Stripping of Super Funds through Stock Shorting and Market Manipulation

Introduction:

This submission has been deliberately written with the least amount of technical content as possible in order that laypersons with limited knowledge can understand the systemic problems behind the regular failure of their Superannuation funds to perform. It addresses just one of the various means available to legally strip funds for the benefit of other persons or entities unrelated to the fund.

Preamble:

Approximately 10% of Gross Salary and Wages paid to Australian Workers is set aside into Superannuation Funds for the retirement of the worker.

These funds are by legislation required to be invested in the variously available vehicles of investment, primarily cash or capital markets and the derivates thereof.

Superannuation Funds investing in the Capital Markets can follow (in simple terms) an "*invest for dividend"* strategy or a "*trade for profit"* strategy.

An "Invest for Dividend" strategy involves buying securities in volumes ranging from insignificant to a strategic stake. (*1) Buying Long or Long Position*

These securities may then be made available as "loan" stock, lent out to other funds to short sell the market. *(2) Short selling stock, shorting*

Lending stock for short selling is legal in Australia – however it is interesting to note that during the GFC shorting was briefly banned, having been deemed to be detrimental to the market and to the economy of the country.

Strategy: *(Values quoted are hypothetical)*

Incoming Super fund $$ marked for investment in the capital markets (say, $20m) are directed to the fund manager, who then chooses a suitable ASX listed company for inclusion in the fund investment portfolio. Selection is made from top 100 and perhaps top 200 ASX listed companies.

E.g. the fund manager might choose ASX listed company XYZ, trading at $5. The fund manager places orders for shares intending to spend $20m.

1. Buying long or Long Position: the buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value.

2. Short selling stock: The sale of a security that is not owned by the seller, or that the seller has borrowed. Short selling is motivated by the belief that a security's price will decline, enabling it to be bought back at a lower price to make a profit.

Through supply and demand the Share Price elevates culminating in a final share price of $7, the average purchase cost per share being $6.

The fund now lists 3,333,333 shares of XYZ in its portfolio, these shares being available for loan to another fund manager ("hedge fund") for short selling on market, as stated before, a legal activity.

The Fund Manager loans XYZ stock to a hedge fund (which they may also manage) under a borrow contract with repayment clauses which may include options other than the repayment of the actual stock borrowed, *(i.e. "in kind").*

The Hedge fund sells the securities on market *(short selling)* taking advantage of a falling share price resultant from the sell-down, buying back the lower-priced securities - the final result being a profit for the Hedge fund and a loss for the Super fund due to the lower market price of the shares.

Simply put:

- Superannuation fund buys shares on market, drives up the price.
- Loans the stock to a Borrower. (e.g. a Hedge Fund (which may be privately owned and nothing to do with Super Funds)
- Hedge Fund and Super fund enter into a commercial 'borrow' agreement, the basic parameters of an agreement include nominal interest on the stock while borrowed and repayment of the stock at a later time*. *(see later clarification: Alternative stock repayment scenario)*
- Hedge Fund then commences to sell the stock on market with the intention to buy back at a lower price.
- Using highly complex algorithmic trading platforms (computerised trading) the Hedge Fund sells the borrowed stock (some or all) on market, in such manner as to drive down the share price in a manner most beneficial to short selling.
- The Share Price is driven down to ($3), the Hedge fund's average selling price is ($5.00)
- The Hedge fund then must repay the shares to the Super Fund, or pay 5 - 7% interest on the contracted value.
- Using computerised trading platforms the Hedge Fund then may proceed to buy on-market replacement stock, in a manner that causes the least rise in the price. Over time the Hedge fund buys the replacement stock at a lower average price ($4) and when the process is completed the share price of XYZ is left at ($5)
- At the beginning the Super fund portfolio value of XYZ was $7 x 3,333,333 or $23,333,333, cost being $20,000,000 to the fund (an 'on-paper' gain of $3.33m) and the Hedge fund portfolio value is $0.

- At the end, the portfolio value of the Super fund is $5 x 3,333,333 or $16.66m, a real loss of $3.33m (and an additional 'on-paper' loss of $3.33m) and the portfolio value (cash) of the Hedge fund is a gain of $3.33m.

- The interest payable by the Hedge Fund may be insignificant if the transaction is completed in the short term.

- The share price and Market valuation of XYZ has been trashed, the Super fund has had $3,333,333 **cash** stripped from its portfolio (but retains dividends paid, if any) and this same value has been added to the Hedge Fund.

Alternative stock repayment scenario:

Repayment may be executed in cash based on the Volume Weighted Average Price (defined period.) This option allows the Hedge fund to choose the most self-beneficial course of repayment. This scenario may be applied in the event the short selling has not achieved the desired effect (beneficial to the Hedge fund), often in the event that the XYZ share price is driven upwards by other market forces, but also in the event that the computer algorithm determines that buying the stock on market would result in a net loss due to low liquidity of stock.

It's legal…So what?

Legislation allows this to happen. Superannuation Funds are legally entitled to lend their stock, other funds can borrow the stock and what happens financially as a result is not construed as illegal.

The primary responsibility of the Trustees of the Super fund is **to ensure the benefits are maximised for members** in accordance with Government approved investment guidelines. The avoidance of this primary responsibility may even be recognised under Common Law as a failure to execute Duty of Care – which directs the primary responsibility of the fund manager to execute actions in favour of the members.

In this area the legislation is lacking:

Introduction of legislation which specifically excludes super funds from loaning stock is one answer, but banning short selling entirely across the ASX would be far more beneficial to the economy.

