Short Selling and Securities Lending in the Midst of Falling and Volatile Markets

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Introduction

The phenomenon of short selling and the thorny issue of how best to regulate it are as old as stock markets themselves. Laws prohibiting short selling were first enacted in 1610 following a well co-ordinated and highly profitable "bear raid" on the shares of the Dutch East India Company.[1] This antagonism towards short selling was based on two beliefs—both of which are very much in evidence today as securities regulators and stock exchanges are once again confronting claims from many market participants that short selling exacerbates fluctuations in share prices and destroys investor confidence.

Short selling was seen then—and still is by many—as immoral. The short seller's gain appeared to depend upon others suffering a loss, since a short sale of shares would only generate a profit if the shares declined in value.[2] In addition, short positions and the need to cover them were thought to create a powerful incentive for the short seller to "hedge" its risk by manipulating the price downwards—a view that was no doubt fuelled by revelations that the prime instigator of the short sale of Dutch East India Company shares was himself responsible for the major cause of the decline in the price of those shares (through his intrigues to establish a rival French East India company).[3] The short sellers and their supporters countered unsuccessfully with two arguments: that the Dutch East India Company shares were overvalued (and, consequently, their short selling aided price discovery) and, more ingenuously, that the need to cover their naked short sales acted as a brake on the downward movement of the price of the shares.[4] Then, as now, there was little sympathy for these arguments.

The debate on the merits and demerits of short selling has continued into the present. Moreover, because short selling, as it is commonly understood, involves selling shares in the expectation or hope that the shares can be subsequently bought back more cheaply, it is in times of falling stock markets that short selling attracts the attention of regulators, politicians and the investing public. The scrutiny to which short selling is now being subjected, in the midst of the current credit crisis, is hardly surprising, given that stock market downturns have routinely been followed by calls to ban short selling.[5] This time round, regulators have been more receptive to these calls. In all of the three jurisdictions examined in this article—the United Kingdom, the United States and Australia—measures have recently been introduced to ban, in various degrees, short selling.[6]

The short selling debate and the recent bans on short selling have been largely concerned with the perceived negative impact of short selling on share prices. The positive contributions of short selling to price discovery and market liquidity have been discounted by regulators confronted with falling markets, increases in price volatility and the erosion of investor confidence. The differences between

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1. See N. De Marchi and P. Harrison, "Trading 'in the Wind' and with Guile: The Troublesome Matter of the Short Selling of Shares in Seventeenth-Century Holland" in N. De Marchi and M. S. Morgan (eds), *Higgling: Transactors and their Markets in the History of Economics* (Durham: Duke University Press, 1994), pp.49–50; A. Bris, W. N. Goetzmann and N. Zhu, "Efficiency and the Bear: Short Sales and Markets around the World" (2007) 62 *Journal of Finance* 1029, 1029.

2. See Marchi and Harrison, "Trading 'in the Wind'" in *Higgling: Transactors and their Markets in the History of Economics*, 1994, pp.60–61.

3. Marchi and Harrison, "Trading 'in the Wind'" in *Higgling: Transactors and their Markets in the History of Economics*, 1994, p.53. The US Securities and Exchange Commission, the Alabama Securities Commission and the New York State Attorney General's Department have all recently commenced investigations into the alleged spreading of false rumours about financial sector companies following short selling of those companies' shares.

4. Marchi and Harrison, "Trading 'in the Wind'" in *Higgling: Transactors and their Markets in the History of Economics*, 1994, p.54.

5. See W. L. Bishop, "Review of "Short Selling: For and Against" (1932) 22 *American Economic Review* 503.

6. At or about the same time as these restrictions were introduced, restrictions on short selling were also announced in Belgium, Canada (Ontario), France, Germany, Hong Kong SAR, Ireland, Netherlands, Russia, Switzerland and Taiwan.

naked short selling and covered short selling have also been discounted in that environment.

This article discusses the contemporary practice of borrowing shares for the purposes of short sales, as opposed to sourcing those shares in the open market for settlement after the sale order has been executed, and places that discussion in the context of the rapidly evolving regulation in the United Kingdom, the United States and Australia. Australia has been included due, in large part, to the recent case of *Beconwood Securities Pty Ltd v ANZ Banking Group Ltd*[7] which decisively addresses the legal characterisation of loans of shares.

Short selling, information asymmetry and downward pressure on share prices

A major concern with short selling is the lack of transparency in relation to short positions. In the absence of accurate and timely information about short selling volumes,[8] market participants are unable to correctly gauge sentiment about the shares in listed companies and the companies themselves are not fully aware of the actions of market participants. This carries the potential to significantly erode the price discovery benefits claimed for short selling.[9]

Short selling contains information that is useful to market participants and listed companies. Not having that information leads to information asymmetries and can place market participants at a disadvantage relative to the short seller. Unlike investors with long positions that are required to disclose substantial shareholdings in listed companies, an equivalent requirement is not normally imposed on short sellers with substantial short positions in the shares of individual companies.

While useful information about the level of covered short selling can be derived from the volume of shares on loan (assuming that information is generally available to market participants), naked short selling cannot, other than through the imposition of mandatory disclosure requirements, ordinarily be detected.[10] This has significant implications. For investors, selling pressures and the demand for shares can be misrepresented if a bear raid is underway. Also, companies themselves would not have material information about the pressures that their shares are under.

Rights issues and scrip-bids

Short selling can have a significant negative impact on corporate actions, irrespective of claims that the shares of the companies concerned were overvalued. This can arise in two important areas.

Short selling, in the context of a rights issue, can, by depressing the price of the issuer's shares relative to the price at which new shares are being offered, hinder the issuer's ability to raise funds. The UK Financial Services Authority (FSA) has recently moved to address what it views as the potential inherent in this instance of short selling for manipulative conduct, by requiring the disclosure of significant short positions during rights issues. Short positions that represent 0.25 per cent of the issued share capital of the company must be disclosed to the market.[11] This is a more stringent requirement than that which applies to long positions during a rights issue. It also represents a major departure from the typical approach of securities regulators which is to penalise the persons involved in manipulative conduct as distinct from imposing constraints upon conduct that of itself is not manipulative.[12]

Similarly, short selling, during a takeover bid of the bidder's shares can, by depressing the price of those shares, disrupt the bidder's ability to implement a scrip-bid for the target, as a fall in the price for the bidder's shares makes a fixed exchange scrip-bid less attractive for the shareholders of both the bidder and the target. The short selling of the bidder's shares in conjunction with a long position in the target's shares is a common arbitrage strategy employed by hedge funds.[13] However, while the hedge fund may be indifferent to absolute price variations in the prices for the bidder's and target's shares (as it is seeking to profit from changes in the spread between the two companies' share prices), the pursuit of this strategy by hedge funds is often the main cause of a fall in the price of the bidder's shares following the announcement of the takeover bid.[14]

7. *Beconwood Securities Pty Ltd v ANZ Banking Group Ltd* [2008] F.C.A. 594 (Federal Court of Australia, May 2, 2008).

8. Of the three markets covered in this article, only Australia provides for general disclosure of short positions and then only of aggregate open short positions for each class of an issuer's shares that a broker has placed sell orders for: Australian Securities Exchange Market Rules rule 19.6.1. In the UK, disclosure is restricted to short sales over significant portions of a company's share capital during rights issues. The other disclosure measures introduced recently in the UK and US, which are discussed below, are temporary in nature.

