹⁶⁴

In *Beconwood* Finkelstein J interpreted the SLA in accordance with its legal nature, not the economic substance.¹⁶⁵ He acknowledged that the 'attempt to characterise the SLA as a mortgage might be attractive if one were permitted to have regard to the economic substance of the arrangement'.¹⁶⁶ In contrast, the Queensland Court of Appeal in *Securities Exchange Guarantee Corp Ltd v Samuel Holdings Pty Ltd*,¹⁶⁷ took an approach based on an analysis of the economic reality of the transaction.¹⁶⁸ Samuel Holdings was a former client of Opes Prime and was owed \$46,998. Samuel opened a "margin lending account" with Opes Prime and wished to purchase shares in Arrow Energy Ltd. Samuel and Opes Prime agreed on a LVR of 60; accordingly Samuel paid \$74,600 (being 40% of the purchase price) to Opes Prime. The shares were subsequently sold and when Opes Prime went into receivership and then liquidation, an outstanding balance of \$46,998 remained owing to Samuel. It made a claim on the National Guarantee Fund, a fund established under the *Corporations Act* and administered by the appellant to compensate persons who suffer loss as a result of dealing in a financial market with a dealer who becomes insolvent.¹⁶⁹

Corporations Regulation 7.5.64(1) establishes a person's right to claim compensation from the fund, and provides that a person may make a claim where a dealer has become insolvent, and the person entrusted

[2008] NSWSC 295; *Melewar Steel Ventures Ltd v Opes Prime Stockbroking Ltd* [2009] NSWSC 22); *CMG Equity Investments Pty Ltd v Australia and New Zealand Banking Group Ltd* (2008) 65 ACSR 650; *Phisci Pty Ltd v Green Frog Nominees Pty Ltd* [2008] FCA 638; *Phisci Pty Ltd v Green Frog Nominees Pty Ltd (No 2)* [2008] FCA 1492; *Altinova Nominees Pty Ltd v Leveraged Capital Pty Ltd* (2008) 66 ACSR 293; *Imobilari Pty Ltd v Opes Prime Stockbroking Ltd* (2008) 252 ALR 41; 69 ACSR 235.

¹⁶⁰ *Re Opes Prime Stockbroking Ltd* (2008) 171 FCR 473.

¹⁶¹ *Re Opes Prime Stockbroking Ltd* (2008) 171 FCR 473, 480 [34].

¹⁶² *Re Opes Prime Stockbroking Ltd* (2008) 171 FCR 473, 487 [62].

¹⁶³ *Re Opes Prime Stockbroking Ltd (No 2)* (2009) 179 FCR 20.

¹⁶⁴ *Re Opes Prime Stockbroking Ltd (recs and mgrs apptd) (in liq) (No 2)* (2009) 73 ACSR 411.

¹⁶⁵ For discussion see Paul Ali, 'Short Selling and Securities Lending in the Midst of Falling and Volatile Markets' (2009) 24 *Journal of International Banking Law & Regulation* 1, 11.

¹⁶⁶ *Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Ltd* (2008) 246 ALR 361, 373 [53].

¹⁶⁷ *Securities Exchange Guarantee Corp Ltd v Samuel Holdings Pty Ltd* [2012] 1 Qd R 377.

¹⁶⁸ *Securities Exchange Guarantee Corp Ltd v Samuel Holdings Pty Ltd* [2012] 1 Qd R 377, 399 [47]-[51] (Chesterman JA, Margaret McMurdo P and Margaret Wilson AJA agreeing).

¹⁶⁹ See *Corporations Act*, Pt 7.5, Div 4.

property to the dealer as part of the dealer's securities business, and the property was entrusted on behalf of the person or on trust for the person.¹⁷⁰ One of the key questions was whether the requirements of reg 7.5.64(1) were satisfied, including whether the money received by Opes Prime was received "on behalf of" Samuel or because Opes Prime was a trustee of the money for Samuel. The court held that it was not sufficient to consider the legal form of the transaction, but that attention must also be paid to the economic reality.¹⁷¹ Even though Opes Prime acquired full legal and beneficial title to the shares, Opes Prime was required to confer on Samuel the economic benefit or detriment from the acquisition and holding of the securities, and accordingly, the shares were held on behalf of Samuel.¹⁷²

In *Re Rosenberg and ASIC*, the Administrative Appeals Tribunal (AAT) was called on to review a decision made by ASIC banning Mr Rosenberg from providing financial services for a period of 4 years.¹⁷³ Mr Rosenberg was the managing director of the Tricom group of companies. Tricom conducted a securities lending business with its clients, whereby its clients lent securities to Tricom as collateral for cash loans. Tricom obtained finance for the loans from a number of lenders, including the ANZ Bank, Merrill Lynch, Credit Suisse and Opes Prime. In February 2008 Opes Prime had lent approximately \$43 million to Tricom in return for the loan of a portfolio of securities transferred to Opes Prime under a standard AMSLA. The majority of these securities (Mr Rosenberg believed) would have been on-lent to Opes Prime's financiers as security for finance provided to Opes Prime.

In March 2008 Mr Rosenberg learned that Opes Prime was in financial difficulties and sought advice on how to secure the return of the securities lent by Tricom to Opes Prime. Mr Rosenberg decided to proceed with 12 special crossings between 2 companies in the Tricom group. A special crossing is a transfer of securities facilitated off-market by a stockbroker. Special crossings must be reported to the market, but may be at any agreed price, and so may bear no relation to the current market price. The obligation to transfer the securities created by the special crossing would serve as a recall notice to Opes Prime to re-deliver the securities. The crossings were reported to the market but prior to settlement Tricom obtained finance from the ANZ to purchase the on-lent securities or their equivalent. Mr Rosenberg therefore informed the ASX that the crossings would be cancelled. ASIC was concerned that the crossings were in breach of s 1041B(1) of the *Corporations Act*, and imposed a banning order on Mr Rosenberg.¹⁷⁴

The AAT held that special crossings which take place off-market, are specifically designated as being special crossings when reported to the market, and can be transacted at any price. Accordingly a reasonable person would understand that the price at which special crossings are effected may not reflect the current market price, and so the evidence did not establish that the crossings had the effect of creating a false or misleading appearance of active trading in financial products.¹⁷⁵

*Eric Preston Pty Ltd v Euroz Securities Ltd*¹⁷⁶ concerned another client of Opes Prime. In early 2008 the plaintiff (and appellant) Eric Preston Pty Ltd wished to purchase shares in Sundance Energy Australia Ltd, but its existing margin lender would not advance funds to Eric Preston to purchase shares in that company. Opes Prime was prepared to provide finance for that purpose. Eric Preston therefore terminated its existing margin lending facility and entered into a margin lending facility with Opes Prime. Upon

¹⁷⁰ *Corporations Regulations 2001* (Cth) reg 7.5.64(1).

