



BRIEFINGS
ON
MARKET
PRACTICE

SHORT SELLING



March 2009

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Short selling plays an important role in the market for various reasons, such as providing more efficient price discovery, mitigating market bubbles, increasing market liquidity, facilitating hedging and other risk management activities, and, importantly, limiting upward market manipulations.

However, short selling may be problematic when the confidence level of the market is at a low. For example, in the context of a credit crisis, where some entities face liquidity challenges but are otherwise solvent, a decrease in their share price, induced by short selling, may lead to further credit tightening for these entities, possibly resulting in bankruptcy. In such circumstances, short selling can be used as a tool to mislead the market, in a downward manipulation; whereby a manipulator short-sells the shares of a company and then spreads rumours about the company's negative prospects. This could harm issuers and investors as well as the integrity of the market.

Technical Committee of the International Organization of Securities Commissions (IOSCO)

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introduction

INTRODUCTION

One of the aspects of securities markets operations that came into intense scrutiny and stringent regulatory actions is the practice of short selling or short interest. The collapse of the structured products market has severely affected the financial health of a large number of global financial institutions owing to large-scale provisioning and write-downs. This led to massive sell-off of the shares of the affected banks and financial institutions.

Fears of massive short selling accentuating the sell-off that could have led to the dramatic decline of shares of financial companies have prompted regulatory agencies all over the world to look at certain aspects of short selling and come out with some pre-emptive measures.

Once again, the subject of short selling has become a topic of debate and discussion. This report presents important aspects of short selling, including recent developments and the evidence from regulatory actions.

What Is Short Selling?

Short selling is the practice of selling shares that the seller does not own at the time of trading. In short selling, the security is usually borrowed from a broker's account and sold in anticipation of a downturn, where it may be repurchased at a profit. The adage 'Buy low, sell high' applies to a short-seller. It is only the order of the trade that is reversed in the case of short selling— the stock is sold first at a higher price and bought later at a lower price.

A typical short-sell transaction would have three parties (the original owner or the lender, the short-seller, and the new buyer), unlike a normal share purchase transaction, which consists of two parties (the buyer and the seller).

A short-seller is required to open a margin account with a broker and sign an agreement saying that he (the short-seller) will maintain a cash margin or pledge his stocks as collateral. The margin account allows him to borrow from the broker, based on the value of his portfolio (which is usually at least 50% of the size of the short-sell transaction).

Types of Short Selling

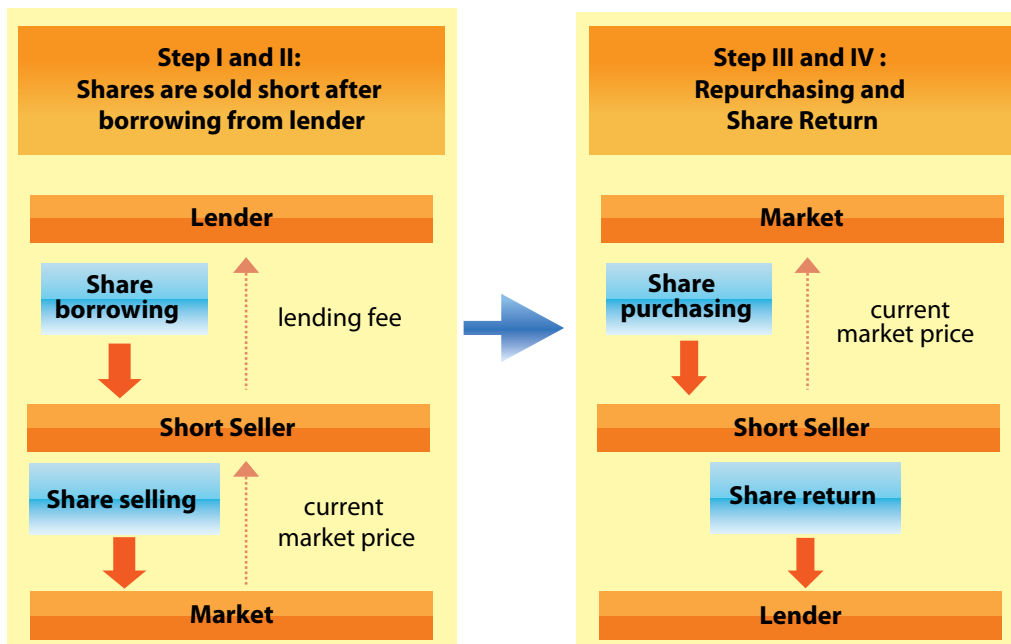
Short-sell transactions are of two types, 'naked' and 'covered'.

In naked short selling, the seller sells shares he does not own, without having set aside any shares to settle the transaction. There are no borrowing fees in this transaction since he did not borrow the shares that have been sold; however, it would normally be subject to any fees that the broker requires to hold the position open. When it is time to exit the short position, the short-seller relies on the same number of shares being available, so that he can buy them back – closing the short position. Naked short selling is often used for intra-day trading, where the position is opened and then closed at some point later in the day. Also, if a market maker does not have a sufficient supply of a particular share to meet client demand then the market maker may employ naked short selling in order to meet that demand.

Covered short selling usually involves a series of transactions.

- In the first stage, the short-seller normally borrows the number of shares that are for short selling so that they can be delivered to the buyer at settlement. The short-seller will normally get cash on delivery of the stocks.
- In the second stage, he short-sells the shares.
- In the third stage, which occurs at some point in the future, he buys the same number of shares so as to return them to the original lender.
- In the fourth stage, the replacement shares are returned to the original lender and the series of transactions is complete.

In addition to the cash markets, short selling can also be carried out by using a number of different derivative instruments, although some of these methods can be hedged by selling in the cash market. For example, a short position can be taken through single stock futures, index futures, options, etc.



Stock Lending

In a practical sense, the term stock lending is used to describe the temporary transfer of securities by one party (the lender) to another (the borrower). The securities on loan are secured either by cash collateral or securities/asset collateral. Under the loan agreement, title to the securities passes on to the borrower. This is more akin to a sale and re-delivery than borrowing as such. Where lenders have agreed to take securities as collateral, they are paid a fee. If lenders take cash as collateral, they pay the borrower interest at a lower than market rate, known as the rebate rate. This allows the lender to reinvest the cash and make a return. However, the borrower is obliged to return the securities to the lender either on demand or at the end of an agreed term. A common reason to borrow securities is to cover a short position. However, this position may not necessarily be a result of speculative activity; it may arise from a dealer's need to borrow securities to provide them for customers making buy orders or as a result of failed settlement. Market makers borrow stock to fill client orders and ensure tight, two-way prices. Securities lending allows market makers to increase liquidity, which in turn helps the markets operate more smoothly and efficiently. Borrowing of securities also occurs as part of financing strategies.

An effective facility for securities lending and borrowing can be an important instrument in the orderly conduct of short selling.

Why Use Short Selling?