9. See Bris, Goetzmann and Zhu, "Efficiency and the Bear" (2007) 62 *Journal of Finance* 1029, 1034–1035.

10. The level of securities lending activity in a market is not a perfect proxy for the level of short sales in that market, as, apart from short sales, securities are borrowed for hedging purposes, to gain access to voting rights, to be the owner of securities for dividends, and to raise secured finance: see D. Duffie, N. Garleanu and L. H. Pedersen, "Securities Lending, Shorting, and Pricing" (2002) 66 *Journal of Financial Economics* 307, 313.

11. See Financial Services Authority (FSA), "Short Selling Instrument 2008" (News Release, June 12, 2008), available at *http://www.fsa.gov.uk/pubs/press/PN0572008_instrument.pdf* [Accessed October 27, 2008].

12. See "Short Selling: Nasty, Brutish and Short", *The Economist*, June 19, 2008.

13. See F. S. Lhabitant, *Handbook of Hedge Funds* (Chichester: John Wiley & Sons, 2006), pp.250–252.

14. See M. Mitchell, T. Pulvino and E. Stafford, "Price Pressure around Mergers" (2004) 59(1) *Journal of Finance* 31, 33 and 37.

Naked short selling

The two types of short selling—naked and covered short selling—both involve the sale of shares with the aim of repurchasing the shares at a lower price. In essence, short selling sees the investor profiting from a fall in the price of the shares.

Naked short selling involves the sale of shares to which the seller does not have title. In contrast to covered short sales, the short seller does not borrow or arrange to borrow shares at the time of sale. The shares must therefore be sourced by the short seller in the open market or borrowed in time for the sale to be settled.

The major concern with naked short sales is that, since the short seller neither holds nor has entered into a firm commitment to borrow the shares being sold, the sale orders that the seller can place are not restricted by the actual number of shares that have been issued or are actually available for purchase or borrowing. Instead, naked short sales can arguably produce an theoretically unlimited number of shares, with short sellers able to place unlimited sale orders with brokers, in the hope of locating shares to settle or even with the deliberate aim of depressing the price of the shares. Naked short selling can create considerable, and potentially deceptive, downward pressure on share prices, as well as increasing the volatility of share prices, destroying investor confidence in companies and impeding the ability of companies to raise funds.[15]

The three jurisdictions mentioned earlier, the United Kingdom, the United States and Australia, have historically adopted different approaches towards naked short selling. All three jurisdictions contain extensive rules dealing with manipulative trading, but those rules are not specifically directed at naked short selling.[16]

In the United Kingdom, naked short selling, to the extent that it does not infringe the rules addressing manipulative trading, has been essentially unregulated. In Australia, naked short selling has been addressed (again, outside of the rules relating to manipulative trading), mainly by attempting to ensure that only relatively liquid shares can be the subject of naked short sales (so, in principle, there will be less prospect of a settlement failure). In marked contrast, the United States views naked short selling as inherently abusive and has sought to restrict it despite there being in place an extensive regulatory regime that deals with manipulative trading. The United States' hostility towards naked short selling has, in recent times, gained considerable traction with regulators in the United Kingdom and Australia, and that attitude has also recently permeated the measures restricting covered short selling that have recently introduced in all three jurisdictions, particularly in the case of Australia.[17]

United Kingdom

The United Kingdom has, in general, not restricted naked short selling but has, instead, left the matter of the short seller being unable or choosing not to settle the sale to the buy-in rules of the London Stock Exchange (LSE). Those rules give the buyer of shares the right to have the LSE purchase the necessary shares, on behalf of the short seller, for delivery to the buyer.[18] The short seller is, in this situation, liable to pay the LSE a nominal penalty, a dealing charge based on the transaction consideration and a further charge to cover the LSE's cost of funding the buy-in.[19]

Also, short sales, whether naked or covered, have until very recently, been mainly free of disclosure requirements; the only disclosure requirement (and this too was only introduced recently) has been in relation to short sales over significant portions of a company's shares during a rights issue.[20]

The environment in the United Kingdom for short selling has now dramatically changed. On September 18, 2008, the FSA, in a co-ordinated approach with the US Securities and Exchange Commission (SEC), introduced a temporary ban on all short sales (naked and covered) in the shares of 32 financial sector companies.[21] That ban runs from September 19

15. See J. W. Christian, R. Shapiro and J. P. Whalen, "Naked Short Selling: How Exposed are Investors?" (2006) 43 *Houston Law Review* 1033, 1059–1060; Securities and Exchange Commission, (SEC). *Amendments to Regulation SHO; Final Rule and Proposed Rule*. 2007 72(156) *Federal Register* 45544, pp.45544–45545 (available at *http://www.sec.gov/rules/final/2007/34-56212fr.pdf* [Accessed October 27, 2008]).

16. These rules are generally framed as prohibitions on trading that creates a false or misleading impression as to the supply of, or demand for, shares or as to the price for shares. Interestingly, one of the justifications presented for removing the tick test in the US was the adequacy of these rules: see SEC, *Regulation SHO and Rule 10a-1*. 2007 72(127) *Federal Register* 36348, p.36352 (available at *http://www.sec.gov/rules/final/2007/34-55970fr.pdf* [Accessed October 27, 2008]).

17. In imposing these constraints on short selling, the regulators in all three markets have given short shift to the ample evidence that limiting the ability of market participants to engage in short selling leads to over-valuation of shares and also means that share prices adjust more slowly to unfavourable information: see E. C. Chang, J. W. Cheng and Y. Yu, "Short-Sales Constraints and Price Discovery: Evidence from the Hong Kong Market" (2007) 62 *Journal of Finance* 2097, 2097–2099 and 2119.

18. Rules of the London Stock Exchange rule 5140.

19. Rules of the London Stock Exchange rule 5151.

20. See FSA, "Short Selling Instrument 2008" (News Release, June 12, 2008).

21. See FSA, "Short Selling (No 2) Instrument 2008" (September 18, 2008) (as amended by "Short Selling (No 3) Instrument 2008" (September 23, 2008) (available at *http://www.fsa.gov.uk/pubs/handbook/instrument2_2008_50.pdf* [Accessed October 27, 2008] and *http://www.fsa.gov.uk/pubs/other/short_selling_instrument.pdf* [Accessed October 27, 2008] respectively). The companies (now 34) are listed in "FSA Amended List, as at 30 September 2008, of UK Incorporated Banks and Insurers in connection with Short Selling (No 2) Instrument 2008". (available at *http://www.fsa.gov.uk/pubs/other/Shortselling_list.pdf*) [Accessed November 24, 2008]. There are exceptions for

to January 16, 2010 (unless further extended). In addition, every person that, at the start of this ban, held a short position relating to 0.25 per cent or more of the issued share capital of one of these financial sector companies, must disclose that position to the market for each day, while the ban remains in force, that that position is held.

Australia

In Australia, the risk that a short seller will fail to settle the sale has been dealt with by ensuring that only sufficiently liquid shares can be sold short.