¹⁷¹ *Securities Exchange Guarantee Corp Ltd v Samuel Holdings Pty Ltd* [2012] 1 Qd R 377, 399 [47]-[51] (Chesterman JA, Margaret McMurdo P and Margaret Wilson AJA agreeing).

¹⁷² *Securities Exchange Guarantee Corp Ltd v Samuel Holdings Pty Ltd* [2012] 1 Qd R 377, 399 [47]-[51] (Chesterman JA, Margaret McMurdo P and Margaret Wilson AJA agreeing).

¹⁷³ *Re Rosenberg and Australian Securities and Investments Commission* (2010) 117 ALD 582.

¹⁷⁴ Section 1041B(1) of the *Corporations Act* provided that '[a] person must not do, or omit to do, an act (whether in this jurisdiction or elsewhere) if that act or omission has or is likely to have the effect of creating, or causing the creation of, a false or misleading appearance:

- (a) of active trading in financial products on a financial market operated in this jurisdiction; or
- (b) with respect to the market for, or the price for trading in, financial products on a financial market operated in this jurisdiction'.

¹⁷⁵ *Re Rosenberg and Australian Securities and Investments Commission* (2010) 117 ALD 582, 603 (Deputy President Handley and Senior Member Frost).

¹⁷⁶ *Eric Preston Pty Ltd v Euroz Securities Ltd* (2011) 274 ALR 705.

Opes Prime's insolvency, Eric Preston suffered significant losses. Eric Preston sued its broker for failing to properly advise it as to the nature of the agreement. The claim was rejected at first instance and on appeal to the Full Federal Court. The facts disclosed that Eric Preston continued to trade and purchase shares under the Opes Prime facility after being appraised of the risks of the agreement with Opes Prime. Further, the court held that brokers are not bound in law to give advice to their clients unless they voluntarily undertake to do so, in which case they are bound to provide the advice in an honest and competent way.¹⁷⁷ A securities lending facility is 'a matter which does not ordinarily relate to the nature or subject matter of the orders which a broker is required to undertake for its client'. While a duty to advise on a 'financial product which the client was considering using in order to facilitate the purchase of stocks or shares' may arise in particular circumstances, no duty was apparent from the present case.¹⁷⁸

ANZ was the bank which provided the funding for Opes Prime's margin lending business. Pursuant to the securities lending agreement between Opes Prime and ANZ, ANZ acquired title to securities lent by Opes Prime. In August 2007, ANZ held 25.94% of the shares in BioProspect Ltd but had not lodged a substantial shareholder notice under s 671B of the *Corporations Act*. In *Re BioProspect Ltd* the Takeovers Panel made a declaration of unacceptable circumstances because ANZ acquired title to the securities in contravention of chapters 6 and 6C of the *Corporations Act*.¹⁷⁹

After the collapse of Opes Prime, ANZ held many securities to which clients of Opes Prime thought they were entitled, and ANZ suffered reputational and financial damage.¹⁸⁰ As a result, ANZ conducted an internal review of its involvement in securities lending businesses.¹⁸¹ The review noted that there was an important distinction between the use of securities lending for "Equity Finance" (where the lender is motivated by the desire to obtain cash financing) and "Standard Securities Lending" (where the borrower of securities is motivated by the desire to acquire particular securities on a short term basis, for example to settle short sales).¹⁸² One of the important findings of the review was that key ANZ staff 'did not appear to fully understand the nature of Equity Finance and the differences between Equity Finance and Standard Securities Lending, including the different risks associated with Equity Finance'.¹⁸³ ANZ acknowledged deficiencies with the LVR models used for Equity Finance¹⁸⁴ as well as other deficiencies, and noted 13 remediation actions that ANZ would take.¹⁸⁵

In summary, the Opes Prime litigation confirmed the intended operation of the AMSLA, namely that it transfers title to shares lent under a securities lending arrangement. Other cases have confirmed other aspects of securities lending. *Re Opes Prime Stockbroking Ltd*¹⁸⁶ held that the netting and close-out provisions of the SLA were not engaged unless a creditor made a call for delivery of the lent securities. In *Re BioProspect Ltd* the Takeovers Panel held that ANZ ought to have lodged substantial shareholder notices in relation to its holding of shares under a securities lending agreement.¹⁸⁷ The case highlights the complexity of securities lending; the ANZ *Securities Lending Review* noted that ANZ staff did not fully understand the nature of the arrangements it entered into with Opes Prime. Finally, it should be noted that Finkelstein J's decision may not fit entirely comfortably with developments in other areas of law. While in *Beconwood* Finkelstein J interpreted the SLA in accordance with its legal nature and not its economic substance, the Queensland Court of Appeal in *Securities Exchange Guarantee Corp v Samuel Holdings* interpreted the same arrangement based on its economic reality.

¹⁷⁷ *Eric Preston Pty Ltd v Euroz Securities Ltd* (2011) 274 ALR 705, 723 [160].

¹⁷⁸ *Eric Preston Pty Ltd v Euroz Securities Ltd* (2011) 274 ALR 705, 723-4 [164]-[165].

¹⁷⁹ *Re BioProspect Ltd* (2008) 26 ACLC 356 at [65].

¹⁸⁰ On the latter see ANZ's *Trading Update*, 28 July 2008.

¹⁸¹ ANZ, *Securities Lending Review* (22 August 2008).

¹⁸² ANZ, *Securities Lending Review* (22 August 2008) ii.

¹⁸³ ANZ, *Securities Lending Review* (22 August 2008) 2.

¹⁸⁴ ANZ, *Securities Lending Review* (22 August 2008), 13.

¹⁸⁵ ANZ, *Securities Lending Review* (22 August 2008), 23-5.

¹⁸⁶ *Re Opes Prime Stockbroking Ltd* (2008) 171 FCR 473.

¹⁸⁷ *Re BioProspect Ltd* (2008) 26 ACLC 356.