Short selling is used to achieve various objectives in today's markets. The IOSCO documents on short selling list the following uses:

- Establish a short position in a security considered to be over-valued, believing that it will be possible to buy it back more cheaply in the future.
- Enable dealers/market makers who do not currently hold the relevant securities in their inventory to fill customer buy orders on demand.
- Facilitate long/short investment strategies, in which portfolios are split between long and short positions with a view to profiting from a relatively stronger performance of the long holdings vis-à-vis the short holdings.
- Lock in an arbitrage profit when an arbitrageur exploits a pricing anomaly between two related instruments by buying the 'cheap' one and short selling the 'dear' one.
- Facilitate hedging, especially of derivative contracts, by enabling anyone exposed to a commitment to buy securities to offset their market risk by establishing a corresponding short position.
- Balance a long position, generally for a specific purpose; e.g., protect a long interest being held for strategic reasons or because it might be fiscally disadvantageous to crystallize a profit through a long position.
- Facilitate the movement of new securities into the market under approved procedures such as price stabilization or 'greenshoe' rules; e.g., when stock is sold by an issue manager or other members of a distribution syndicate to meet strong demand for securities in the knowledge that the issuer will make available additional securities to cover their 'shorts'.

Who Are Short-Sellers?

The main short-sellers differ considerably from market to market. Differences are likely to reflect such factors as market microstructure (e.g., the role of market makers), liquidity (since low liquidity will tend to deter fund managers and other investors from using short selling strategically), and the nature of any restrictions on short selling activity imposed by regulators or market authorities, or under investment laws or mandates.

Market makers/principal dealers

In equity markets, where market makers play a predominant role or intermediaries commonly facilitate customer trades on a principal basis, the major intermediaries are frequently a major source (if not the major source) of short selling activity. They may go short when filling customer buy orders on demand, as part of their proprietary trading or as part of the general risk management of their inventory. Although many trading positions are covered, or largely covered, by purchases made over the rest of the trading day, liquidity providers are generally active stock borrowers too.

Hedge funds

A second major group that uses short selling is hedge funds. Hedge funds are far more active on both sides of the market (i.e., the long and the short side) than long-term institutional investors, such as pension funds. When pursuing momentum strategies, they take substantial short positions as well as long positions (though the number of short-only funds is a very small proportion of total hedge fund assets). When adopting a more market neutral approach, they utilize various long/short strategies, designed essentially to secure returns in any market conditions by correctly predicting trends in relative prices.

Others

Mostly, major long-term fund managers (e.g., of pension and insurance funds) do not use short selling. In addition to being natural long-term holders of the securities they acquire, they are also often prohibited from making short sales, either by regulation or under the contractual or other terms governing investment policy in respect of the funds that they manage. The extent to which private investors use short selling depends both on local investment practice and culture, as well as local regulation. In some markets, there is retail demand for short selling facilities and the markets have developed services to facilitate this, in particular, through the provision by brokers or specialist houses of retail stock lending facilities. These are commonly used in, for instance, Japan, the US, and Canada. In other markets, there is less interest on the part of private investors, and brokers are disinclined to invest in the operational infrastructure they would need to support such a service.

History of Short Selling

The first case of short selling dates back to 1609 when Dutch trader Isaac Le Maire, a big share holder of the Vereenigde Oostindische Compagnie (VOC)—the Dutch East-India Company, was blamed for causing a drop in the share price of the company. Way back in 1602, Le Maire had invested about 85,000 guilders¹ in the VOC. By 1609, the VOC still was not paying dividends, and Le Maire's ships on the Baltic routes were under constant threats of attack by English ships due to trading conflicts between the British and the VOC. Le Maire decided to sell his shares and sold even more than he had. Under pressure from the directors of the VOC, the Dutch government regarded this as an outrageous act and took steps to eliminate selling of shares for forward delivery that were not owned by the seller at the time of the forward sale. In modern sources, e.g., de Marchi and Harrison (1994), this has been portrayed as a ban on short selling. The ban was revoked a couple of years later.

Short selling has been a target of ire since at least the eighteenth century when England banned it outright. It was perceived as a magnifying effect in the violent downturn in the Dutch tulip market in the 17th century. In another well-referenced example, George Soros became notorious for "breaking the Bank of England" on Black Wednesday of 1992, when he went short more than \$10 billion worth of pounds sterling. The term 'short' was in use from at least the mid-19th century. It is commonly understood that 'short' is used because the short-seller is in a deficit position with his brokerage house.

Short-sellers were blamed for the Wall Street Crash of 1929. Regulations governing short selling were implemented in the US in 1929 and in 1940. Political fallout from the 1929 crash led Congress to enact a law banning short-sellers from selling shares during a downtick; this was known as the uptick rule, and was in effect until 2007. President Herbert Hoover condemned short-sellers and even J. Edgar Hoover said he would investigate short-sellers for their role in prolonging the Depression. Legislation introduced in 1940 banned mutual funds from short selling (this law was lifted in 1997). A few years later, in 1949, Alfred Winslow Jones

The 'uptick rule' also known as the 'plus tick rule' is a securities trading rule used to regulate short selling in financial markets. The rule mandates that every short-sell transaction be entered at a price that is higher than the price of the previous trade. This rule was introduced in the Securities Exchange Act of 1934 as Rule 10a-1. The uptick rule prevents short-sellers from adding to the downward momentum when the price of an asset is already experiencing sharp declines. The SEC made the controversial decision to eliminate the uptick rule in June 2007 after its analysis showed it did little to prevent the manipulation of share prices. However, Federal Reserve chairman Ben Bernanke said if the rules were still in place, "it might have had some benefit" in preventing the market meltdown.

founded a fund (that was unregulated) that bought stocks while short selling other stocks, hence hedging some of the market risk, and the hedge fund was born.

Some typical examples of mass short-selling activity are during 'bubbles', such as the dot-com bubble. At such periods, short-sellers sell hoping for a market correction. Negative news, such as litigation against a company, will also entice professional traders to short-sell the stock.

In September 2008, short selling was seen as a contributing factor to undesirable market volatility and subsequently was temporarily prohibited by the US Securities and Exchange Commission (SEC) for 799 financial companies in an effort to stabilize the market price of the company stocks. This was followed by similar prohibitions from market regulators in the UK, Australia, and Spain, to name a few.

¹The 'guilder' – Dutch *gulden* was the currency of the Netherlands from the 13th century until 2002, when it was replaced by the euro.

Studies on Short Selling

The study on short selling has been sizeable. Because short selling is considered as an important factor leading to better price discovery, greater liquidity, and market efficiency, the topic was of significant interest to researchers and financial professionals from the perspective of regulation and market practice. The studies are conducted on a number of aspects relating to the operation of short selling. A recent study on short selling by Financial Services Authority, UK, notes that a general view of the empirical literature is that short selling allows negative expectations about share price developments to feed more directly into the actual share price, thus leading to efficient price discovery process. There were also studies following the temporary restrictions imposed on short selling in several countries following the regulatory actions in the US in September 2008.

A gist of the major studies conducted on short selling and their respective findings are given below.

Seneca (1967)	An increase in short interest was a bearish indicator.
Miller (1977)	Informed, bullish investors may force stock prices above the price that would prevail in the absence of short-sell restrictions, leading to overpricing securities. When informed, bearish investors are willing and able to sell short, negative information is more rapidly incorporated into stock prices, resulting in few overvalued securities. In the absence of short selling, stock prices tend to reflect the view of the more optimistic investors.
Harrison and Krepes (1978)	Short-sell constraints can result in stock prices that exceed the valuation of even the most optimistic investor.
Diamond and Verrecchia (1987)	Although short-sell restrictions do not lead to an upward bias in prices, they do reduce the speed at which stock prices adjust to private—especially private negative—information. Short-sell restrictions will reduce liquidity during downward price movements.
Asquith, <i>et al.</i> (1995)	Strong negative relation between short positions and returns, both during the time the stocks are heavily shorted and over the following two years. Short positions convey negative information about a stock, which feeds into its valuation.
Safieddine, <i>et al.</i> (1996)	Seasoned equity offers are preceded by abnormally high levels of short selling. Higher levels of short selling are associated with reduced proceeds from the equity issue.
Aitken, <i>et al.</i> (1998)	Short selling is likely to be involved in arbitrage, or activates hedging, and trades executed near the end of the year are less likely to precipitate a negative price reaction. Restrictions on short selling discourage liquidity—motivated traders leaving a preponderance of informationally motivated behaviour.