Only shares that have been approved by the Australian Securities Exchange (ASX) can be the subject of a naked short sale.[22] The criteria for approval comprise the number of shares on issue, the market capitalisation of the shares and whether the shares are, in the ASX's opinion, sufficiently liquid.[23] Until recently, the shares of over 400 issuers were approved by the ASX for short sales.[24] On September 19, 2008, the ASX, following discussions with the Australian Securities and Investments Commission (ASIC), announced that it had removed all shares from this list, effectively banning naked short sales in Australia.[25]

It is intended that this ban will be reviewed when new legislation dealing with short selling is introduced in Australia.[26] However, the draft Bill released by the Australian Treasury on September 23, 2008 deals only with the disclosure requirements for covered short selling and makes no mention of naked short selling. It is conceivable, in view of the current hostility in Australia towards short selling in general, that this ban will be made permanent.

Apart from this ban on naked short selling, naked short sales of the shares of a takeover target have been prohibited during a takeover bid.[27] This is, again, a liquidity issue since it is considered that, as shares are sold into the takeover bid by the target's shareholders, the consequent decrease in the supply of shares increases the risk of settlement failure. Covered short sales can still be effected during a takeover, as could naked short sales of the bidder's shares.

There has also been an attempt in Australia to increase the transparency of short selling. A short seller must inform its broker that the sale order that it is placing is for a short sale and the broker must, in turn, disclose to the market its net short position for the different shares that it has executed such orders for.[28] There is, however, no requirement for individual short positions to be disclosed to the market. The transparency gains from these disclosure requirements have proven, in practice, to be doubtful. Naked short sales are clearly subject to these requirements but it is highly unlikely that they have captured covered short sales.

United States

In contrast to the United Kingdom and Australia, the United States has adopted a much more hostile attitude towards naked short selling with far greater weight being given there to the risk that a short seller may intentionally choose to cause a naked short sale to fail to settle, in order to manipulate the price of the shares downwards or simply because it is cheaper for the seller to meet the buy-in costs of failing to settle than the costs of borrowing the shares.[29]

The centrepiece of the US anti-naked short selling regulation is the SEC's Regulation SHO. That regulation requires brokers to ensure that—if at the time of sale order being placed with the broker the short seller has not borrowed the shares or arranged to borrow the shares—they must have "reasonable grounds to believe that the [shares] can be borrowed" in time for settlement before the sale order from the short seller can be accepted.[30] There is, however, no requirement to disclose the level of short sales to the market.

The reasonable grounds mentioned above can include an assurance from the short seller that it has

market making activities, as well as arbitrage and hedging transactions (where a post-ban short sale is offset with a long position in the same company). However, merger arbitrage transactions (which involve short and long positions in respect of different companies) where one or both of the merger parties is a financial sector company are subject to the ban. The ban, in contrast to those imposed in the US and Australia, also applies to short positions in the shares of financial sector companies implemented in the over-the-counter markets, thus capturing transactions ranging from retail contracts for differences and spread bets to wholesale equity swaps: see FSA, "Short Selling (No 4) Instrument 2008. FAQs Version 4 - Issued 31 October 2008" (available at *http://www.fsa.gov.uk/pubs/other/Short_selling_FAQs_V4.pdf*) [Accessed November 24, 2008].

22. Corporations Act 2001 (Commonwealth of Australia) s.1020b(4)(e); Australian Securities Exchange (ASX) Market Rules rules 19.1.4 and 19.3.1.

23. ASX Market Rules rule 19.7.1.

24. See *http://www.asx.com.au/data/shortsell.txt* [Accessed October 27, 2008]. This list is current only to September 18, 2008.

25. See ASX, "Abolition of Naked Short Selling" (Media Release, (September 19, 2008), available at *http://www.asx.com.au/about/pdf/mr_190908_abolition_naked_short_selling.pdf* [Accessed October 27, 2008]. Naked short selling remains permitted in a narrow range of situations (including for the purposes of arbitrage transactions): Corporations Act 2001 s.1020B(4)(a) to (c).

26. See ASX, "Abolition of Naked Short Selling" (2008).

27. ASX Market Rules rules 19.5.3 and 20.7.1.

28. Corporations Act 2001 s.1020B(5); ASX Market Rules rule 19.6.1(a).

29. See SEC, *Naked Short Selling Anti-Fraud Rule; Proposed Rule*. 2008 73(56) *Federal Register* 15376, pp.15376–15378 and 15381–15382 (available at *http://www.sec.gov/rules/proposed/2008/34-57511.pdf* [Accessed October 27, 2008]); R. B. Evans, C. C. Geczy, D. K. Musto and A. V. Reed, "Failure is an Option: Impediments to Short Selling and Option Prices" (2008) *Review of Financial Studies Advance Access*, 1–2.

30. SEC, Regulation SHO rule 203(b)(1)(ii).

identified a source of borrowable shares, provided that it is reasonable for the broker to rely on that assurance.[31] The SEC has also indicated a willingness to accept blanket assurances in the form of ‘‘Easy to Borrow’’ lists of shares with inclusion on such a list being an indicator of liquidity.[32] A short seller can thus satisfy the reasonable grounds test without having to supply evidence of a firm arrangement to borrow the shares ahead of settlement.[33]

The SEC has recently acknowledged that this test is open to abuse, with some short sellers deceiving their brokers about having located sufficient borrowable shares and with others simply misrepresenting their short sale orders as conventional sale orders.[34] To combat this, the SEC has introduced an offence specifically directed at short sellers that mislead their brokers about their intention or ability to deliver shares for settlement.[35] A short seller will be treated as having failed to meet the reasonable grounds requirement (and will therefore be guilty of an offence) if it represents to the broker that it has located a source of sufficient borrowable shares but, in fact, has never contacted that source or has contacted that source and been informed that sufficient shares would not be available in time for settlement.[36] It, however, still remains possible for a short seller to satisfy the reasonable grounds test through the use of ‘‘Easy to Borrow’’ lists.

The flaws in the reasonable grounds test have prompted the SEC to take two further measures to address settlement failure. First, in relation to financial sector shares, the SEC has taken more drastic action to combat the possibility that naked short selling might be exacerbating the crisis of confidence in the US financial sector. On July 15, 2008, the SEC issued an emergency order which had the effect of prohibiting naked short selling of the shares of 19 financial sector companies from July 21 to July 29 (later extended to August 12).[37] The reasonable grounds test was basically disapplied to the shares of these companies and, accordingly, any person wishing to short those shares had to borrow or arrange to borrow the shares before an order for the short sale could be executed. While Regulation SHO permits naked short selling provided that the reasonable grounds test has been met, the arrangement to borrow stipulated in the emergency order:

> ‘‘. . . means a bona fide agreement to borrow the [shares] such that the [shares] being borrowed [are] set aside at the time of the arrangement solely for the person requesting the [shares]’’.[38]

The SEC has now moved far beyond the terms of this emergency order. On September 19, 2008, it announced a fresh measure to ban all short selling—whether naked or covered—in the shares of 799 financial sector companies.[39] This ban has been driven by the SEC’s view that short selling in general, not just naked short selling, has been responsible for the recent ‘‘sudden and excessive fluctuations’’ of the share prices of financial sector companies. The ban, like its predecessor, is temporary and ended on

31. See SEC, *Short Sales; Final Rule and Notice*. 2004 69(151) *Federal Register* 48008, p.48014 (available at *http://www.sec.gov/rules/final/34-50103.pdf* [Accessed October 27, 2008]). The SEC has stated that it would not be reasonable for a broker to rely on such an assurance where the broker knows or should reasonably know that the short seller’s assurances have in past led to settlement failures.