C. Other Cases

Securities lending has also featured in several other cases. *Lift Capital Partners v Merrill Lynch International*¹⁸⁸ concerned a margin lending business operated by Lift Capital. Lift Capital lent funds, which were obtained from companies in the Merrill Lynch group, to its clients upon the security of ASX listed shares. The shares obtained from clients were transferred in favour of Merrill Lynch entities. Lift Capital went into administration and then liquidation; Merrill Lynch sold sufficient shares to extinguish the debt owed to it by Lift Capital. The question for decision was whether those transfers occurred so as to transfer title to the shares free from the interests of the clients as mortgagor so that the clients no longer had a proprietary interest in the shares.

Under the facility agreement between Lift Capital and its clients, the client mortgaged the shares in favour of Lift Capital. Thus the client owned the shares, subject to the equitable interest of Lift Capital as mortgagee and subject also to the ability of Lift Capital to deal with the shares as provided for in the facility agreement. Lift Capital argued that a further agreement described as the Client AMSLA came into force, under a power of attorney granted to Lift Capital by the clients under the facility agreement. However Barrett J held that this agreement did not come into effect because appropriate steps were not taken under the power of attorney to bind the clients.¹⁸⁹

Barrett J also held that a provision of the facility agreement which denied the operation of the mortgage where the shares were transferred had an unconscionable operation. His Honour observed that 'Lift Capital made no attempt to explain to potential clients through the product disclosure statements that a client's mortgaged shares might, at the will of Lift Capital and without notice to the client (either before or after the event), be subjected to a securities lending arrangement so that the client's interest in those shares was taken away'. Further, '[n]either product disclosure statement referred to the risks inherent in securities lending arrangements', which risks were summarised in *Beconwood*.¹⁹⁰

Primebroker Securities Ltd v Fortis Clearing Sydney Pty Ltd concerned the insolvency of the investor client in a securities lending arrangement.¹⁹¹ Fortis provided various financial services to its clients, including securities lending services, and entered into an AMSLA with Primebroker, pursuant to which Fortis advanced funds to Primebroker. On 4 July 2008 Primebroker was indebted to Fortis in the amount of approximately \$20 million and Fortis held borrowed securities with a market value exceeding the loan amount. ANZ appointed receivers and managers of Primebroker, which constituted an event of default under the AMSLA. It was later placed into liquidation. When notified of the appointment, Fortis, in the face of protest by Primebroker, immediately began to sell the borrowed securities over a 10 day period, at prices substantially below market price. Primebroker sued Fortis for the difference between the market price and the sale price. The Victorian Supreme Court held that the netting and set-off provisions of the AMSLA, namely clause 8, were applicable.¹⁹² Accordingly, the balance due to Primebroker was to be calculated by reference to the market value of the securities, not the amount realised by Fortis from the sale of the securities.¹⁹³ As a result, Fortis had to account to Primebroker for the difference.

¹⁸⁸ *Lift Capital Partners Pty Ltd v Merrill Lynch International* (2009) 73 NSWLR 404.

¹⁸⁹ *Lift Capital Partners Pty Ltd v Merrill Lynch International* (2009) 73 NSWLR 404, 412-20.

¹⁹⁰ *Lift Capital Partners Pty Ltd v Merrill Lynch International* (2009) 73 NSWLR 404, 432 [145]-[146], referring to *Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Ltd* (2008) 246 ALR 361 at [8].

¹⁹¹ *Primebroker Securities Ltd (recs and mgrs apptd) (in liq) v Fortis Clearing Sydney Pty Ltd* (2009) 28 VR 479.

¹⁹² This was notwithstanding that the parties had amended the AMSLA by executing an amendment deed: *Primebroker Securities Ltd (recs and mgrs apptd) (in liq) v Fortis Clearing Sydney Pty Ltd* (2009) 28 VR 479, 495 [66].

¹⁹³ See also *Primebroker Securities Ltd (recs and mgrs apptd) (in liq) v Fortis Clearing Sydney Pty Ltd* (2011) 83 ACSR 119.

D. Regulatory Response during the Financial Crisis

As with regulators in other countries, ASIC took various steps to deal with turbulence and instability during the global financial crisis.¹⁹⁴ On 19 September 2008 ASIC, together with the Australian Securities Exchange (ASX), introduced measures targeted at short selling. The ASX announced that from the opening of trading on 22 September 2008, all securities would be removed from its list of securities approved for naked short selling under s 1020B(4)(e),¹⁹⁵ abolishing naked short sales in relation to ASX listed products.¹⁹⁶ ASIC also issued Regulatory Guide 196 and Class Order 08/751, which confirmed that a legally binding right to have securities delivered under a securities lending arrangement entered into by the seller would constitute a ‘presently exercisable and unconditional right to vest’ within the meaning of s 1020B.¹⁹⁷ The order also imposed reporting requirements on brokers and disclosure requirements on clients.¹⁹⁸ In the accompanying explanatory statement ASIC noted the prevalent view in the market that a seller who had entered into a securities lending arrangement had a presently exercisable and unconditional right to vest the securities and so could sell securities short without complying with the reporting and other requirements applicable to short sales.¹⁹⁹

On 21 September 2008 ASIC, relying on its power under s 1020F(1)(c) of the *Corporations Act*, banned all covered short selling of securities on Australian financial markets, including short selling relying on a securities lending arrangement.²⁰⁰ The explanatory statement noted that the prohibitions on short selling implemented in the United States, United Kingdom and other jurisdictions increased the risks for the Australian market.²⁰¹ This was extended to managed investment products on the following day.²⁰² ASIC later exempted from the prohibition on covered short selling hedging by market makers, dual listed arbitrage transactions and index arbitrage transactions, hedging in relation to underwriting reinvestment plans and interest purchase plans, and conversions products.²⁰³ Further exemptions were made for exchange traded options,²⁰⁴ and bonds.²⁰⁵

On 13 November 2008 ASIC removed the ban on covered short selling for non-financial securities,²⁰⁶ while retaining the ban in relation to financial securities.²⁰⁷ The *Corporations Amendment (Short Selling) Act 2008 (Cth)*, which has been described above, received assent on 11 December 2008, with various provisions of the Act coming into force on 11 December 2008, 11 January 2009 and the remainder no later than 11 December 2009. On 25 May 2009 ASIC removed the ban on covered short selling for financial securities.²⁰⁸ ASIC’s view was that:

¹⁹⁴ Australian Securities and Investments Commission, *Short Selling: Post Implementation Review* (Report 302, September 2012).

¹⁹⁵ ASX Market Rules, *Section 19: Short Selling – Cash Market Products* <http://www.asx.com.au/documents/rules/asx_section_19.pdf>.