Houge, <i>et al.</i> (2001)	Institutional controls restrict short selling in the early post-offering period.
Gintschel (2001)	Stocks with unexpectedly low short interest experience significantly positive abnormal returns (21 basis points) upon announcement, while stocks with unexpectedly high short interest have significantly negative abnormal returns (23 basis points).
Chen, <i>et al.</i> (2002)	Stocks that experience declines in breadth of ownership (used as a proxy for short constraints) subsequently underperform those that experience increases.
Desai, <i>et al.</i> (2002)	Heavily shorted firms exhibit significant negative abnormal returns even after controlling for other factors. The negativity of returns is positively related to the level of short positions. Heavily shorted firms are also more likely to delist from NASDAQ than firms with otherwise similar characteristics.
Ofek, <i>et al.</i> (2003)	Substantial practical short-sell constraints for Internet stocks during the dotcom bubble. The burst of the bubble coincided with the expiration of lock-up agreements.
Christophe, <i>et al.</i> (2004)	Negative relationship between short selling prior to an announcement and the post-announcement change in share prices and that abnormally large changes in short selling are often followed by substantial post-announcement share price movements. Short-sellers appear to be more focused on stocks with low book-to-market valuations or low standardized unexpected earnings. More extensive and timely disclosures of short-selling activity could increase the amount of information available to investors and thereby improve market efficiency and the orderliness of movements in securities prices.
Lamont (2004)	Firms underperform in the year subsequent to legal and regulatory action, a result consistent with the hypothesis that short-selling constraints facilitate stock overpricing and low subsequent returns.
Charoenrook and Daouk (2005)	Less volatile aggregate stock returns and greater liquidity in markets permit short selling. Prices tend to increase when short-sell restrictions are lifted. Removing restrictions on short selling leads to gains in efficiency.
Bai, <i>et al.</i> (2006)	Stock prices may actually be lower with short-sell restrictions because investors demand a higher risk premium.
Boehme <i>et al.</i> (2006)	Short selling, which helps impound negative information into prices, acts as a counterbalance to incentives to inflate share prices.
Bris, <i>et al.</i> (2007)	Short selling does not affect the frequency of extreme negative returns. However, without short-sell restrictions, extreme returns become more negative.
Alexander and Peterson (2008)	No evidence that the temporary suspension of price tests negatively impacted market quality as measured by liquidity, volatility, and price efficiency.
Boulton, Braga Alves (2008)	Short-sell restrictions negatively impacted the market quality of the stocks they were designed to protect. Restrictions on short selling have a negative impact on market quality and the price discovery process.

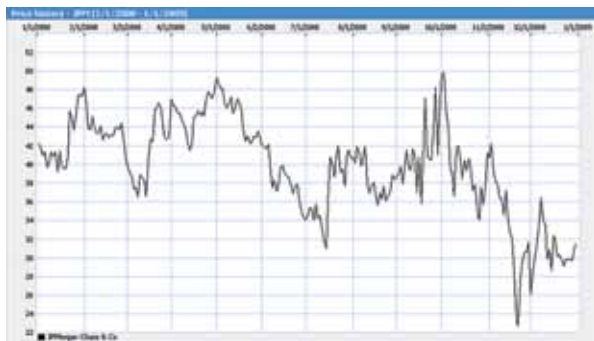
Sources: IOSCO, FSA, Boulton and Braga-Alves (2008)

Concerns on Short Selling

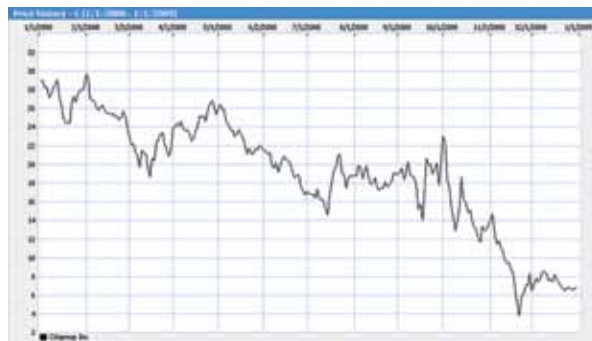
Short selling has always been under the regulatory scanner, the latest being a series of restrictions imposed by the US Securities and Exchange Commission (SEC) in July 2008 in response to the steep decline in share prices of financial stocks, following a similar decision by the UK's Financial Services Authority (FSA). The premise of the regulators was that short-sellers were engaging in market manipulation, especially of financial sector shares, without basing their decision on market fundamentals. Healthy banks were suffering as a result, and the concern was expressed.

This concern is a reflection of the decline in stock prices of major banking and financial institutions over the year, and especially in the later half, as seen in the price charts below. The seriousness of events prompted US authorities and market regulators in several major economies to impose restrictions on short selling in an effort to reduce volatility and stabilize markets.