32. SEC, *Short Sales; Final Rule and Notice*. 2004 69(151) *Federal Register* 48008, p.48014.

33. The requirement in Regulation SHO (rule 203(b)(1)(iii)) that the broker document compliance with the reasonable grounds test is not a requirement that the broker must obtain verifiable evidence of compliance by the short seller but merely that the broker document that it ‘‘is relying on [the short seller’s] assurance and that the [broker] has reasonable grounds to believe that the [short seller] has borrowed or arranged to borrow’’ the shares: see the SEC’s comments at *http://www.sec.gov/divisions/marketreg/emordershortsalesfaq.htm* [Accessed October 27, 2008].

34. SEC, *Naked Short Selling Anti-Fraud Rule; Proposed Rule*. 2008 73(56) *Federal Register* 15376, p.15377. See also Christian, Shapiro and Whalen, ‘‘Naked Short Selling: How Exposed are Investors?’’ (2006) 43 *Houston Law Review* 1033, 1071.

35. See SEC, *Emergency Order pursuant to section 12(k)(2) of the Securities Exchange Act of 1934 taking Temporary Action to Respond to Market Developments*. 2008 Release No.58572 (available at *http://www.sec.gov/rules/other/2008/34-58572.pdf* [Accessed October 27, 2008]). This offence was made permanent in SEC, ‘‘‘Naked’ Short Selling Antifraud Rule’’ 73(202) *Federal Register* 61666.

36. See SEC, *Naked Short Selling Anti-Fraud Rule; Proposed Rule*. 2008 73(56) *Federal Register* 15376, pp.15378–15379.

37. See SEC, *Emergency Order pursuant to section 12(k)(2) of the Securities Exchange Act of 1934 taking Temporary Action to Respond to Market Developments*. 2008 Release No.58166 (as extended in Release No.58248, July 29, 2008)(available at *http://www.sec.gov/rules/other/2008/34-58166.pdf* [Accessed October 27, 2008] and *http://www.sec.gov/rules/other/2008/34-58248.pdf* [Accessed October 27, 2008] respectively). The 19 companies are listed in Appendix A of these releases.

38. See the SEC’s comments at *http://www.sec.gov/divisions/marketreg/emordershortsalesfaq.htm* [Accessed October 27, 2008]. (as amended by Release No.58723, October 2, 2008 (available at *http://www.sec.gov/rules/other/2008/34-58723.pdf*) [Accessed November 24, 2008]).

39. See SEC, *Emergency Order pursuant to section 12(k)(2) of the Securities Exchange Act of 1934 taking Temporary Action to Respond to Market Developments*. 2008 Release No.58592 (available at *http://www.sec.gov/rules/other/2008/34-58592.pdf* [Accessed October 27, 2008]). The companies to which this order applies are listed in Appendix A. The SEC subsequently issued an amendment to this order authorising each of the US exchanges (e.g. the American Stock Exchange, NASDAQ and the New York Stock Exchange) to add financial sector companies whose shares are traded on the exchange but which are not included in the list of 799 companies. In addition, companies covered by the initial SEC list or added by an exchange can opt out of having their shares subjected to the prohibition on short selling: see SEC, *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*. 2008 Release No.58611) (available at *http://www.sec.gov/rules/other/2008/34-58611.pdf* [Accessed October 27, 2008]). The same amendment also introduces a number of exceptions to the ban, including, in line with the UK ban, short sales in connection with market making activities unless the market maker knows the transaction will create or increase a net short position in shares.

October 17, 2008, but it can be extended and there is also the possibility that the SEC could apply the ban to the shares of other companies (given that the original ban applied only to 19 companies).

Secondly, the SEC has introduced a temporary penalty for settlement failures this penalty expires July 31, 2009 unless further extended).[40] Where, under a short sale, shares are not delivered in time for settlement, the broker must either borrow or purchase the required shares before trading commences on the next day. If the broker fails to do this, it will be prohibited from executing further short sales for any customer in those shares unless the shares have been pre-borrowed or the customer has entered into a binding arrangement to borrow the shares. Its customers will no longer have the benefit of the reasonable grounds test.

In addition, the latest emergency order has been coupled with a new disclosure requirement for fund managers, and applies to all short sales. Fund managers with US $100 million or more under management must now disclose to the market, on a weekly basis, the value and size of their aggregate short sales of individual shares (where the short position accounts for 0.25 per cent or more of the issued share capital of a company or the shares of the company that have been sold short have a market value of US $1 million or more).[41] This disclosure requirement is also temporary, and ended on October 17, 2008.

Covered short selling

Covered short sales involve selling shares that have been ''borrowed'' under a securities loan, with the objective of buying back the shares at a lower price for return to the lender. Both limbs of this so-called loan—under which shares are sourced by the seller/borrower and later returned to the lender—involve the transfer of title to shares. Securities loans make possible covered short sales, but the focus of what regulation there is on covered short sales has been on the short sale itself rather than on the means by which the short sale has been ''funded''.[42] This could, however, change in the near future with regulators viewing the disclosure of securities lending data as complementing the measures recently introduced to improve the transparency of short selling.[43] As will be seen later, it is likely that this skewed focus has, in the case of Australia, resulted in a regulatory framework for covered short sales that is fundamentally flawed.

United Kingdom and United States

Of the United Kingdom, United States and Australia, only the last has attempted to regulated covered short sales in any detail. In the United Kingdom, the buy-in rules are unlikely to be triggered by covered short sales while, in the United States, Regulation SHO contains a blanket permission for covered short sales.[44] However, as discussed earlier, short sales, including covered short sales, of the shares of financial sector companies have been temporarily banned in the United Kingdom and the United States, and that ban has been coupled with new (also temporary) disclosure requirements that apply to all short sales.

Australia

In Australia, the circumstances in which short sales may be effected have been framed as exceptions to the requirement in the Australian companies legislation that a seller of shares must have (or reasonably believe

40. See SEC, *Emergency Order pursuant to section 12(k)(2) of the Securities Exchange Act of 1934 taking Temporary Action to Respond to Market Developments*. 2008 Release No.58572. (as amended by Release No.58773, October 14, 2008) (available at *http://www.sec.gov/rules/other/2008/34-58572.pdf* [Accessed November 24, 2008] and *http://www.sec.gov/rules/final/2008/34-58773.pdf* [Accessed November 24, 2008] respectively).

41. See SEC, *Emergency Order pursuant to section 12(k)(2) of the Securities Exchange Act of 1934 taking Temporary Action to Respond to Market Developments.* 2008 Release No.58591 and Release No.58724, October 2, 2008 (as amended by Release No.58591A, September 21, 2008) (available at *http://www.sec.gov/rules/other/2008/34-58591.pdf* [Accessed October 27, 2008] and *http://www.sec.gov/rules/other/2008/34-58591a.pdf* [Accessed October 27, 2008] and *http://www.sec.gov/rules/other/2008/34-58724.pdf* [Accessed November 24, 2008] respectively).