¹⁹⁶ Australian Securities Exchange, ‘Abolition of Naked Short Selling’ (Media Release, 19 September 2008).

¹⁹⁷ Australian Securities and Investments Commission, Regulatory Guide 196: *Short Selling* (19 September 2008), [28]-[34]. See also Class Order 08/751 (19 September 2008), cl 4(6).

¹⁹⁸ ASIC, Class Order 08/751 (19 September 2008), cl 4(2),(3),(5). This class order was subsequently revoked by ASIC, Class Order 09/1063 (8 December 2009).

¹⁹⁹ ASIC, Explanatory Statement, Class Order 08/751 (19 September 2008), 1.

²⁰⁰ ASIC, Class Order 08/752 (21 September 2008), 2.

²⁰¹ ASIC, Explanatory Statement, Class Order 08/752 (21 September 2008), 1-2.

²⁰² ASIC, Class Order 08/753 (22 September 2008).

²⁰³ ASIC, Class Order 08/763 (23 September 2008). ASIC, Class Order 08/801 (24 October 2008) amended the provision introduced by this Class Order, by removing the limitation to convertible securities where the number of shares issued on conversion was referable to the volume weighted average price of the shares.

²⁰⁴ ASIC, Class Order 08/764 (23 September 2008) (subsequently amended by ASIC, Class Order 09/1063 (8 December 2009)); ASIC, Class Order 09/1051 (5 January 2009).

²⁰⁵ ASIC, Class Order 09/1051 (5 January 2009).

²⁰⁶ Defined as securities or products that were not a constituent of the S&P/ASX 200 Financials: ASIC, Class Order 08/824 (13 November 2008), cl 4, inserting notional s 1020BD(1A)(a).

²⁰⁷ ASIC, Class Order 08/824 (13 November 2008), cl 4, inserting notional s 1020BD(1A)(a).

²⁰⁸ ASIC, Class Order 09/39 (25 May 2009).

The [Corporations] Act recognises that short selling has a legitimate role in the market. The ban on covered short selling was a temporary measure aimed at limiting the potential for the Australian markets to become disorderly due to short selling during a time of turmoil in the global financial markets. ASIC has now decided that it is not warranted for the ban to continue.²⁰⁹

Subsequently, ASIC issued class orders, exempting various entities and transactions from complying with certain provisions of Part 7.9, including exempting market makers for hedging risks using financial products on the S&P/ASX 200 index as part of its market making activities,²¹⁰ deferred purchase agreements,²¹¹ short positions below a threshold of \$100,000,²¹² and made various other amendments to the short selling regime.²¹³

In September 2012 ASIC released a review of the short selling measures.²¹⁴ It identified the objectives of the measures relating to short selling as being to:

- (a) maintain the orderly functioning of the Australian financial market by implementing measures and appropriate exemptions to regulate short selling;
- (b) enhance confidence and integrity in the Australian financial market by providing greater transparency of short selling for investors and market participants; and
- (c) avoid the extreme share price movements that might have occurred in the Australian market if Australia had maintained policies on short selling that were more permissive than its international peers at that time.²¹⁵

ASIC noted that a study published in 2010²¹⁶ revealed that the ban on short selling significantly reduced trading in Australian financial stocks.²¹⁷ ASIC found that it was difficult to determine the impact of the short selling ban on stock prices in isolation, because other measures played crucial roles in supporting investor confidence.²¹⁸ The review also noted that participants in the securities lending industry suffered as a result of the measures,²¹⁹ and noted the costs incurred by industry in complying with the measures.²²⁰

E. Inquiry into Financial Products and Services in Australia

In 2009 the Commonwealth Parliamentary Joint Committee on Corporations and Financial Services conducted an inquiry into *Financial Products and Services in Australia*, in response to the collapse of financial services providers, especially Opes Prime and Storm Financial.²²¹ The Report noted the distinction between traditional margin lending and Opes Prime's business model, whereby legal and beneficial title was transferred to Opes Prime; and that this was not understood by Opes Prime's investors.²²² It considered the conduct of ANZ and ASIC.²²³

²⁰⁹ ASIC, Explanatory Statement, Class Order 09/39 (25 May 2009), 2.

²¹⁰ ASIC, Class Order 09/774 (18 September 2009). See also ASIC, Class Order 10/288 (21 April 2010).

²¹¹ ASIC, Class Order 10/111 (15 February 2010).

²¹² ASIC, Class Order 10/135 (14 April 2010).

²¹³ ASIC, Class Order 10/464 (17 June 2010); ASIC, Class Order 10/1037 (24 December 2010).

²¹⁴ ASIC, *Short Selling: Post Implementation Review* (Report 302, September 2012).

²¹⁵ ASIC, *Short Selling: Post Implementation Review* (Report 302, September 2012), 9.

²¹⁶ Uwe Helmes, Julie Henker and Thomas Henker, 'The Effect of the Ban on Short Selling on Market Efficiency and Volatility' (Paper presented at the 2011 Financial Management Association, Denver, Colorado, United States, 2011).

²¹⁷ ASIC, *Short Selling: Post Implementation Review* (Report 302, September 2012), 13.

²¹⁸ ASIC, *Short Selling: Post Implementation Review* (Report 302, September 2012), 15, listing 3 measures: (a) the government guarantee on deposits; (b) the government guarantee on offshore debt raisings; and (c) confidence in prudential regulation (APRA) and capital reserves.

²¹⁹ ASIC, *Short Selling: Post Implementation Review* (Report 302, September 2012), 18.

²²⁰ ASIC, *Short Selling: Post Implementation Review* (Report 302, September 2012), 19-20.

²²¹ Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into Financial Products and Services in Australia* (23 November 2009). Storm Financial was a company that operated a margin lending business.

²²² Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into Financial Products and Services in Australia* (23 November 2009), 53-59.