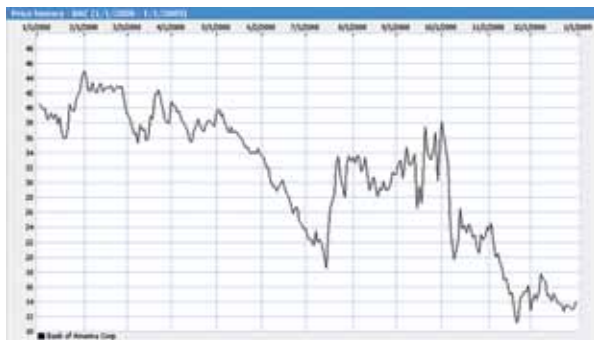
JP Morgan



Citigroup



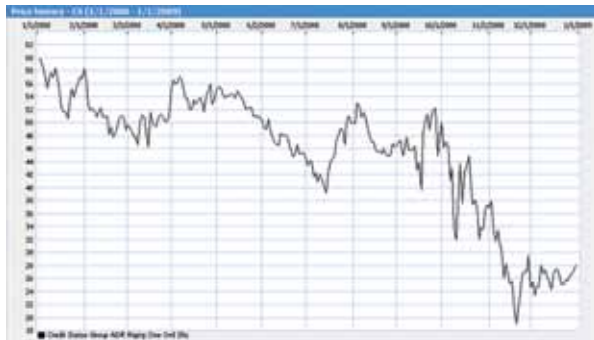
Bank of America



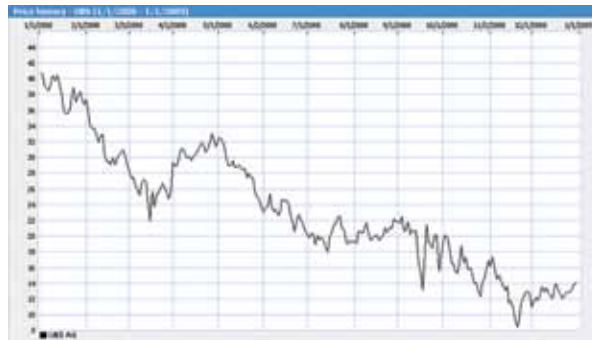
Goldman Sachs



Credit Suisse



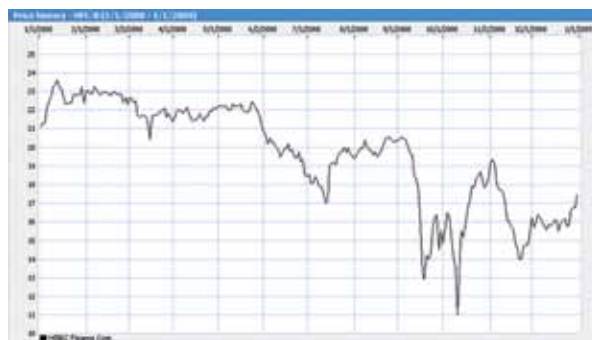
UBS



Deutsche Bank

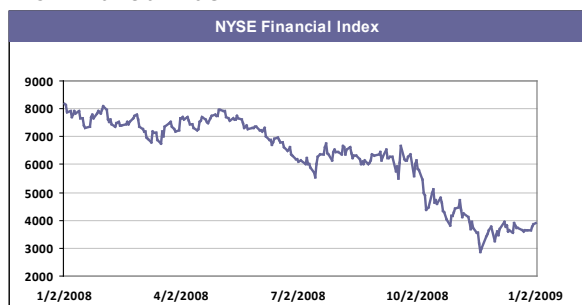


HSBC



Beyond the banking and financial stocks, the stocks that led in pulling the stock market toward 11-year lows were leading industrial companies and manufacturers of basic consumer goods. The decline in the Dow Jones Industrial Average from a record high in October 2007 to the low in November 2008 was contributed by American International Group (539.17 points), Boeing (519.62 points), Caterpillar (398.29 points), IBM (370.59 points), and American Express (364.42 points).

NYSE Financial Index



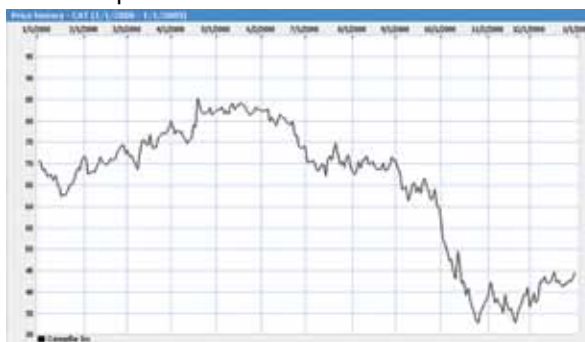
American International Group (AIG)



Boeing Co



Caterpillar Inc



American Express Co



International Business Machines Corp(IBM)



Regulatory Action on Short Selling: A Global Overview

In 2008, a wave of restrictions on short selling was announced by major markets. On July 15, 2008, the Securities Exchange Commission of the United States issued an emergency order with an objective to "enhance investor protection against naked short selling in the securities of Fannie Mae, Freddie Mac, and primary dealers at commercials and investment banks". The Order required that anyone with short-sell positions should arrange beforehand to borrow the securities and deliver them at settlement. The Order, which was originally to be terminated on July 29, was later extended upto August 15, 2008. The stocks of the following institutions were covered under the Order.

1. BNP Paribas Securities Corp
2. Bank of America Corp
3. Barclays PLC
4. Citigroup Inc.
5. Credit Suisse Group
6. Daiwa Securities Group Inc.
7. Deutsche Bank Group
8. Allianz SE
9. Goldman Sachs Group Inc.
10. Royal Bank ADS
11. HSBC Holdings PLC ADS
12. JP Morgan Chase & Co.
13. Lehman Brothers Holdings Inc.
14. Merrill Lynch & Co, Inc.
15. Mizuho Financial Group Inc.
16. Morgan Stanley
17. UBS AG
18. Freddie Mac
19. Fannie Mae

Following the US action, several countries in Europe and Asia have announced varying degrees of restrictions on short selling. The UK imposed temporary restrictions on September 18, 2008, following the market turbulence that rose out of collapse of Lehman Brothers. During this period, more than 20 countries announced restrictions on short selling. (See table below.)

	What type of short position is covered by the prohibition?	What is the threshold for any disclosure obligation?	Physical (P) or economic (E) interest caught?	Exemption available for market maker or equivalent
United Kingdom	Net Position	0.25% of issued share capital	E	Y
United States	Naked and covered	0.25% of issued share capital	E	Y
Australia	Covered	Any net short position	P	Y
Austria	Net Position	0.25% of issued share capital	E	N
Belgium	Naked	0.25% of issued share capital	E	Y
Canada	Naked and covered	N/A	P	Y
France	Naked	0.25% of issued share capital	E	Y
Germany	Naked	N/A	P	Y
Hungary	N/A	Any short position	P	N
Ireland	Net Position	0.25% of issued share capital	E	Y
Italy	Naked	N/A	P	Y
Korea	Naked and covered	N/A	P	Y
Luxembourg	Net Position	N/A	E	Y
Netherlands	Naked	0.25% of issued share capital	P	Y
Portugal	Naked	0.25% of issued share capital	E	Y
Russia	Naked and covered	N/A	P	N
Singapore	Naked	N/A	E	N
Spain	N/A	0.25% of issued share capital	E	N
Switzerland (SFBC/SWX)	Naked	N/A	P	N
Switzerland (SWX Europe)	Net Position	N/A	P	N
Taiwan	Naked and covered	N/A	P	N

Note: Physical interest indicates the actual sale of the security, whereas economic interest denotes any instrument (short positions under options and other derivative instruments referencing the shares) giving rise to an exposure, whether direct or indirect, to the issued share capital of a company.

Source: Clifford Chance LLP, September 2008

Though these restrictions were for a limited period, in some countries these restrictions have lapsed, whereas in a few others these are extended or put under review.

The restrictions on short selling have lapsed in the US and Canada and expired in the UK, Austria, Italy, and the Netherlands in January 2009. These will expire by March 2009 in Belgium, Germany, and Japan, and by May 2009 in Greece. As of January 2009, short selling restrictions are still under review in a number of countries, including Denmark, Hungary, Iceland, Ireland, Korea, Luxembourg, Norway, Portugal, Russia, Singapore, Spain, Switzerland, and Taiwan.

Nature of Restrictions Imposed in Each Country										
Country	Financials					Non-financials				
	Ban	Naked	Cover	Phys	Econ	Ban	Naked	Cover	Phys	Econ
Australia	Y	Y	Y	Y	N	Y	Y	Y	Y	N
Austria	N	N	N	N	N	N	N	N	N	N
Belgium	Y	Y	N	N	Y	N	N	N	N	N
Canada	Y	Y	Y	N	Y	N	N	N	N	N
France	Y	Y	N	N	Y	N	N	N	N	N
Germany	Y	Y	N	Y	N	N	N	N	N	N
Greece	N	N	N	N	N	N	N	N	N	N
Ireland	Y	Y	Y	N	Y	N	N	N	N	N
Italy	Y	Y	N	Y	N	N	N	N	N	N
Japan	N	N	N	N	N	N	N	N	N	N
Nether.	Y	Y	N	Y	N	N	N	N	N	N
Portugal	Y	Y	N	N	Y	N	N	N	N	N
Spain	N	N	N	N	N	N	N	N	N	N
Sweden	N	N	N	N	N	N	N	N	N	N
Switz.	Y	Y	N	Y	N	Y	Y	N	Y	N
UK	Y	Y	Y	N	Y	N	N	N	N	N
US	Y	Y	Y	N	Y	N	N	N	N	N

Note: The first column in each section ('Ban') denotes whether a new restriction was placed on short selling financial and non-financial stocks respectively. The second and third columns denote whether this was a ban on naked and/or covered short selling. The fourth and fifth columns denote whether the ban related to physical or economic positions.

