



ASX

AUSTRALIAN STOCK EXCHANGE

BUSINESS RULE GUIDANCE NOTE

BUSINESS RULE 2.11 - SHORT SELLING

No: 11/97

Date: 8 December 1997 (revised for ASX demutualisation October 1998).

This Guidance Note supersedes:

- *Guidance Note No 2/95 (titled "Business Rules 2.17 and 2.18" and dated 26 May 1995); and*
- *Guidance Note No 6/95 (titled "Business Rules 2.18 and 2.4(4)(i) Short Sales and Option Arbitraging" and dated 26 May 1995).*

Purpose

The purpose of this guidance note is to provide assistance to market participants on the interpretation of Business Rule 2.11 which relates to short selling.

Background

Short selling of securities is regulated by the Corporations Act and the ASX Business Rules.

Section 846(1) of the Corporations Act contains a general prohibition against short selling. However, a sale of securities is not a short sale where the seller has, at the time of the sale, a presently exercisable and unconditional right to vest the Security in the buyer. Section 846(3) of the Corporations Act expressly exempts five types of sale transactions from the prohibition on short selling:

S846(3)(a) transactions. That is a sale in relation to an odd lots transaction [no longer relevant];

S846(3)(b) transactions. That is a sale as part of an arbitrage transaction (as defined in section 9 of the Corporations Act);

S846(3)(c) transactions. That is a sale of securities where, prior to the sale, the short seller had already contracted to buy those securities and the right to have those securities vested in the short seller is conditional only upon the matters set out in section 846(3)(c) of the Corporations Act;

S846(3)(d) transactions. That is a sale where the short seller of securities -

- (a) is not an associate of the body corporate which issued or made available the securities;
- (b) has made arrangements prior to the short sale that will enable the short seller to deliver securities of the class sold to the buyer within 3 business days after the short sale; and
- (c) if the securities are quoted securities, the requirements set out in section 846(3)(d)(iii) of the Corporations Act are complied with; and

S846(3)(e) transactions. That is a sale where the seller short sells securities which have been declared by the board of a securities exchange, in accordance with its business rules, to be a class of securities to which section 846(3)(e) of the Corporations Act applies (ie short sales in accordance with ASX Business Rules). Under Business Rule 2.11.3(1), securities which have been so declared comprise of Approved Securities and Public Securities.

Business Rule 2.11 contains the provisions on short selling of securities. Business Rule 2.11.1(1) states that:

“A Participating Organisation is only permitted to effect a Short Sale in accordance with the Corporations Act and this Rule 2.11.”

A Short Sale is defined in Business Rule 2.1 to mean:

*“a sale of a Security where at the time of sale the seller does not have a **presently exercisable and unconditional right to vest the Security in the buyer** other than by reason solely of the sale constituting a Conditional Sale and cognate expressions have a corresponding meaning.”*

Other Business Rule requirements for short selling which are not canvassed in this Guidance Note include:

Rule 2.11.4(1): limit to percentage of quoted securities which may be short sold.

Rule 2.11.4(2): prohibition on short sales of Approved Securities during the offer period of a Takeover Offer or in the period immediately following a Takeover Announcement in respect of those securities and that offer has not closed, lapsed or been withdrawn.

Rule 2.11.4(3): short sales of Public Securities shall not be made with a settlement date more than 10 Trading Days after the date of sale.

Rule 2.11.5: margin of cover and calls for additional margin of cover.

Interpretation

This Guidance Note seeks to clarify the following matters:

1. What is a “presently exercisable and unconditional right to vest the Security in the buyer”

The Exchange takes the view that the phrase “presently exercisable and unconditional right to vest the Security in the buyer” encompasses more than mere ownership of securities. Accordingly, if a seller has entered into an enforceable agreement which grants the seller an unconditional right to transfer a number of securities to the buyer, the seller has a “presently exercisable and unconditional right to vest the Security in the buyer”. It follows that, in such a situation, there is no short selling under the Corporations Act and the Business Rules. Accordingly, Business Rule 2.11 does not apply.

Three specific situations are examined below. In each situation, it is assumed that the seller of the securities does not own the securities and is relying on the circumstances described below to ensure that the sale of securities is not a short sale.

(a) Borrowing Arrangements

Assume a seller entered into a securities borrowing arrangement with an owner of securities prior to making a sale.

In such circumstances the issue is whether the seller having a borrowing arrangement in place has a “presently exercisable and unconditional right to vest the Security in the buyer”?

This will depend on the terms of the borrowing arrangement. Each arrangement must be considered on its own terms. For example, where there is a master securities borrowing agreement and the agreement requires:

- (i) the seller/borrower to make a request for a transfer of the securities when he/she wishes to borrow the securities; and
- (ii) the transfer of securities is conditional upon the lender’s agreement,

the Exchange is of the view that the seller/borrower does not have a “presently exercisable and unconditional right to vest the Security in the buyer” until such time as the lender has agreed to the request of the seller/borrower.

If, at the time of the sale of securities the lender has not agreed to the request of the seller/borrower, the seller does not have a presently exercisable and unconditional right to vest the Security in the buyer.

The Business Rules do not expressly require a borrowing arrangement or other types of prior arrangements relating to delivery of securities to be in writing. However, the Exchange is of the view that prudence and best practice requires that such arrangements and any notices or requests for securities made pursuant to such arrangements should be in writing or, at the very least, confirmed in writing. This is because if there were a dispute between a borrower and a lender as to the existence or terms of a verbal borrowing agreement, the borrower may face difficulties in enforcing a verbal agreement in the absence of any documentation or other evidence of the borrowing arrangement.