The Committee considered that the product offered by Opes Prime was inappropriate for unsophisticated retail investors, but stopped short of recommending that the provision of such products to retail investors should be banned.²²⁴ Instead, it considered that a range of factors should ensure that such products will not be made available to an inappropriate customer base in the future, namely:

- increased investor awareness and scepticism following recent collapses
- increased caution from banks with regard to engaging in the securities lending business;
- the passage of the *Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009*; and
- increased obligations on financial advisers with regard to the standard of advice they give to their clients.²²⁵

Further, the Committee believed that inadequate disclosure to investors contributed to their lack of understanding of the risks involved with using securities lending for what was in substance margin lending. The Committee recommended improved disclosure to address this problem.²²⁶ This recommendation has been criticised as being unlikely to afford adequate protection to investors.²²⁷

In a study of 16,491 stocks in 30 countries, during the period January 2008 to June 2009, Beber and Pagano found that the bans or constraints on short selling imposed by regulators around the globe in response to the financial crisis were detrimental for market liquidity, especially for stocks with small capitalisation and no listed options, slowed price discovery, especially in bear markets, and failed to support prices.²²⁸ The prohibitions on short sales imposed by regulators during the crisis have been criticised by commentators.²²⁹

V. REGULATION OF SHORT SELLING AND SECURITIES LENDING BY IOSCO, IN EUROPE, THE UNITED KINGDOM AND THE UNITED STATES

This section outlines key aspects of the regulation of securities lending by the International Organization of Securities Commissions (IOSCO), in Europe, the United States and the United Kingdom. This section also briefly outlines the approach taken to short selling and securities lending during the financial crisis.

A. *International Organization of Securities Commissions Recommendations*

After the market turbulence of 2007-8, the Technical Committee of IOSCO established a Task Force on Short Selling (of which ASIC was a member) to suggest principles for a consistent international approach to short selling. In June 2009 the Committee released a report on the regulation of short selling, noting that while short selling served legitimate functions, certain types of short selling may contribute to disorderly markets. It recommended four ‘high level’ principles for the effective regulation of short selling.

²²³ Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into Financial Products and Services in Australia* (23 November 2009), 59-64.

²²⁴ Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into Financial Products and Services in Australia* (23 November 2009), 65.

²²⁵ Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into Financial Products and Services in Australia* (23 November 2009), 65-6.

²²⁶ Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into Financial Products and Services in Australia* (23 November 2009), 67, chs 5 and 6.

²²⁷ Keturah Whitford, ‘No Margin for Error: Regulation of Retail Margin Lending and Securities Lending in Australia in the Wake of Recent Corporate Collapses’ (2011) 22 *Journal of Banking and Finance Law and Practice* 114, 120.

²²⁸ Alessandro Beber & Marco Pagano, ‘Short-Selling Bans Around the World: Evidence from the 2007–09 Crisis’ (2013) 68 *Journal of Finance* 343.

²²⁹ Stephen Kirchner, ‘Shooting the Messenger: The Political Economy of Short Selling’, in Stephen Kirchner (ed), *Shooting the Messenger: The Ban on Short Selling* (CIS Policy Forum 19, Centre for Independent Studies, February 2010) 3–10; Emiliós Avgouleas, ‘A New Framework for the Global Regulation of Short Sales: Why Prohibition Is Inefficient and Disclosure Insufficient’ (2009) 15 *Stanford Journal of Law, Business and Finance* 376.

First, ‘short selling should be subject to appropriate controls to reduce or minimise the potential risks that could affect the orderly and efficient functioning and stability of markets’, including measures such as requiring short sellers to pre-borrow shares before selling them short (‘locate’ requirements) and regulation for strict settlement of failed trades to discourage abusive short selling behaviour.²³⁰ Secondly, ‘short selling should be subject to a reporting regime that provides timely information to the market or to market authorities’, based on the view that disclosure of short positions can assist effective securities regulation and promote orderly markets.²³¹ Thirdly, ‘short selling should be subject to an effective compliance and enforcement system’ in order to instil discipline and minimise settlement failure.²³² Finally, ‘short selling regulations should allow appropriate exceptions for certain types of transactions for efficient market functioning and development’ so as not to stifle legitimate short selling activities such as hedging, market making and arbitrage activities.²³³

The Committee considered that it was not its role to determine whether short selling should be permitted in a particular jurisdiction; this was a matter for the regulators in each jurisdiction to determine. Further, the Committee emphasised that these principles were high level principles only and that regulators should have a significant degree of flexibility and freedom to design the detail of short selling regulation, for example as to the trigger level of reporting and the frequency of reporting.²³⁴

B. Securities Lending in Europe

1. Transparency Directive on Disclosure

On 15 December 2004 the European Union (EU) adopted a directive, known as the Transparency Directive, intended to harmonise the disclosure obligations of entities listed on a stock exchange within the European Union.²³⁵ Article 9, paragraph 1, of the Transparency Directive requires member states to ensure that shareholders whose holding of voting rights in a listed entity reaches, exceeds or falls below a specified threshold notify the issuer of that fact.²³⁶ Article 10 provides that the notification requirement in paragraph 1 of Article 9 also applies where a person is entitled to acquire, dispose of, or exercise ‘voting rights held by a third party under an agreement concluded with that person or entity providing for the temporary transfer for consideration of the voting rights in question’.

According to a review of the operation of the Transparency Directive commissioned in 2009 by the European Commission (the Transparency Directive Assessment Report), Article 9 read with Article 10 of the Transparency Directive requires notification of a stock lending transaction by both the borrower and lender.²³⁷ However, this interpretation has not been adopted uniformly by EU member states.²³⁸ The

²³⁰ Technical Committee of the International Organization of Securities Commissions, *Regulation of Short Selling: Final Report* (June 2009), 7–10.

²³¹ Technical Committee of the International Organization of Securities Commissions, *Regulation of Short Selling: Final Report* (June 2009), 10–16.

²³² Technical Committee of the International Organization of Securities Commissions, *Regulation of Short Selling: Final Report* (June 2009), 16–18.

²³³ Technical Committee of the International Organization of Securities Commissions, *Regulation of Short Selling: Final Report* (June 2009), 18–19.

²³⁴ For discussion see Roberta S Karmel, ‘IOSCO’s Response to the Financial Crisis’ (2011) 37 *Journal of Corporation Law* 849.

²³⁵ *Directive (EC) No 109/2004 of the European Parliament and Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC* [2004] OJ L 390/38 (“Transparency Directive”).

²³⁶ The thresholds are 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75%.

²³⁷ Mazars and Marccus Partners, *Transparency Directive Assessment Report – Prepared for the European Commission Internal Market and Services DG*, Final Report 124 (2009), 120–132.

²³⁸ Committee of European Securities Regulators, *Summary of Responses to Questionnaire on Transposition of the Transparency Directive*, CESR/08-514B (2008), 3 (‘Member States have also taken divergent approaches with respect to securities lending. In some Member States, securities lending triggers a disclosure obligation on the part of both the borrower and the lender, while in others only on the part of the borrower’).

underlying rationale for the Transparency Directive requirement, according to the Transparency Directive Assessment Report, is that disclosure by both borrower and lender was the only way to provide a complete picture of the transaction to the market.²³⁹ These requirements have been supplemented by the *Regulation on Short Selling and Certain Aspects of Credit Default Swaps*, which is discussed in the next section.