42. Securities loans are not, however, used exclusively to fund covered short sales.

43. This is one of the options for improving the transparency of covered short selling proposed by the Australian Treasury: see Australian Treasury. *Exposure Draft of the Corporations Amendment (Short Selling) Bill 2008: Commentary*. 2008, paras 29, 40–41 and 46 (available at *http://www.treasury.gov.au/documents/1418/PDF/Exposure_Draft_Corporations_Amendment_(Short_Selling)_Bill_2008_Commentary.pdf* [Accessed October 27, 2008]). The Australian Reserve Bank has also recently announced its support for the disclosure of securities lending data to the market: see Reserve Bank of Australia, ''Financial Stability Review'' (September 25, 2008), p.63 and Reserve Bank of Australia, ''Consultation on Variation of Financial Stability Standard for Securities Settlement Facilities: Disclosure of Equities Securities Lending'' (October 24, 2008). None of the UK, US and Australia has in place disclosure requirements specifically directed at securities lending. However, a securities loan is capable of triggering the disclosure obligations that apply in those jurisdictions to substantial shareholdings on the part of both the borrower (as the party that has acquired the shares lent) and the lender (due to its right of recall).

44. Regulation SHO rule 203(b)(1)(i). In 2007, the SEC eliminated the tick test for short sales: SEC, *Regulation SHO and Rule 10a-1*. 2007 72(127) *Federal Register* 36348 (available at *http://www.sec.gov/rules/final/2007/34-55970fr.pdf* [Accessed October 27, 2008]). There is no tick test in the UK for short sales (and the tick test that is meant to apply to covered sales in Australia can be avoided by market participants).

that it has), at the time of sale, "a presently exercisable and unconditional right to vest" those shares in the buyer.[45] Naked short sales clearly do not satisfy this requirement—and naked short sales can therefore only be legally undertaken by bringing the sale within the terms of one of the above exceptions.[46]

The exception that is designed to capture covered short sales requires that the short seller have in place arrangements to ensure that the settlement of the sale can be effected within three business days of the short sale order being executed and that the sale be disclosed to the market.[47] A tick test is also imposed.[48] This exception, unlike the one that applies to naked short sales, does not restrict short sales to shares that have been approved by the ASX for short sale.

Covered short sales are subject to the same disclosure requirements as naked short sales in Australia. Again, there is no requirement for individual short positions to be disclosed to the market.[49] Nor, in terms of the information provided to the market, is any distinction drawn between naked short sales and covered short sales. However, due to the scope for market participants to characterise covered short sales in a manner that exempts those short sales from the disclosure and other requirements, it is highly likely that historical volumes of short selling activity have related mainly to naked short sales and therefore have understated considerably the level of short sales in the Australian market.

A short seller that has entered into a securities loan for the purpose of borrowing shares which can then be sold short arguably complies with the above statutory requirement (and does not therefore need to comply with the exception).[50] A short seller that has, at or before the time of the sale of the shares, taken delivery of the shares under a securities loan is in the same position as a seller of shares under a conventional sale, with both parties holding title to the shares for which sale orders have been placed.[51] This characterisation of a covered short sale as legally no different to a conventional sale of securities has meant that covered short sales could be effected in Australia free of the restrictions that are supposed to apply to such sales.[52]

This definitional ambiguity surrounding covered short sales has been recognised by ASIC which, on September 19, 2008, issued an order modifying how covered short sales are treated by the Australian companies' legislation.[53] That Order explicitly subjects covered short sales to the disclosure requirements mentioned above (namely, the short seller must inform its broker that it is placing an order with the broker for a covered short sale and the broker must disclose to the market its net short position for the different shares that it has executed such orders for).[54]

This new approach—which involved rendering the exception for naked short selling inoperative and making clear that all covered short sales were to be treated as if they fell within the statutory exception mentioned above—lasted all of two days. ASIC appears to have been concerned that the temporary bans on financial sector short selling in the United Kingdom and United States would create an incentive for short sellers to engage in regulatory arbitrage by migrating their activity to the Australian market.[55] ASIC issued a further order banning all covered short selling (except in relation to market making activity) in the Australian market for a period of 30 days from September 22, 2008.[56] This went far beyond the temporary bans introduced in the United Kingdom and the United States and also contradicted ASIC's earlier position on covered short selling. It is possible that this represented an over-reaction on ASIC's part (as the financial sector companies detailed in the United Kingdom and the United States bans are not listed in Australia and Australian financial sector companies have been relatively insulated from the sub-prime and securitisation-related problems that have afflicted their United Kingdom and United

45. Corporations Act 2001 s.1020B(2).
46. The relevant exception is contained in Corporations Act 2001 s.1020B(4)(e) and, as noted above, this exception has been nullified through the removal of all shares from the ASX's approved list.
47. Corporations Act 2001 s.1020B(4)(d).
48. Corporations Act 2001 s.1020B(4)(d)(iii).
49. Corporations Act 2001 s.1020B(5); ASX Market Rules rule 19.6.1(b).
50. This interpretation is supported by the Australian Securities and Investments Commission's (ASIC) comments on s.1020B(2): see ASIC, "Short Selling: Overview of s 1020B" (Regulatory Guide 196, 2008), paras 9–10. The various ASIC documents mentioned in this fn. and the following fnn. are available at *http://www.asic.gov.au/asic/asic.nsf/byheadline/Short+selling?openDocument* [Accessed October 27, 2008].
51. The position of a short seller that has entered into a securities loan but has not, at the time of placing the sale order, taken delivery of the shares is less clear-cut. ASIC has taken the view that a written confirmation from the lender to the short seller that it will deliver the shares to the latter for settlement is sufficient for the purpose of Corporations Act 2001 s.1020B(2) but anything less than a firm commitment of this type may place the short seller in breach of Corporation Act 2001 s.1020B(2): ASIC, "Short Selling: Overview of s 1020B" (Regulatory Guide 196, 2008), paras 11–13.
52. The same loophole is present in the ASX Market Rules due to the definition of short sales in rule 2.10 as sales where at the time of sale the seller does not have "a presently exercisable and unconditional right to vest" the shares in the buyer. Accordingly, a seller of borrowed shares does not need to comply with the disclosure requirements contained in the Market Rules (ASX Market Rules rule 19.6.1(a)).
53. See ASIC, Class Order 08/751 (September 19, 2008).
54. This Order makes no mention of the other requirements imposed by the Australian companies' legislation on covered short sales. ASIC appears to take the view that notwithstanding its own analysis of covered short sales (involving pre-delivered shares or firm commitments to deliver shares for settlement) in the context of s.1020B(2) that the exception in s.1020B(4)(e)—and, in particular, the tick test contained there—applies to such covered short sales: ASIC, "Short Selling: Overview of s 1020B" (Regulatory Guide 196, 2008), Table 1.
55. See ASIC, "Covered Short Selling not Permitted", (Media Release, September 21, 2008).
56. See ASIC, Class Order 08/752 (September 21, 2008).

States counterparts). Nonetheless, the removal of all shares from the ASX's approved list and ASIC's latest order on covered short selling would have had the effect of temporarily banning all short selling in Australia.

The view that ASIC's blanket ban on covered short selling was perhaps an over-reaction and was too quickly implemented, found support when, a day after the ban came into force, ASIC announced a series of major exceptions to the ban.[57] These exceptions were designed to bring ASIC's ban more or less in line with the market making and other exceptions recognised in the United Kingdom and the United States (although the ASIC ban applied generally to all shares).[58] ASIC has since stated that the 30-day banning period (as extended to November 18, 2008) was only to apply to non-financial sector shares and that the ban on covered short sales of financial sector shares will continue until January 27, 2009.