Source: *The Impact of Short Sale Restrictions, Marsh and Niemer, November 2008*

Consultations

Several consultations on short selling are undertaken. The Committee of European Securities Regulators (CESR) called for evidence from market participants on short selling to help a task force constituted for the purpose. The task force is mandated with three important aspects: (1) to assess the impact of the measures that were initiated by the CESR members; (2) consider the range of policy options for taking a more convergent approach; and (3) enhance the coordination and cooperation between CESR members on the decisions taken at the national level. In January 2009, Financial Services Authority of the United Kingdom published a Discussion Paper on Short Selling, giving scope for consultations on this till May 8, 2009. The Discussion Paper explored several ways of imposition of restrictions on short selling, which include prohibiting short selling of all stocks; prohibiting naked short selling; prohibiting short selling of financial sector stocks; prohibiting short selling of stocks in companies engaging in rights issues; prohibiting short selling by underwriters of rights issues; prohibiting short selling where there is urgent needs; introducing circuit breakers and a tick rule. Notwithstanding the above options, the paper concludes, "We do not think any direct constraints on short selling are currently justified. Nevertheless, extreme market conditions could re-emerge where the risks posed by short selling warrant some form of emergency intervention, most likely in the form of a prohibition. So, we will continue to monitor markets and stand ready to reintroduce a prohibition should this be warranted, if necessary without consultation."

Questions for Consultation

The Discussion Paper by the FSA has raised the following questions for consultation:

1. What are the views on the costs and benefits of a blanket ban on short selling? (Please quantify wherever possible.)
2. Do you agree that there should not be a ban on all forms of short selling?
3. Do you think any further measures are necessary to deal with the naked short selling? If so, what is required and why?
4. Should short selling of financial stocks be banned permanently?
5. Do you agree that, subject to having a satisfactory disclosure regime, we should not ban short selling of the stocks of companies engaging in rights issues?
6. Do you agree that we should not ban short selling by underwriters of rights issues? (Of the shares they are underwriting for the duration of the underwriting process.)
7. Should we intervene to ban short selling on an emergency basis wherever necessary? (For example, to combat market abuse and /or to maintain orderly markets.)
8. Do you agree that no additional circuit-breakers should be introduced?
9. Do you agree that we should not introduce a tick rule?
10. Are there any other direct constraints on short selling that you think ought to be considered? (If so, please provide information regarding their costs and benefits.)

Responses

The Board of Directors of the World Federation of Exchanges, a global body of the stock exchanges, in a recent statement said, "Short-selling is a well established market mechanism, which contributes to their liquidity and efficiency. It should be conducted subject to regulations which enhance the public's confidence in exchanges. Rules governing short-selling should include borrowing and delivery requirements, and should be strictly enforced. All short-selling transactions should comply with rules prohibiting market manipulation."

The responses of a sample of institutions in a consultation conducted by the Committee of European Securities Regulators are reproduced in the following table.

Institution	Response to the CESR Call for Evidence on Short Selling
London Stock Exchange	While we recognize that regulatory intervention was taken in a number of countries due to widespread concerns about market volatility, we believe that short selling is an integral part of the proper functioning of equity markets and a legitimate investment technique. Research commissioned by us on the effect of the recent ban on short selling introduced in the UK found that market quality (defined as price volatility and liquidity) was reduced in the affected stocks in the period following the ban. The research was UK-focused, but we believe the findings will be of interest to all CESR members who have implemented national short-selling restrictions.
European Banking Federation	There are divergent views about the impact of the recent bans and restrictions imposed by some CESR members on short selling, and more work is necessary to establish whether these initiatives have reached their objective; whether some kind of restriction can, in general, be a useful tool to calm down markets in exceptional circumstances, such as those that occurred in the third quarter of 2007. However, there is agreement among market participants that there should be no general ban of short selling or of securities lending; as well as about the harmful consequences that arose from the divergences across member states in the measures that were taken. If further research demonstrates the added value of such measures, we believe that reporting and/or disclosure solutions would be the preferable solution. However, in this case, a number of further questions about the substance and way of making the disclosures would need to be clarified. We caution that any measures that are considered going forward must be subject to a cost-impact study to ensure that their expected benefits outweigh the costs. Furthermore, measures that are demonstrated to be necessary must be designed so as to lead to more harmonized rules across member states, globally.
International Securities Lending Association	In our view, the restrictions on short selling introduced since September 2008 have had little or no effect on share price returns. But they have impaired market efficiency, reduced liquidity, raised trading costs for investors, and created compliance costs for market participants. In addition, particular measures in some countries have caused practical difficulties for securities lenders and their agents.

NYSE Euronext	<p>We believe that it is key to ensure that short selling does not constitute any abuse in itself, and that regulatory intervention is justified in such cases only, i.e., where the level of short selling results in market distortion or where it is a consequence of a market abuse. Short selling may indeed constitute an abuse in the case of knowledge of forthcoming events like capital raising, or if the short position is accompanied by the dissemination of rumours on a considered share. However, except in these circumstances, short selling is a legitimate investment technique that does not constitute any abuse per se and therefore does not require any intervention from the regulators. Short selling can even improve liquidity and the price formation process, hence enhance market efficiency.</p> <p>In these sensitive periods where short selling may constitute a market abuse (i.e., in the case of capital raising or when there are rumours on a share), such abuses can be avoided by taking the following actions: either by ensuring transparency of investment firms' 'short sales' to the rest of the market; or by imposing the transmission of the relevant information on these trades, including OTC transactions, to the competent authority during the said sensitive periods. At NYSE Euronext, we consider that the second alternative would be the most appropriate and practically efficient for all, i.e., the transmission to the regulators of information on short selling done during "sensitive periods". Indeed, this option would require minimum IT adaptations on the side of market participants —our systems already allow the inclusion of a specific field in orders' messages sent to the regulated market. Moreover, this would allow the competent authority to undertake a systematic analysis of the trades declared 'short' by intermediaries during the sensitive periods of capital raising and in the case of rumours on a share.</p>
BME-Spanish Exchanges	<p>From the point of view of market microstructure, short selling covered by stock lending can contribute to increase the liquidity of the market as shown by some academic papers on the subject. This practice allows market participants to put in place different market strategies. The experience accumulated in the last months since the implementation of measures restricting short selling all over the world has shown no evidence of impact in the price formation of the stocks. Moreover, current restrictions lead the market to an asymmetric situation in a double bias. One is in the price formation with less sellers and the other is the obligation of information on short positions of certain stocks, whereas this obligation does not apply to long positions. Measures on short-selling restrictions should be harmonized in the European Markets in order to prevent stricter systems from losing competitiveness or being subject to regulatory arbitrage.</p>
Hedge Fund Standards Board (HFSB)	<p>Short selling is a crucial component of an efficient capital market. Without it, investors will be far less confident about remaining invested and markets will be far less efficient. A good example of the inefficient capital allocation that can occur when markets operate without correction is the wasteful investment in overpriced securities that is observable during bubbles. The dotcom bubble of 1998/2000 or the house price bubble of 2005/2007 provides ample evidence of this. Short selling is a crucial mechanism to burst bubbles, sometimes even preventing them from happening. Notwithstanding these benefits, we are aware that there can be cases of market abuse in the context of short selling. One such activity is called 'short and distort', where false rumours are spread causing a stock to fall. This is similar to market abuse activity in the context of long positions such as 'pump and dump'. All such market manipulation is already illegal under current EU legislation (Market Abuse Directive), and the HFSB has set out best practice standards to help hedge fund managers comply with these legal and regulatory requirements. It is important to note that the best practice approaches identified by the HFSB might well merit consideration for adoption by all investors in addition to hedge funds.</p>
Union of Listed Companies (ULC)	<p>ULC does not support any regulatory banning of short selling. Short selling is a driving force for markets. What, however, needs to be regulated is the abuse of short-selling practices and the coordination of regulatory efforts. To that effect ULC believes that the following measures should be considered: Strengthening transparency, Enhancing market integrity. An EU-wide market practice on short selling could be helpful to that effect, imposing all other practices that do not confront to such requirements to greater scrutiny by the relevant authorities. Improving coordination and communication between regulatory authorities should be established in case short-selling activities of an investment firm of one member state exceed specific thresholds in an issuer listed in another member state.</p>