2. *EU Regulation on Short Selling*

In March 2012 the European Union adopted a *Regulation on Short Selling and Certain Aspects of Credit Default Swaps*.²⁴⁰ This Regulation, which came into force on 1 November 2012, has direct applicability in member states. The regulation aimed to lay down a common regulatory framework for short selling and credit default swaps, increase the transparency of short positions held by investors in EU securities and reduce settlement risks and other risks associated with naked short selling.²⁴¹ The Regulation requires that where a person has a net short position that reaches or falls below 0.2% of the issued share capital of a company and each 0.1% after that to make disclosure to the relevant competent authority.²⁴² Public disclosure is required for short positions of 0.5% of the issued share capital of a company and each 0.1% after that.²⁴³

Article 12 also requires that, prior to effecting a short sale, a person must have fulfilled one of the following conditions:

- (a) the person has borrowed the share;
- (b) the person has entered into an agreement to borrow the share or has a legally enforceable claim to have a corresponding number of securities of the same class transferred so that settlement can be effected;
- (c) the person has entered into an arrangement with a third party who has confirmed that the share has been located and there is a reasonable expectation that settlement can be effected when it is due.²⁴⁴

This requirement is similar to the US ‘locate’ requirement and the Australian requirement to have ‘a presently exercisable and unconditional right to vest the products in the buyer’.

The Regulation also confers power on Member States to take a range of measures in exceptional circumstances to reduce threats to market stability arising from short selling (and credit default swaps), for example by imposing further disclosure requirements or restricting or prohibiting short selling where the price of a financial instrument has fallen significantly during a trading day.²⁴⁵

C. *Securities Lending in the United Kingdom*

The UK financial regulator, the Financial Services Authority (FSA),²⁴⁶ considered short selling to be a legitimate investment activity.²⁴⁷ Nevertheless it considered that disclosure would serve a useful purpose

²³⁹ Mazars and Marccus Partners, *Transparency Directive Assessment Report*, 124–5.

²⁴⁰ The Regulation followed numerous inquiries and reports: European Securities Markets Expert Group, *Position on Short Selling* (2009); Committee of European Securities Regulators, *Model for a Pan-European Short Selling Disclosure Regime*, Report CESR/10-088 (2010); Committee of European Securities Regulators, *Technical Details of the Pan-European Short Selling Disclosure Regime*, Report CESR/10-453 (2010).

²⁴¹ For critique, see Oskari Juurikkala, ‘Credit Default Swaps and the EU Short Selling Regulation: A Critical Analysis’ (2012) 9 *European Company and Financial Law Review* 307.

²⁴² *Regulation (EU) No 236/2012 of the European Parliament and Council of 14 March 2012 on Short Selling and Certain Aspects of Credit Default Swaps* [2012] OJ L 86/1 (‘*Short Selling Regulation*’), Article 5.

²⁴³ *Short Selling Regulation*, Article 6.

²⁴⁴ *Short Selling Regulation*, Article 12.

²⁴⁵ *Short Selling Regulation*, Articles 18, 19, 20, 22, 23, 24.

²⁴⁶ The FSA has since been split into the Prudential Regulation Authority and the Financial Conduct Authority by the *Financial Services Act 2012* (UK).

²⁴⁷ Financial Services Authority, *Short Selling*, Discussion Paper No 17 (October 2002) 4.

in informing the market.²⁴⁸ In June 2008 it introduced a requirement to disclose short positions of 0.25% of the issued shares in stocks admitted to trading on prescribed markets which are undertaking rights issues.²⁴⁹ During the financial crisis, the FSA took temporary action to respond to market instability. On 18 September 2008 the FSA announced that it would amend the Code of Market Conduct to prohibit the active creation or increase of net short positions in publicly quoted financial companies. Further, the FSA required daily disclosure of all net short positions greater than 0.25% of the ordinary share capital of the relevant companies held at close of trading on the previous working day.²⁵⁰ The ban on short selling was not re-enacted after its expiry, but the FSA continued to require disclosure of short positions.²⁵¹ Subsequently, the EU *Regulation on Short Selling and Certain Aspects of Credit Default Swaps* came into effect, with direct applicability in the UK.²⁵² As a result, the FSA repealed the short selling regime contained in the Financial Stability and Market Confidence Sourcebook.

In 2009 the Panel on Takeovers and Mergers Code Committee undertook a review of the Rules of the Takeover Code to consider the adequacy of the disclosure regime, and consider whether any amendments were required to ‘increase transparency in relation to the positions of, and dealings by, persons involved in takeover offers’.²⁵³ The Panel considered that the treatment of securities borrowing and lending under the Code may be out of step with market reality as it relied on the assumption that lent securities will be recalled by, and redelivered to, the lender prior to the time of an offer-related vote or acceptance decision, which may not always be correct. Further, the Committee noted that it is not considered legitimate for a person to borrow securities with the aim of voting them. However, it did not propose amendments to the Code.²⁵⁴

Finally, it should be noted that any person who conducts a securities borrowing or lending business would generally be carrying on a regulated activity within the meaning of the *Financial Services and Markets Act 2000 (Regulated Activities) Order 2001*, and so would have to be authorised under that Act.²⁵⁵ Securities borrowers and lenders would also be subject to generally applicable market conduct rules and practices.²⁵⁶

D. Securities Lending in the US

1. Regulation of short selling

Section 10(a) of the *Exchange Act 1934* gives the US Securities and Exchange Commission (SEC) power to regulate short selling on national securities exchanges.²⁵⁷ It has used this power to regulate short sales,

²⁴⁸ Financial Services Authority, *More Transparency for the Market Following the FSA’s Short Selling Review*, PN/057/2003 (30 April 2003).

²⁴⁹ Financial Services Authority, *Financial Services Authority Introduces Disclosure Regime for Significant Short Positions in Companies Undertaking Rights Issues*, PN/057/2008 (13 June 2008).

²⁵⁰ Financial Services Authority, *FSA Statement on Short Positions in Financial Stocks*, PN/102/2008 (18 September 2008).

²⁵¹ Financial Services Authority, *Short Selling: Feedback on DP09/1*, Feedback Statement FS09/4 (October 2009).

²⁵² Financial Services Authority, *Short Selling Regulation – Handbook Changes*, Policy Statement No 12/19 (November 2012) 5.