ASX (and ASIC) say that short selling adds "balance" to the market, that it contributes to efficient price discovery, increases market liquidity, facilitates hedging and other risk management activities and can possibly help mitigate market bubbles etc. If short selling is so good for the market, why was it banned during the GFC? Simply put, banning short selling during the GFC was one of several factors that induced an improvement in the economy of Australia.

Management fees:

While the Super fund is being stripped, a **management fee** is applied, earning a preset income for the financial institution from the fund whatever the result. See linked article below: *"Fees Cost Super Investors Billions"*

What happens elsewhere?

It has been widely proved that "Active" portfolio management does NOT outperform "Passive" portfolio management in the long term, when large sums are invested.

Almost all of the Super funds (Pension funds) in USA are passively managed by a dumb computer pre-programmed with diversified portfolio guidelines aligned with "Modern Portfolio theory" – devised by Harry Markowitz in 1952, writing a book on the subject in 1959, and winning a Nobel Prize in Economics for it in 1990. (http://en.wikipedia.org/wiki/Modern_portfolio_theory)

So why are Super funds "Actively managed"?

Actively managed funds present more stripping opportunities than passively managed funds, as outlined in the following articles:

Fees Cost Super Investors Billions
http://www.theage.com.au/business/fees-cost-super-investors-billions-20100304-plwn.html

Super Funds Grab a Third of Savings in Fees
http://www.news.com.au/finance/superannuation/super-funds-grab-up-to-a-third-of-your-savings-in-fees/story-e6frfmdi-1226581824230

We Pay Billions for No Benefit
http://www.news.com.au/finance/we-pay-billions-for-no-benefit/story-e6frfm1i-1226025092108

The Australian "Super Fund industry" is applying high fees and stripping from the funds using unregulated channels for the benefit of persons other than members of the Funds.

In Singapore, they have one National Fund for everyone run by the Federal Government:

This is the website of the **Central Provident Fund** of the Singapore Government:

http://mycpf.cpf.gov.sg/CPF/About-Us/Mission-and-Vision/Mission

It is run along similar lines to the Qld Government owned QIC (Qld Investment Corporation).

In USA, there are almost no "active" managers of pension moneys. No one pretends he/she can beat the passive approach.

Outcomes:

Financial institutions need to control the amount stripped from the funds – after all, they need to protect their source of liquidity, and if the Super fund continually reported a loss, people would withdraw their cash and direct it in favor of another fund or institution. Clearly then it would be of short term benefit if the institution were to allow stripping of Super funds for the benefit of Hedge fund to the extent that it produces a continual net loss.

The reality is a compromised approach: The Super Fund is still stripped for the benefit of the Hedge fund, but is "allowed" to provide an "acceptable" profit to report - better than bank interest, so that the majority of the fund members are inclined to leave their money with that particular institution or fund manager.

(ref: "exit fees")

Recommendations:

Control and Regulation of the Financial Services industry is clearly not the answer – as has been reported or described in most of the submissions to this Senate Inquiry the Financial Services industry as a whole continues to find new ways of exploiting their activities for their own best benefit, rather than for the benefit of the fund members.

Any investigation into management of Public Superannuation funds by institutions *versus* management of Public Service Funds by the Government will reveal the benefits of placing superannuation funds under the direct control of the government.

The following recommendations are proposed *(but not confined to):*

- Super Funds prevented from loaning stock under all circumstances
- Super Funds to be taken over by the Federal Government under restrictive guidelines preventing a government from using the funds for "Pet" projects that have a poor guarantee of return
- Super Funds to invest in income-producing Infrastructure (instead of selling off to Foreign entities) e.g. utilities, airports, ports, rail and toll roads.
- Super Funds to invest in ASX listed companies.
- Implementation of reward-based whistleblower incentives applicable to Corporate and Government wrongdoings recommended similar to the US Dodd-Frank reforms, viz: p13: http://www.banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf

(A study of the Dodd-Frank reforms would provide a great deal of information for consideration by the Senate Committee)

In conclusion:

As variously described by submissions to the Senate Inquiry, the Financial Services Industry appears to be inadequately controlled or regulated, in this case the applicability references the Superannuation funds of the Australian Workers.

If the purpose of the Senate Inquiry is to evaluate the effectiveness of ASIC, it logically follows that there is concern that ASIC is failing in areas of their charge; not only in preventing or constraining the activities described herein in accordance with fair practice, but also by their enabling of an environment which encourages the Financial Services industry to conduct activities disfavoring the benefit of the Fund members.

There is no doubt that both ASIC and the Financial Services Industry will attempt to provide the Senate Inquiry with material that supports their stance on this matter, including references to accountability to the standards set by Government, investment in approved companies, accountability by directors and transparency of fee structure including annual reports and operating costs, and much more.

However, outlining the terms of reference for the Super Fund operating parameters applicable to Financial Institutions ***does not and will never highlight legal activities employed to strip value from funds for the benefit of undisclosed persons or entities.***

Australia needs to move towards a system where SMSF's and a Government operated retirement funds with individual accounts co-exist, with Government owned banks providing a competitive balance in the economy. (The scope of this subject is too far-reaching to be included in this paper; however our Financial Services Industry prevented this from being established during the early years of Howard Government, a much forgotten but momentous decision.)

The Senate must recognize it is charged with providing an assessment of ASIC and ultimately of the Financial Services Industry *for the benefit of the people and for the economy of the country – both present and future.*

In this case there can be no doubt that the benefit for the people and the economy of the country rests with change and greater control, as has successfully been implemented in other jurisdictions.

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