Impact of Recent Short Selling Restrictions

Although short selling has long been controversial, the rationale for restrictions is quite often contested. A number of empirical studies revealed that restrictions on short selling might not have led to the expected outcome.

In a discussion paper, Financial Services Authority, London, brings out certain important aspects of the regulatory restrictions in short selling on three most major aspects of the markets, namely returns, volatility, and liquidity.

THEORY	EVIDENCE
RETURNS Short selling amplifies price declines, taking the stock prices below their fundamental value. An effective short selling ban would reduce extreme negative returns for restricted shares and also, possibly, increase average returns for restricted shares.	Behaviour of share returns did not change significantly after the introduction of the temporary ban. In the 15 days after a ban on short selling was introduced in the UK, restricted stocks performed better than the FTSE 350. However, in other periods, average returns for the restricted stocks are generally in line with the returns on FTSE 350 pre-ban and post-ban. In the 30 days before the introduction of the temporary ban, we do not find evidence that short selling is amplifying negative returns.
VOLATILITY A ban on short selling would lead to lower volatility for restricted share.	Volatility in the market has risen sharply after the introduction of the temporary ban on short selling on September 18, 2008, but has come down to levels observed before the introduction of the temporary ban.
LIQUIDITY Lower traded volumes and higher bid-ask spread for shares on the restricted list to be expected.	Immediately after the introduction of the temporary ban, trading volume for restricted shares increased relative to market. However, a marked decrease was observed later in trading volumes for the restricted shares. Bid-ask spreads have increased market-wide after the introduction of temporary ban. However, spreads for the restricted stocks have increased considerably more than they have for the market as a whole.

Source: FSA, United Kingdom

Several studies have evaluated the effect of the restrictions on short selling imposed by the US, the UK, and other major countries from July 2008 onwards. A gist of the scope and outcome of these studies is given below.

Marsh and Niemer (2008) Assessment of short selling restrictions, including mean and median daily returns, their standard deviation, skewness and kurtosis and their first order auto-correlation, and the goodness of fit market model of daily returns.	No strong evidence that restrictions on short selling in the UK or elsewhere changed the behaviour of stock returns. They also detect no sign that stock market efficiency declined as a result of the restriction.
Clifton and Snape (2008) Examined liquidity measures such as bid-ask spread, bid and ask depths, number of trades and volumes traded, and number of shares transacted, etc.	After the temporary ban, stocks on the restricted list have lower liquidity compared to the control stocks and after controlling for market-wide changes such as increased volatility.
Bris (2008) Compared stock returns, firm fundamentals, measures of market quality and pricing efficiency, etc.	Share price performance and market quality of the affected stocks are worse than that of comparable stocks prior to the ban. The affected stocks suffered a significant decline in market efficiency.
Boehmer, <i>et al.</i> (2008) Compare a selection of NYSE listed stocks on the restricted list with NYSE listed comparator stocks not subject to the ban.	Stocks on the restricted list experienced a share price increase at the start of the ban and a temporary share price decline when short selling resumed after the end of the ban. However, market quality for these stocks, as measured by spread, the five-minute price impacts of trades and intra-day volatility, decreased.

<p>Boulton, Braga Alves (2008) Examined changes in the underlying market quality for the stocks subject to the restrictions, including liquidity, volatility, and the incorporation of idiosyncratic risk into stock prices.</p>	<p>The study reports a positive market reaction to the announcement of the restrictions. The study finds average cumulative abnormal returns of 12.9% for the restricted sample in the four trading days between the announcement and implementation of the restrictions. However, over the four trading days following the expiration of the order, the gains associated with the announcement period were partially reversed, with the restricted sample stocks experiencing a mean cumulative abnormal return of -5.2%.</p>
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Costs and Benefits

Essentially, significance of any regulatory measures is assessed in terms of the costs and benefits. The FSA, in its recent consultations on the subject, also outlined the importance of costs and benefits in each of the aspects of regulating or restricting short selling.

COSTS	BENEFITS
<p>Impose compliance costs on firms, such as legal advice, adjustment of IT systems. The average initial compliance costs associated with temporary ban on short selling in the United Kingdom amounted to 40,000 pounds sterling per firm. Average cost of complying with the ban worked out to 6,500 pounds sterling per firm. There are also certain indirect costs in terms of reduction in speed of price adjustment, liquidity and opportunity costs in the form of foregone trading profits.</p>	<p>Eliminate risks associated with short selling, such as market abuse, disorderly markets, and settlement issues. A ban on naked short selling would reduce the risk of settlement failures brought about by the inability of naked short-sellers to source stock to fulfill their delivery obligations. A ban on short selling in financial sector stocks can, if complied with, eliminate the potential negative effects of short selling in these particular stocks (market abuse, disorderly markets, and settlement issues). A ban will remove potential conflicts of interest for underwriters.</p>

Current Position

There are two schools of thought regarding the legitimacy of short selling as an activity and its impact on the declining stock prices. On the one hand, the votaries of short selling consider it as a desirable and an essential feature of a securities market, not only to provide liquidity, but also to help price corrections in overvalued stocks. In their view, the restrictions on short selling distort efficient price discovery, give promoters the unfettered freedom to manipulate prices, and favour manipulators than rational investors. They argue that in a declining market, short covering of positions opened at the beginning of the downturn, arrests the declining trend. They also bring a body of academic literature in strong support of their case for short selling. Further, in an efficient futures market, the relationship between spot price and futures price of the underlying asset is governed by cash-and-carry arbitrage and reverse cash-and-carry arbitrage. The latter requires that traders should be able to sell the underlying security short unless, of course, there is enough number of traders who own the security and are able to sell it cash to take advantage of too low a futures price.

The critics of short selling, on the other hand, are convinced that short selling, directly or indirectly, poses potential risks and can easily destabilize the market. They believe that short selling can intensify the declining trend in share prices, increase share price volatility, and force the price of individual stocks down to levels that might not otherwise be reached. They also argue that declining trend in the share prices of a company can even impact its fund raising capability and undermine the commercial confidence of the company. In a bear market, in particular, short selling can contribute to disorderly trading, give rise to heightened short-term price volatility, and could be used in manipulative trading strategies.