²⁵³ Panel on Takeovers and Mergers Code Committee, *Extending the Code’s Disclosure Regime*, Consultation Paper 2009/1 (8 May 2009), 1.

²⁵⁴ Panel on Takeovers and Mergers Code Committee, *Extending the Code’s Disclosure Regime*, Consultation Paper 2009/1 (8 May 2009), 48ff.

²⁵⁵ Mark C Faulkner, *An Introduction to Securities Lending* (4th ed, Spitalfields, 2007), 13.

²⁵⁶ Mark C Faulkner, *An Introduction to Securities Lending: First Canadian Edition* (Spitalfields, 2006), 61.

²⁵⁷ Section 10(a) provides: ‘It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
(a)(1) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security other than a government security, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors’.

with implications for securities lending.²⁵⁸ In July 2004 the SEC implemented a range of measures regulating short sales, namely several rules collectively known as ‘Regulation SHO’.²⁵⁹ The SEC was concerned to prevent or restrict abusive “naked” short selling, which they defined as ‘selling short without having borrowed the securities to make delivery’.²⁶⁰ Regulation SHO consists of the following rules.²⁶¹ First, rule 200, which defines “short sale” as the ‘sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller’.²⁶² Rule 200 also contains a “marking” requirement, requiring brokers and dealers to mark all orders to sell as “long”, “short” or “short exempt”.²⁶³

Rule 202T was a temporary provision established as a pilot program enabling the SEC to suspend the short sale price test in order to assess its appropriateness. Former rule 10a–1, known as the “uptick rule” or “tick test” provided that, subject to certain exceptions, a listed security could only be sold short at a price above the price at which the immediately preceding sale was effected (“plus tick”), or at the last sale price if it was higher than the last different price (“zero plus tick”).²⁶⁴ Following this pilot, the uptick rule was abolished in 2007, later to be replaced in 2010 by rule 201 which inserted a “short sale related circuit breaker”. If triggered, this circuit breaker imposes a restriction on the prices at which securities may be sold short, which aims to restrict the scale of intra-day price declines for securities.²⁶⁵ The rule prevents a trading centre from effecting a short sale of a covered security where the security’s price decreases by 10% or more from the price as at close of trading on the previous day.²⁶⁶

Rule 203 prohibits brokers and dealers from lending securities that have been sold “long”²⁶⁷ and also prohibits naked short sales by imposing a ‘locate’ requirement.²⁶⁸ Prior to accepting or effecting a short sale in an equity security, brokers and dealers must have borrowed the security or have reasonable grounds to believe that the security can be borrowed to ensure delivery on the due date. Securities on “Easy to Borrow” lists would satisfy the reasonable grounds requirement. The securities must be located and documented prior to the transaction taking place.²⁶⁹ Exceptions to this rule were later removed.²⁷⁰

Regulation SHO has subsequently been amended on several occasions.²⁷¹ The desire to restrict abusive naked short selling is a persistent theme of these amendments.²⁷²

²⁵⁸ Note also *Regulation M*, 17 CFR 242.100, which regulates several aspects of short selling, but is not discussed in this paper.

²⁵⁹ Securities and Exchange Commission, *Short Sales: Final Rule and Notice*, 69 Fed Reg 48008 (28 July 2004). This release also made several minor amendments to Regulation M.

²⁶⁰ Securities and Exchange Commission, *Short Sales: Final Rule and Notice*, 69 Fed Reg 48008, 48009 (28 July 2004).

²⁶¹ *Regulation SHO – Regulation of Short Sales*, 17 CFR 242.200 (28 July 2004).

²⁶² *Regulation SHO*, 17 CFR 242.200, rule 200(a).

²⁶³ *Regulation SHO*, 17 CFR 242.200, rule 200(g).

²⁶⁴ Securities and Exchange Commission, *Amendments to Regulation SHO*, Release No. 34-61595, 75 Fed Reg 11232, 11235 (26 February 2010).

²⁶⁵ Securities and Exchange Commission, *Amendments to Regulation SHO*, Release No. 34-61595, 75 Fed Reg 11232 (26 February 2010).

²⁶⁶ Securities and Exchange Commission, *Amendments to Regulation SHO*, Release No. 34-61595, 75 Fed Reg 11232 (26 February 2010).

²⁶⁷ *Regulation SHO*, 17 CFR 242.200, rule 203(a).

²⁶⁸ *Regulation SHO*, 17 CFR 242.200, rule 203(b).

²⁶⁹ SEC, *Short Sales: Final Rule and Notice*, 69 Fed Reg 48008, 48014 (6 August 2004).

²⁷⁰ Securities and Exchange Commission, *Amendments to Regulation SHO*, Release No. 34-56212, 69 Fed Reg 45544 (7 August 2007); Securities and Exchange Commission, *Amendments to Regulation SHO*, Release No. 34-58775, 73 Fed Reg 61690 (14 October 2008).

²⁷¹ Amendments include Securities and Exchange Commission, *Amendments to Regulation SHO*, Release No. 34-58773, 73 Fed Reg 61706 (14 October 2008); Securities and Exchange Commission, “*Naked*” *Short Selling Antifraud Rule*, Release No. 34-58774, 73 Fed Reg 61666 (14 October 2008); Securities and Exchange Commission, *Amendments to Regulation SHO*, Release No. 34-58775, 73 Fed Reg 61690 (14 October 2008); Securities and Exchange Commission, *Amendments to Regulation SHO*, Release No. 34-60388, 74 Fed Reg 38266 (27 July 2009);

The SEC took a range of actions during the financial crisis in an attempt to stabilise markets.²⁷³ In July 2008 the SEC banned naked short selling of 19 listed financial stocks by providing that no person may effect a short sale in these securities without having made arrangements to borrow or otherwise have the securities available in its inventory.²⁷⁴ The SEC expressed concern with the ‘substantial threat of sudden and excessive fluctuations of securities prices generally’ and took this action in order to protect investors and to maintain fair and orderly securities markets.²⁷⁵

On 18 September 2008 the SEC, concerned about the destabilising effect of short selling, banned short selling of the stocks of 799 named financial sector companies, with exceptions for market makers (the banning order).²⁷⁶ On the same day the SEC, expressing concern regarding ‘sudden and unexplained declines in the prices of securities’, imposed additional disclosure requirements, requiring certain institutional investors²⁷⁷ to make weekly disclosure of all securities sold short.²⁷⁸ Three days later the SEC empowered securities exchanges to select and publish lists of the financial institutions to whom the banning order would apply. Where any financial institution was so named, short selling of that institution’s shares was prohibited.²⁷⁹ A temporary amendment to Regulation SHO was introduced on 14 October 2008, strengthening delivery requirements for equity securities, requiring market participants to close out failures to deliver within one trading day of settlement day by purchasing or borrowing securities.²⁸⁰

2. Disclosure of short sales

The US system of disclosure is ‘bewilderingly complex’.²⁸¹ Reforms have been proposed to simplify the system, including as it applies to securities lending and borrowing.²⁸² In summary, any person who

Securities and Exchange Commission, *Amendments to Regulation SHO*, Release No. 34-61595, 75 Fed Reg 11232 (26 February 2010).