Draft legislation dealing with short sales was released by the Australian Treasury on the same day as ASIC's modification of its covered short selling ban.[59] This legislation applies only to covered short sales and makes it clear that short sellers must disclose to their brokers that the sale orders being placed are for short sales.[60] Non-compliance will be an offence. This is a further indication, if any was needed, that the existing disclosure regime has proved ineffective in relation to increasing the transparency of short selling activities in the Australian market.[61] On the other hand, it is a welcome indication of the desire to re-allow covered short selling.[62]

57. See ASIC, ''Update on ASIC's Response to Short Selling: 23 September 2008 Release'' and Class Order 08/764 (September 23, 2008).

58. See ASIC, ''ASIC Extends Ban on Covered Short Selling'' (October 21, 2008) and ASIC, ''ASIC Lifts Ban on Covered Short Selling for Non-Financial Securities'' (November 13, 2008).

59. Corporations Amendment (Short Selling) Bill 2008 (exposure draft, September 23, 2008) (available at *http://www.treasury.gov.au/documents/1418/PDF/Corporations_Amendment_(Short_Selling)_Bill_2008.pdf* [Accessed October 27, 2008]). This Bill was introduced into the Australian Parliament on November 13, 2008.

60. Draft s.1020BA(3). The draft legislation also requires brokers to disclose covered short sales to the market: draft s.1020BB(2). This gives legislative force to the disclosure requirements contained in the ASX Market Rules (which were also being avoided due to the characterisation of covered short sales as being no different to conventional sales) and makes non-compliance by a broker an offence.

61. The fact that covered short sales could be characterised as falling outside s.1020B(4)(e) is acknowledged by draft s.1020BA(1)(d). See also Australian Treasury. *Exposure Draft of the Corporations Amendment (Short Selling) Bill 2008: Commentary*. 2008, paras 8–9 and 19.

62. Australian Treasury. *Exposure Draft of the Corporations Amendment (Short Selling) Bill 2008: Commentary*. 2008, para.24. The detail of the disclosure requirements is being left to regulations (a draft of which is yet to be released). One of the options being considered is a requirement for the mandatory disclosure of securities lending activity in shares.

Securities loans

A securities loan is an arrangement where shares (or other securities) are transferred from one party (the lender) to the other (the borrower), in exchange for the payment by the borrower of a fee to the lender and the borrower agreeing to return equivalent shares.[63]

Securities loans, in the wholesale market, are generally arranged through intermediaries such as custodian banks, brokers, specialist lending intermediaries or prime brokers which are able to pool shares made available for lending by their own clients (such as pension funds and insurance companies). This carries the advantages of scale and liquidity for borrowers. Also, the clients of these intermediaries share in the benefit of the fees generated by securities lending through, for instance, lower custody fees.

Despite the use of the term ''loan''—which signifies that the transfer of shares is essentially temporary with the borrower being obligated to ''repay'' the loan by the transfer back of equivalent shares—each of the two transfer limbs of the transaction is a sale of shares. The borrower acquires title to the shares being borrowed and, like any purchaser of shares, enjoys the full legal incidents of ownership; the borrower can sell the shares (as is the case when a covered short sale is being executed), ''on-lend'' the shares to a third party, or retain the shares and exercise the voting rights attached to them.[64]

Separation of legal and economic incidents of ownership

A securities loan effects a bifurcation of the legal incidents of ownership and the economic incidents of ownership. While the initial transfer of shares under a securities loan vests title in the borrower and that title carries with it enjoyment of the economic incidents that ordinarily flow from title, the borrower is obligated, under the terms of the loan, to pay to the lender amounts equivalent to any distributions received by the borrower during the term of the loan.[65] In addition, the lender remains exposed to price risk in relation to the shares that have been lent as, under the terms of the securities loan, the borrower can

63. See M. C. Faulkner, *An Introduction to Securities Lending*, 4th edn (London: Spitalfields Advisors, 2007), p.15; J. C. King, *An Introduction to Securities Lending (Australia)* (Sydney: Mallesons Stephen Jaques, 2005), pp.13–14. See also Global Master Securities Lending Agreement (GMSLA), cll 4.1 and 8.8; Australian Master Securities Lending Agreement (AMSLA), cll 4.1 and 7.1.

64. As regards the practice of using securities loans to borrow shares for the purpose of voting them, see further H. T. C. Hu and B. Black, ''The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership'' (2006) 79 *Southern California Law Review* 811.

65. GMSLA cl.6.1; AMSLA cl.4.2(a).

''return'' equivalent shares to the lender at a pre-agreed price (via the return of the collateral provided by the borrower).[66]

Voting

The lender, having transferred title to the shares to the borrower, does not retain any entitlement to vote those shares. If the lender wishes to vote the shares, it must ''recall'' them from the borrower, by terminating the loan and having the borrower transfer to it equivalent shares.[67]

Collateralisation

Securities loans are invariably collateralised, with the borrower providing cash (or other collateral such as securities) to the lender to support the performance by the borrower of its obligations under the loan. Cash constitutes the most common form of collateral.[68] This collateralisation is, in common with the so-called loan of the shares, effected by a transfer of title to the collateral.[69]

Distributions in respect of the collateral lodged with the lender are treated in the same way as distributions in respect of the shares that have been lent. The lender must pay to the borrower amounts equivalent to distributions received on the collateral during the term of the loan.[70] The lender is also free to re-use the collateral and can, in the case of collateral that comprises shares, vote the collateral.[71]

On the termination of loan, the borrower transfers to the lender equivalent shares to those borrowed against the lender's transfer of cash (or equivalent securities to those lodged by the borrower as collateral) to the borrower.[72]

Re-characterisation risk

A securities loan normally comprises two pairs of transfers: an initial transfer of shares against the delivery of collateral and a transfer back to the original transferor of equivalent shares against the return of the collateral.[73] Each of the transfers is, on their own, incontrovertibly a transfer of title to the shares or collateral.

However, when coupled together, the second transfer raises the issue of the proper legal characterisation of a securities loan as that transfer brings to mind a critical feature of secured loans, namely the return or redemption of the secured property on the performance of the obligation secured. This is particularly pertinent where the collateral lodged in support of the borrower's obligation to transfer back to the lender equivalent shares comprises cash. It is possible to view the securities loan as an in-substance secured loan: that is, the initial transfer of shares from the lender to the borrower against the delivery of cash collateral is in substance a loan of that cash collateral from the borrower to the lender supported by the lender's transfer of the shares. The transfer of equivalent shares against the return of the cash collateral is therefore, in essence, the redemption of shares through the repayment of the cash collateral by the lender to the borrower.

The initial transfer of the shares viewed in this light is not an absolute transfer to the borrower but, instead, a transfer by way of mortgage or charge.

This is not an anomalous result. There is, as a leading commentator notes, a very long line of cases dealing with the recharacterisation of purported absolute transfers as giving rise instead to the creation of a security interest over the transferred property.[74] The issue here is well explained in *Manchester Sheffield and Lincolnshire Railway Co v North Central Wagon Co*[75]:

> ''As regards their legal incidents, there is all the difference in the world between a mortgage and a sale with a right of repurchase. But if the transaction is completed by a redemption or repurchase, as the case may require, there is no difference in the actual result.''