It is noteworthy that despite the conflicting schools of thought, securities market regulators in most countries and, in particular, in all developed securities markets, recognize short selling as a legitimate investment activity. Such jurisdictions also have an active market for equity derivatives, which include stock futures. Some of the jurisdictions even recognize the usefulness of naked short selling in certain circumstances and, instead of prohibiting short selling, the regulators have permitted it to take place within a regulated framework. The International Organization of Securities Commissions (IOSCO) has also reviewed short selling and securities lending practices across markets and has recommended transparency of short selling, rather than prohibit it.

The FSA is of the view that short selling is not in itself manipulative. Rather, it is seen as a valid investment practice that, in essence, represents the opposite of taking a long position. However, short selling, like any other form of trading, may be manipulative, when misused.

The SEC is of the view that although the vast majority of short selling is legal, abusive short-sell practices are illegal. For example, it is prohibited for any person to engage in a series of transactions in order to create actual or apparent active trading in a security or to depress the price of a security for the purpose of inducing the purchase or sale of the security by others. Thus, short selling to manipulate the price of a stock is prohibited.

The Secondary Market Advisory Committee of SEBI is of the view that genuine short selling could exacerbate price decline, but that by itself may not be construed as a manipulative activity unless there are also evidences of market misconduct. However, the Committee felt that abusive short selling practices to manipulate the price of a stock will continue to be treated as market misconduct and attract appropriate regulatory action.

Looking Ahead

The IOSCO Technical Committee members have taken steps or reconfirmed existing measures to minimize the possibility of abusive short selling at a time when the global credit markets are experiencing significant tightening. These measures include:

- Confirm or impose new bans on naked short selling by requiring market participants to either borrow or make arrangements to borrow securities before conducting short-sell transactions (in some jurisdictions this outcome was achieved with the cooperation of regulated or licensed exchanges), while ensuring that bans on naked short selling do not negatively impact critical market functions such as securities lending.
- Make it mandatory for certain investors to report short selling or net short-sell positions to regulators, self-regulatory bodies, or the public.
- Conduct heightened surveillance of trading to detect abusive short selling.
- Share surveillance information among members to address abusive short selling.

Regulatory Actions Undertaken in Different Countries

United States

On July 15, 2008, the US Securities and Exchange Commission announced temporary restrictions on naked short selling of the stocks of 19 financial firms. This Emergency Order went on till August 2008. The US introduced a prohibition of naked and covered short selling for 306 financial stocks on September 22, 2008. After October 8, the ban only applied to naked short positions.

Regulation SHO

In the US, since January 2005, the SEC has done away with the age-old down tick rule, which was adopted by the SEC in 1938. Tick rule gave way to Regulation SHO, which establishes two requirements called 'locate' and 'close-out' to address problems associated with failures to deliver, including potentially abusive naked short selling. 'Locate' requires a broker-dealer to have reasonable grounds to believe that the security can be borrowed so that it can be delivered on the due date of delivery before a short-sell order in any equity security is made effective. (This 'Locate' must be made and documented before the short-sell order is effective.) The 'close-out' requirement imposes additional delivery requirements on broker-dealers for securities in which there are a relatively substantial number of extended delivery failures at a registered clearing agency ('threshold securities').

It is not uncommon that trades remain unsettled on the stock exchanges in the US. The SEC recognizes a tolerance level of unsettled trades for five consecutive settlements, before taking action under SHO. The new requirements have been introduced in the wake of controversies arising from trades remaining unsettled in the Depositories Trust & Clearing Corp. (DTCC) for several settlements as a result of naked short selling and failed settlements and circulation of counterfeit shares in a number of listed securities of small cap and in 'pink sheet' companies.

United Kingdom

On September 18, 2008, the Financial Services Authority (FSA) introduced temporary short selling measures in relation to stocks in the UK financial sector companies on an emergency basis. It was done at a time of extreme market turbulence, manifested in the forms of high and prolonged price volatility and downward pressure on the prices of financial stocks, in particular. There were concerns by the heightened risks of market abuse and disorderly markets posed by short selling in these conditions. The temporary measures effectively banned the active creation or increase of net short positions in the stocks of the UK financial sector companies and required disclosure to the market of significant short positions in those stocks. The FSA released a Discussion Paper on Short Selling.

India

SEBI reviews its regulatory policies periodically. The policy on short selling and securities lending and borrowing by the Secondary Market Advisory Committee has made some recommendations in this regard.

- The Committee recommended that in the Indian context, 'short selling' may be defined as selling a stock which the seller does not own at the time of trade.
- Present regulatory restrictions, which allow only the retail investors to short-sell, should be removed to enable a level playing field for all classes of investors. In other words, the institutional investors who are currently prohibited should be permitted to short-sell.
- The Committee recommended that in the Indian securities market, a securities lending and borrowing scheme must be put in place to provide the necessary impetus for short selling. The introduction of a full-fledged scheme for securities lending and borrowing should be simultaneous with the introduction of short selling by the institutional investors.
- The Committee recommended that in the Indian securities market, naked short selling should not be permitted and, accordingly, all investors would be mandatorily required to honour the obligation of delivering the securities at the time of settlement.

Salient Features of Securities Lending Scheme, 1997

- The lender enters into an agreement with an approved intermediary (AI) registered with SEBI for depositing the securities for the purpose of lending. The borrower shall enter into an agreement with the AI for the purpose of borrowing of securities. The AI liaises between the lender and the borrower.
- The AI shall guarantee the return of the equivalent securities of the same type and class to the lender along with the corporate benefits accrued on them during the tenure of the borrowing. In case of failure of the borrower to return the securities, the AI shall be liable for making good the loss caused to the lender.
- The AI retains the securities deposited by the lender in his custody as a trustee and shall lend the securities deposited by the lender to the borrower from time to time.
- The title of the securities lent to the borrower shall vest with the borrower and the borrower shall be entitled to deal with or dispose of the securities borrowed in any manner whatsoever.
- The agreement between the lender and the AI and the borrower and the AI, shall provide for the period of depositing/lending of securities, charges or fees for depositing/lending and borrowing, collateral securities for borrowing, etc.
- The AI shall be entitled to receive fees for lending from the borrower and collateral securities in the form of cash, bank guarantee, government securities, certificate of deposits, other securities, etc.
- In the event of failure to return the securities, the borrower shall become a defaulter and the AI has the right to liquidate the collateral, in order to purchase equivalent securities of the same class from the market, for returning the securities to the lender. The AI shall be entitled to take any action, as deemed appropriate, against the defaulting borrower to make good his loss, if any.
- The AI shall notify defaults by any borrower to the Board, the concerned stock exchange, and the concerned authorities for initiation of appropriate action against the defaulter.

The SMAC recommended that appropriate amendments be made with a view to align the model agreements in the Indian securities market with the internationally accepted standards and also felt that adequate disclosure of the lending and borrowing transactions to the market was necessary.

Japan

The Financial Services Agency (FSA) of Japan has decided to take additional measures to strengthen the restrictions on short selling of stocks. The following regulatory measures have already been taken on short selling with regard to all listed stocks in Japan:

1. An 'uptick rule requirement' that prohibits, in principle, short selling at prices no higher than the latest market price.
2. Requirements for traders to verify and mark whether or not the transactions in question are short selling.
3. Request on exchanges to make daily announcements on their aggregate price of short selling regarding all securities and aggregate price of short selling by sector.