²⁷² Securities and Exchange Commission, *Amendments to Regulation SHO*, Release No. 34-58773, 73 Fed Reg 61706, 61707–61710 (14 October 2008).

²⁷³ See Katherine McGavin, ‘Short Selling in a Financial Crisis: The Regulation of Short Sales in the United Kingdom and the United States’ (2010) 30 *Northwestern Journal of International Law & Business* 201.

²⁷⁴ Securities and Exchange Commission, *Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, Release No. 34-58166, 73 Fed Reg 42379 (15 July 2008).

²⁷⁵ Note also Securities and Exchange Commission, *Amendment to Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, Release No. 34-58190, 73 Fed Reg 42837 (18 July 2008), which amended the 15 July 2008 order.

²⁷⁶ Securities and Exchange Commission, *Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, Release No. 34-58592, 73 Fed Reg 55169 (18 September 2008). This order was extended on 2 October 2008 by Securities and Exchange Commission, *Order Extending Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, Release No. 58723, 73 Fed Reg 58994 (2 October 2008).

²⁷⁷ Namely, institutional investment managers that exercise investment discretion with respect to accounts holding section 13(f) securities having an aggregate fair market value on the last trading day of any month of any calendar year of at least US\$100,000,000.

²⁷⁸ Securities and Exchange Commission, *Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, Release No. 34-58591, 73 Fed Reg 55175 (18 September 2008). This order was extended on 2 October 2008 by Securities and Exchange Commission, *Amendment to Order and Order Extending Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, Release No. 58724, 73 Fed Reg 58987 (2 October 2008).

²⁷⁹ Securities and Exchange Commission, *Amendment to Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, Release No. 34-58611, 73 Fed Reg 55556 (21 September 2008).

²⁸⁰ Securities and Exchange Commission, *Amendments to Regulation SHO*, Release No. 34-58773, 73 Fed Reg 61706 (14 October 2008).

²⁸¹ Henry T C Hu and Bernard Black, ‘The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership’ (2006) 79 *Southern California Law Review* 811, 864.

acquires beneficial ownership of 5% or more of a public company's shares must file a Schedule 13D with the SEC, which includes shares acquired through borrowing of securities;²⁸³ Form 13F, which requires institutional money managers to disclose their holdings at the end of each quarter, does not apply to securities borrowing or lending;²⁸⁴ the insider and 10% shareholder disclosure requirement (s 16) does not require disclosure of borrowed securities;²⁸⁵ and mutual funds, which are required to report quarterly to the SEC on their portfolio holdings, are not required to report securities lending or borrowing.²⁸⁶

VI. CONCLUSION

This paper has examined the legal structure and regulation of securities loans in Australia, Europe, the United Kingdom and United States, including an examination of Australian and international industry standard form contracts.

In Australia (which is the principal focus of this paper), naked short selling is not permitted under s 1020B, which requires sellers of securities and other financial products to have 'a presently exercisable and unconditional right to vest' the securities.²⁸⁷ Covered short selling, where sellers have the right to vest the relevant products, is permitted. Holding legal title to securities would satisfy the condition set out in s 1020B, as would a binding commitment to have securities transferred pursuant to an AMSLA. For covered short sales, reporting of both the number of s 1020B products sold and overall short positions held is required.

Borrowers under securities lending transactions are required to make disclosure of substantial holdings under the substantial holdings disclosure regime of the *Corporations Act* because a loan of securities involves the transfer of legal title to those securities, including all voting and other rights attached to those securities and thus confers a "relevant interest" in those securities on the borrower. In addition, ASIC has issued a Class Order which provides that the lender under a securities lending arrangement is taken to have a relevant interest in the securities, so that the lender will also be required to make disclosure.

Securities lending typically takes place using an AMSLA. The AMSLA stipulates that a loan of securities transfers 'all right, title and interest in and to' those securities, free from any encumbrances or other interests. The AMSLA requires the borrower to "manufacture" to the lender the economic benefits of ownership, such as dividends and the benefits of any corporate action. The borrower must use its best endeavours to ensure that any voting rights attached to borrowed securities are exercised in accordance with the lender's instructions. The borrower must provide collateral to the lender, and ensure that the value of the collateral remains at the agreed level. The borrower is required to redeliver equivalent securities at the termination of the loan. The lender may call for the redelivery of the borrowed securities at any time by giving notice. If an event of default occurs, the parties' delivery and payment obligations are accelerated and set-off against each other.

The intended operation of the AMSLA was upheld by Finkelstein J in the *Beconwood* case, which held that the agreement transferred title to borrowed securities rather than being characterised as a mortgage of the shares in favour of the borrower. The GMSLA is broadly equivalent to the AMSLA, with a key point of difference being that the GMSLA provides that the borrower (whether of borrowed securities or collateral) has no obligation to exercise voting rights in accordance with the instructions of the lender,

²⁸² Henry T C Hu and Bernard Black, 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership' (2006) 79 *Southern California Law Review* 811, 864–886.

²⁸³ Certain types of institutional investors can file a more abbreviated Schedule 13G, which requires reporting of year-end holdings of securities.

²⁸⁴ Henry T C Hu and Bernard Black, 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership' (2006) 79 *Southern California Law Review* 811, 871–872.

²⁸⁵ Henry T C Hu and Bernard Black, 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership' (2006) 79 *Southern California Law Review* 811, 873.

²⁸⁶ Henry T C Hu and Bernard Black, 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership' (2006) 79 *Southern California Law Review* 811, 875.

²⁸⁷ With some exceptions to this basic rule under various exemptions issued by ASIC.

unless the parties have agreed otherwise. Finkelstein J's characterisation of the AMSLA has been upheld in subsequent decisions and the risk that the AMSLA (and equivalent agreements) will be treated as creating a security interest under the PPSA appears to be minimal.