Which of the two categories such a sale will fall into depends upon the real intention of the parties, not merely the terms in which that sale has been documented.[76] This point, and the risk

66. GMSLA cll 8.1 and 8.4; AMSLA cll 6.6(a) and 8.1.
67. GMSLA cll 6.3 and 8.2; AMSLA cl.7.2. The AMSLA provides for the borrower to use its best endeavours to vote the shares in accordance with the wishes of the lender (cl.4.3). The parties can opt out of this, in which case the lender would have to recall the shares to vote them.
68. See Faulkner, *An Introduction to Securities Lending*, 4th edn (2007), p.18; King, *An Introduction to Securities Lending (Australia)* (2005), pp.17–18.
69. See Faulkner, *An Introduction to Securities Lending*, 4th edn (2007), pp.15–20; King, *An Introduction to Securities Lending (Australia)* (2005), pp.14–20. See also GMSLA cll 4.2 and 5.1; AMSLA cll 4.1 and 6.1.
70. GMSLA cl.6.1; AMSLA cl.6.7.
71. GMSLA cl.6.3; AMSLA cl.4.3. GMSLA cll 6.3 and 8.2; AMSLA cl.7.2.
72. GMSLA cll 8.1 and 8.4; AMSLA cll 6.6(a) and 8.1.
73. GMSLA cl.4.3; AMSLA cl.6.1.
74. See J. Benjamin, *Interests in Securities* (Oxford: Oxford University Press, 2000), pp.132–133.
75. *Manchester Sheffield and Lincolnshire Railway Co v North Central Wagon Co* (1888) L.R. 13 App. Cas. 554 at 567–568. The author is indebted to Ms A. M. Neagle for this reference: see A. M. Neagle, ''Recharacterization Risk in Securitization and Other Structured Finance Transactions—Looking Beyond the Demise of the Fixed Charge'' in J. J. de Vries Robbe and P. U. Ali (eds), *Expansion and Diversification in Securitization* (The Hague: Kluwer Law International, 2008), p.367.
76. For example, *In re Criimi Mae, Inc* 251 B.R. 796 (2000) where a repo—documented using the (then) Bond Market Association's Master Repo Agreement which provided for the sale of securities coupled with an agreement to buy-back the same or equivalent securities at a different price on a future date—was held to create a security interest over the securities.

of recharacterisation, is explicitly acknowledged in the Opinion Letter relating to the leading standard-form contract for securities loans, the Global Master Securities Lending Agreement.[77]

The recharacterisation of a securities loan as a secured loan has considerable consequences for the parties on the bankruptcy of the borrower and also on the borrower's ability to re-use the borrowed shares.[78]

If title to those shares has passed absolutely to the borrower then the lender has only a personal claim—no different to that held by the borrower's unsecured creditors—against the borrower should the borrower default in transferring equivalent shares to the lender on the termination of the securities loan.[79] That personal claim ranks equally with the borrower's unsecured creditors and is subordinate to the claims of the borrower's secured creditors. However, if the transfer to the borrower is by way of mortgage or charge, the lender is entitled to redeem the shares by transferring the cash collateral to the borrower. The borrower, in this second situation, never becomes the unencumbered owner of the shares but is, at most, the holder of title to the shares minus an equity of redemption in the shares retained by the lender. That being the case, the shares do not form part of the estate of the borrower available to its creditors and, as regards the redemption of shares, the lender enjoys a right superior to that of the borrower's creditors (secured and unsecured).

Beconwood Securities Pty Ltd v ANZ Banking Group Ltd

This very point fell to be decided in the recent Australian case of *Beconwood Securities Pty Ltd v ANZ Banking Group Ltd*.[80] This case involved the proper characterisation of a securities loan entered into between the two plaintiffs and their broker, Opes Prime Stockbroking Ltd. Under this securities loan, the broker advanced cash to the plaintiffs in exchange for the delivery of shares. The cash advanced to the plaintiffs had been raised by the broker under a second securities loan with the defendant, ANZ, which involved the broker transferring the shares that it had borrowed to a nominee of ANZ. The plaintiffs contended that, despite the terms of the securities loan between them and the broker, the securities loan created in substance a mortgage of the shares in favour of the broker, meaning that, on the repayment of the cash advance, the plaintiffs could redeem the shares. This proprietary claim, if upheld, would place the plaintiffs in a position where they could assert priority over ANZ to the shares.[81]

The Court decisively rejected the plaintiffs' claim, holding that the securities loan was effective to vest title to the shares absolutely in the broker in accordance with the terms of the securities loan.[82]

The Court treated three attributes of the securities loan as influential in determining that the securities loan gave rise to a sale of the borrowed shares and not a mortgage[83]:

- The terms of the loan provided for unencumbered title to the shares and the collateral to pass on delivery.[84]
- There was no obligation, on termination of the loan, to return *in specie* the shares originally lent or the collateral.[85]
- The remedies that applied under the terms of the loan on the default of one of the parties had the effect of converting the delivery obligations in

See further J. L. Schroeder, "A Repo Opera: How Criimi Mae got Repos Backwards" (2002) 76 *American Bankruptcy Law Journal* 565, 588–607.

77. See Clifford Chance, "Opinion Letter issued in connection with the 2000 Global Master Securities Lending Agreement to the International Securities Lenders Association" (August 30, 2000), para.2.2.

78. As regards the latter point, there is doubt as to whether the borrower of shares as the holder of a security interest over those shares would be able to re-hypothecate the shares. Such a re-hypothecation may be invalidated as a clog on the lender's equity of redemption in the shares: see Benjamin, *Interests in Securities* (2000), pp.111–116. This can be contrasted with the position in the US where the secured party's ability to re-hypothecate the secured property has received statutory validation: see K. C. Kettering, "Repledge Deconstructed" (1999) 69 *University of Pittsburgh Law Review* 45, 175–191.

79. See J. Benjamin, M. Yates and G. Montagu, *The Law of Global Custody*, 2nd edn (London: Butterworths, London, 2002), p.43. This is why securities loans are typically collateralised.

80. *Beconwood Securities Pty Ltd v ANZ Banking Group Ltd* [2008] F.C.A. 594.

81. This recharacterisation of the securities loan to which the plaintiffs were parties as a mortgage or charge would entail the plaintiffs retaining an equity of redemption (if the loan was recharacterised as a mortgage) or holding equitable title to the shares encumbered by an equitable interest in favour of the broker (if the loan was recharacterised as a charge). In neither case, would the second securities loan be effective to vest legal (and equitable) title to the shares absolutely in ANZ's nominee.

82. The documentation employed was based on the Australian standard-form contract for securities loan (AMSLA) which is, in turn, based on the predecessor to the current GMSLA: see *Beconwood Securities v ANZ* [2008] F.C.A. 594 at 15. The terms of the Beconwood loan that proved influential in the case are consistent with the terms of the AMSLA and GMSLA.