(b) Company Issued Options

A seller may seek to “cover” a sale transaction of shares in a listed company by a purchase of options issued by the same company and quoted by the Exchange. This practice is also known as “option arbitrage”. In this example, the seller does not have a current shareholding in the listed company and it is the seller’s intention to exercise the options and deliver the newly issued shares to the buyer. In such circumstances, the issue is whether this amounts to a short sale?

The Exchange is of the view that such “option arbitrage” (even where the options are acquired beforehand) amounts to a short sale because at the time of sale all that the seller has is a contractual right against the listed company for the allotment of securities in the future through the exercise of the options. In other words, at the time of sale there is not a “presently exercisable and unconditional right to vest the Security in the buyer” and it is thus characterised as a short sale.

In addition, the short sale will also amount to a contravention of Business Rule 2.4.1(1) because, at the time of the sale, the securities dealt with had not been admitted to Official Quotation. Official Quotation can only be applied for by the listed company after the options have been exercised and allotment has taken place. This is an important principle because the number of securities admitted to quotation at any given point in time should be known and certain. It should be noted that if the Participating Organisation is able to fulfil its settlement obligation in an option arbitrage by having the options converted and the shares admitted to Official Quotation by the time settlement is required, this does not “cure” the contraventions of Business Rule 2.11 and Business Rule 2.4.1(1) referred to previously.

(c) Entitlement under a Trust

A seller may be entitled to a number of securities under a trust arrangement and he/she may seek to “cover” a sale transaction by relying on his/her entitlement under the trust. If such a seller is entitled, under the trust, to call for the securities to be transferred to him/her or at his/her direction at any time, then the Exchange is of the view that such a seller has a presently exercisable and unconditional right to vest the Security, which form part of the trust property, in the buyer. In such a situation, it follows that the sale is not a short sale of securities.

2. What is the position where a sale is “covered” by Exchange Traded Options

Corporations Regulation 7.4.08 specifically exempts a sale of securities, which is able to be “covered” by exercising exchange traded options over the same class of securities, from the prohibition against short selling in section 846(1) of the Corporations Act. In such a situation, it follows that the sale is not a short sale of securities.

3. What are the Reporting Requirements

In addition to the reporting obligations contained in Business Rule 2.15, where a Participating Organisation effects a short sale of securities, regard should also be had to the reporting requirements under Business Rule 2.11. These reporting requirements are summarised in the following table:

PERMITTED SHORT SALES	OBLIGATION TO REPORT SHORT SALE TO ASX	APPLICABLE BUSINESS RULE
S846(3)(b) TRANSACTIONS (ie. ARBITRAGE TRANSACTIONS) (a) Sale fully covered prior to close of 2 nd Business Day (b) Sale not fully covered prior to close of 2 nd Business Day	No reporting requirements Report shortfall prior to close of business on 2 nd Business Day; and thereafter, on a daily basis until the shortfall no longer exists and the sale obligation is covered	N/A BR 2.11.2(2)(b)
S846(3)(c) TRANSACTIONS	No reporting requirements	N/A

PERMITTED SHORT SALES	OBLIGATION TO REPORT SHORT SALE TO ASX	APPLICABLE BUSINESS RULE
S846(3)(d) TRANSACTIONS	Report as part of net short sale position by 7.30 pm on the same Trading Day	BR 2.11.3 (3) & (4)

PERMITTED SHORT SALES	OBLIGATION TO REPORT SHORT SALE TO ASX	APPLICABLE BUSINESS RULE
<p>S846(3)(e) (ie BUSINESS RULES TRANSACTIONS)</p> <p>(a) Approved Securities</p> <p>(b) Public Securities</p> <p>(i) Transaction closed out during the week</p> <p>(ii) Transaction not closed out during the week</p>	<p>Immediately report the short sale through SEATS, using parameter S; and</p> <p>Report as part of net short sale position by 7.30 pm on the same Trading Day</p> <p>No reporting requirements</p> <p>Report shortfall by 10 am on first Trading Day in each week.</p>	<p>BR 2.11.8(1) & BR 2.15.9(1)</p> <p>BR 2.11.3 (3) & (4)</p> <p>N/A</p> <p>BR 2.11.3(12)</p>

4. Timeliness in Reporting Net Short Sale Positions

It has come to the attention of the Exchange that some Participating Organisations have been dilatory in reporting their net Short Sale positions as required by Business Rule 2.11.3(3). The Exchange views such dilatory conduct seriously. If unchecked, it may lead to large scale delays in informing the market of the level of short sales in a given period and hence affect the integrity of the market. Accordingly, the Exchange reminds Participating Organisations of their need to fulfil their reporting obligations on a timely basis.

Qualification

ASX has published this note to promote commercial certainty, reduce costs to business and assist market participants. Nothing in this note necessarily binds ASX in the application of the Rules in a particular case. In issuing this note ASX is not providing legal advice and market participants should obtain their own advice from a qualified professional person in respect of their obligations. ASX may replace this note at any time. Readers should contact ASX to ensure they have the latest version.

Enquiries

As this note is only a guide to ASX practice, participants are advised to contact ASX to discuss their particular circumstances. The Participant Services Manager or Co-ordinator assigned to serve each Participating Organisation is available to discuss any questions you have in relation to this guidance note. Alternatively you could contact the relevant ASX offices below.

PARTICIPANT SERVICES

Adelaide	Manager, Participant Services Ph: (08) 8216 5031 Fax: (08) 8216 5098
Brisbane	Manager, Participant Services Ph: (07) 3835 4030 Fax: (07) 3839 7008
Melbourne	Manager, Participant Services Ph: (03) 9617 7820 Fax: (03) 9614 7124
Perth	Manager, Participant Services Ph: (08) 9224 0001 Fax: (08) 9221 2020
Sydney	Manager, Participant Services Ph: (02) 9227 0694 Fax: (02) 9231 3609