83. *Beconwood Securities v ANZ* [2008] F.C.A. 594 at 17. See also M. Legg, "The Opes Prime Litigation: Securities 'Lending' Transfers Legal Title to Securities" (2008) 26 *Company and Securities Law Journal* 407, 410–411. The plaintiffs did not raise an alternative claim that the securities loan could be recharacterised as creating a charge in favour of the broker, no doubt because the same impediments could be raised to that claim. However, they did allege that the securities loan created a charge over the shares in *their* favour, in support of the broker's obligation to deliver the same or equivalent shares on termination of the loan. This charge has the flavour of an equitable lien about it (but this particular point was not canvassed). The Court considered that no charge arose in favour of the plaintiffs as basically the broker could deal with the borrowed shares as it saw fit and return equivalent shares sourced in the open market: *Beconwood Securities v ANZ* [2008] F.C.A. 594 at 18–20.

84. *Cf* GMSLA cl.4.2; AMSLA cl.4.1.

85. *Cf* GMSLA cll 4.2, 8.1 and 8.4; AMSLA cll 6.6(a) and 8.1.

relation to the shares and collateral into payment obligations that could be netted.[86]

This finding, however, is not entirely free from doubt. The Court was at pains to note that the proper characterisation of the securities loan was to be "determined by its legal nature, not to its economic effect" with the legal nature of the loan to be ascertained from the terms in which the loan had been documented and "the genesis of the transaction, its background, its context, and the market in which the parties are operating".[87] This approach which treats the matter of characterisation as predominantly one of construction, sits uncomfortably with the recent line of cases, including the well known decisions of the House of the Lords and the Privy Council dealing with the proper characterisation of putative fixed charges over book debts, where greater weight has been given to the economic substance of the transaction.[88]

Also, the single most important factor in leading the Court to decide that the securities loan constituted a sale, not a mortgage, of the shares was the inability of the plaintiffs, under the terms of the securities loan, to redeem *in specie* the shares transferred.[89] This focus on whether the plaintiffs could demand the return of the actual shares transferred by them to the broker can be explained by the Court's emphasis on what it viewed as the legal nature of the transaction as opposed to its economic substance. Far less weight was given to the fact that the economic substance of a mortgage, compared to a sale, is that the risk that the transferred property will not be sufficient to meet the transferor's obligations (in this case, the repayment of the cash collateral) to the transferee is borne by the transferor. The substance of a sale is that the transfer of property passes all of the risks and benefits of that property to the transferee. In contrast, under a mortgage, the transferee can recover any shortfall in the value of the property from the transferor but is liable to account to the transferor for any surplus remaining once the transferor's obligations to the transferee have been discharged.[90]

It may be thought surprising that greater attention was not given to the economic substance of the transaction, particularly since the securities loan in question had been entered into, not to provide the borrower (the broker) with the temporary use of shares, but, instead, to allow the lenders (the plaintiffs) to raise cash to finance further investment by them in shares. The shares were held by the broker as collateral to support the plaintiffs' obligation to repay the cash advanced and the securities loan was, in fact, being utilised as an in-substance margin loan (with the plaintiffs being required to "top up" the collateral by "lending" further shares). The small and mid-cap nature of the issuers of the shares—and the relatively thin liquidity of some of these shares—meant that the plaintiffs and other customers of the borrowers had had to resort to securities loans to raise funds to finance their share dealings as those funds would not have been as readily obtainable or even obtainable at all via conventional margin loans.

The effective equation by the court of a mortgage with the ability to have the transferee return *in specie* the property initially transferred, also sits uncomfortably with the practice of using fungible financial assets or, more precisely, fractional, undivided beneficial interests in trust estates, as collateral. Units in investment trusts are routinely used as collateral in margin loans, while debt securities held in custody are routinely used as collateral to support derivatives transactions and other financial markets dealings. In neither of these cases does the discharge of the secured obligation result in the return to the obligor's unencumbered ownership of the financial assets initially secured. Instead, the obligor has restored to it its unencumbered ownership of a fractional interest in a fungible pool of financial assets equivalent to those over which the security interest was initially granted.[91]

It is thus possible that the Australian courts may not have heard the last of the plaintiffs' contention that they, apparently in common with several other clients of the broker, thought they were entering into a conventional margin loan. The introduction in Australia of a personal property securities regime modeled on the United States' art.9 in the near future may also impact the characterisation of securities loans and this risk is greatest where the securities loans have been employed as substitutes for margin loans.[92]

86. *Cf* GMSLA cll 9.1, 9.2 and 10; AMSLA cll 8.2 to 8.4.
87. *Beconwood Securities v ANZ* [2008] F.C.A. 594 at 13–14.
88. See further Neagle, "Recharacterization Risk in Securitization and Other Structured Finance Transactions" in *Expansion and Diversification in Securitization*, 2008, pp.349–360.
89. It is interesting to contemplate how the Court, with its insistence on redemption *in specie* for mortgages, would have addressed Professor Goode's contention that, due to the nature of the interest constituted by shares in the share capital of a company, what the lender receives, on the termination of a securities loan, is not equivalent shares to those lent but identical shares: see R. M. Goode, *Legal Problems of Credit and Security*, 3rd edn (London: Sweet & Maxwell, 2003), p.220, fn.57.
90. This is the test employed in determining whether a transfer of assets, in a cash securitisation, is a "true sale": see S. L. Schwarcz, *Structured Finance: A Guide to the Principles of Asset Securitization*, 3rd edn (New York: Practicing Law Institute, 2003), paras [4-2] and [4-3].
91. See further Benjamin, *Interests in Securities* (2000), pp.36, 53–59 and especially pp.236–237 (the changing nature of the pool of financial assets does not, of itself, convert the security interest into a floating charge).
92. It is open to an Australian court to depart from the line of cases in the US holding that repos are but back-to-back sales, a point that in the US is still not wholly free of controversy. Also, in particular, refer to K. C. Kettering, "Securitization and its Discontents: The Dynamics of Financial Product Development" (2008) 29 *Cardozo Law Review* 1553, 1641–1645.

Conclusion

The present volatility in world financial markets has led regulators to curtail sharply the use of the one transaction—the short sale—that seems to them and many market participants to be exerting undue downward pressure on share prices. In the United Kingdom, the United States and Australia, securities regulators have imposed temporary bans of varying severity on short selling. It is clear that, in the midst of falling markets, regulators are of the view that the negative impact of short selling on share prices considerably outweighs the positive contributions that short selling has long been understood to make to price discovery and liquidity.

It is also likely that even when a measure of what is seen as normality returns to world financial markets that the recently introduced constraints on short selling will not be lifted entirely. Naked short selling, in the view of its perceived potential for manipulative trading, is unlikely to be tolerated as it once was in the United Kingdom and Australia, with the likelihood of greater convergence in those jurisdictions towards the United States' position on naked short sales. Covered short sales could also be made subject to permanent disclosure requirements in the United Kingdom and the United States, while in Australia the foreshadowed legislative reform will close off the definitional ambiguity that has allowed covered short sales to avoid the disclosure requirements that were intended to apply to them.

This focus on short selling has also drawn greater attention to securities loans and the role of these loans in facilitating short selling. The disclosure requirements that are now being applied to covered short sales may well lead to the imposition of similar requirements on securities loans, and this can only contribute positively to market transparency and hence price discovery.

In addition, the legal nature of securities loans has recently been clarified in one of the very few cases on the sale versus mortgage issue, from a major common law jurisdiction, to address securities loans specifically. The guidance provided by *Beconwood Securities Pty Ltd v ANZ Banking Group Ltd* is likely to prove invaluable when unravelling the ownership rights to shares held in custody that have been lent for short sales as well as in relation to share-based financing generally.