In addition, the FSA has decided to prohibit naked short selling as a temporary measure (effective until March 31, 2009). It has also been decided that holders of a short position of a certain level or more (in principle, 0.25% or more of outstanding stocks) will be required to report to exchanges through securities firms.

Australia

The Australian Government introduced the Corporations Amendment (Short Selling) Act 2008, which prohibits naked short selling for all stocks including Exchange-Traded Funds (except naked shorts in an underlying financial product resulting from the exercise of an Options Market Contract). The Act also does not permit covered short sales of all listed stocks (subject to a limited number of exceptions). Trading participants are required to continue to report their net short-sell position for each stock to the Exchange on a daily basis. The net short-sell position includes naked short selling in an

underlying financial product resulting from the exercise of an Options Market Contract and covered short selling made by a trading participant, who is exempt from the prohibition of covered short selling as per the Australia Securities and Investment Commission.

Annexure II

Regulatory Approaches to Short Selling				
Jurisdictions	General approach	Instrument limitations	Trading controls ²	Disclosure
Australia	Illegal to sell a security which the seller does not have right to vest unless under exemption approved by the regulator	Liquid securities only; no more than 10% per issue; not during takeovers	Tick rule	Yes
Brazil	No restrictions	None	None	Stock lending
Canada ³	Permitted, subject to reporting and margin requirements, and trading controls	None	Tick rule	Yes
France	No restrictions	None	None	No
Germany	No restrictions	None	None	No
Hong Kong	Illegal to sell a security which the seller does not have right to vest unless exempted under the law by the regulator	Liquid securities and underlying securities of a derivative and approved ETF	Tick rule	Yes
Italy	No restrictions	None	None	No
Japan	Permitted subject to trading rules and margin requirements	None	Tick rule	Yes
Malaysia	Permitted on-exchange with pre-arranged stock borrowing ⁴	Liquid securities only	Tick rule	Yes
Mexico	Permitted on-exchange, subject to certain restrictions	Higher liquidity equities only	Tick rule	Yes
Netherlands	No restrictions	None	None	Yes
Singapore	Unrestricted, but exchange may suspend individual securities if speculative activity is excessive or abuse is suspected	None, unless security is temporarily designated as ineligible	None	No
Spain	No restrictions but stock must be borrowed by the day of delivery	None	None	Stock lending

Sweden	No restrictions	None	None	Yes
Switzerland	No restrictions	None	None	No
UK	No restrictions	None	None	Planned
US	Permitted, subject to trading rules, borrowing requirements and margin requirements	None	Tick and best bid rules	Yes

2. Markets/exchanges adopting tick rules generally provide various exemptions for market-making and a variety of hedging, risk management or arbitrage trades. Strict adherence to an up-tick rule would otherwise make it impossible to carry out many trades where timely execution is critical, leading to reduced liquidity or increased risk.

3. This reflects the regulations of the Canadian provincial regulators and exchanges/SROs.

4. Malaysia introduced a regulatory framework for short selling in June 1996. This was suspended in September 1997 as one of several measures to maintain market stability during the Asian crisis.

Annexure III

Short Selling across Countries

Country	When was short selling allowed	When was securities lending allowed	Whether short selling is practised	Comments
Argentina	1999	1991	No	Equity lending is rare and occurs only between brokers. Short selling cannot last more than 360 days in a row. Only allowed for 16 stocks.
Australia	Before 1990	Before 1990	Yes	Securities can be borrowed from ASX and counter-party. Cash and non-cash collateral are accepted at 105-110% of the underlying value of the loan securities. Collateral is marked-to-market daily.
Austria	Before 1990	Before 1990	Yes	
Belgium	Before 1990	Before 1990	Yes	There is no organized market for stock lending and borrowing. A law on securities lending was passed in March 1999 but still pending. There is no official regulation on short selling stocks.
Brazil	Before 1990	Before 1990	No	CBLC has been authorized to maintain a securities lending programme. Under CVM Instruction No. 249, only entities which offer settlement, registration, and custody services in the Brazilian market are authorized to provide securities lending services. Accordingly, foreign investors are not authorized to engage in directed/discretionary lending activities that are outside the CBLC programme.
Canada	Before 1990	Before 1990	Yes	The market for securities lending is large (40+ billion-dollar business) and well developed.
Chile	Allowed in 1999	Allowed in 1999	No	Short selling cannot last more than 360 days in a row. The entity (including individuals) who is lending the stocks maintains the beneficial ownership, except the right to vote.
Colombia	Not allowed	Not allowed	No	Securities lending is not authorized.
Czech Republic	Before 1990	Before 1990	Yes	There is no regulations on short selling since Prague Stock Exchange (PSE) was opened in 1993. It is possible to sell securities only if absent securities are bought or borrowed before the settlement date.
Denmark	Before 1990	Before 1990	Yes	No regulatory barriers inhibiting securities lending.
Finland	Allowed in 1998	Before 1990	No	The transfer tax laws place a serious burden on the activity.

France	Before 1990	Before 1990	Yes	Securities lending was permitted by law in 1987 and 1988. All establishments (domestic and foreign) are eligible for short selling as long as they are recognized as counter-parties.
Germany	Before 1990	Before 1990	Yes	A securities lending facility was created in 1989 to improve market liquidity.
Greece	Not allowed	Not allowed	No	Securities lending and borrowing have been legalized by the Greek Parliament but the operational framework has yet to be established.
Hong Kong	Allowed in 1996	Before 1990	Yes	Short selling was allowed for 33 stocks in 1994, and then to a wide range of stocks in 1996.
India	Before 1990	Before 1990	No	Not popular among market players. Not allowed for foreign investors.
Indonesia	Not allowed	Allowed in 1996	No	No guidelines have been provided by BAPEPAM, the Indonesian Regulatory Authority for the Indonesian Capital Market.
Ireland	Before 1990	Before 1990	Yes	Securities lending volume is still limited.
Israel	Before 1990	Before 1990	No	The TASE does not offer a securities lending programme to its members. TASE rules indicate that the securities account of a TASE member at clearing house may not enter into a short position intentionally.
Italy	Before 1990	Before 1990	Yes	
Japan	Before 1990	Before 1990	Yes	Allowed for stocks listed on the first section of the exchanges.
Jordan	Not allowed	Not allowed	No	
Luxembourg	Before 1990	Before 1990	Yes	
Malaysia	Allowed in 1995, Prohibited again in 1997	Allowed in 1995, Prohibited again in 1997	Yes	Short selling and securities lending were suspended during the regional financial crisis of 1997. With the economic recovery, improvements in report requirements, prudential controls and the cessation of trading of KLSE-listed securities offshore, short selling and securities lending are expected to be restored.
Mexico	Before 1990	Before 1990	Yes	The system is generally used as a safeguard against failing to deliver rather than securities lending as a product. Foreign investors are eligible to participate in securities lending through a local broker. Margin is 150%.
Netherlands	Before 1990	Before 1990	Yes	There is a central lending facility at the ASE.
New Zealand	Allowed in 1992	Not allowed	No	Tax regulations prevents onshore securities lending from taking off.
Norway	Allowed in 1992	Allowed in 1996	Yes	Securities lending is still in the early stages of development and tax implications are being discussed at the Ministry of Finance.
Pakistan	Not allowed	Not allowed	No	There are no regulations that restrict foreign investors from lending or borrowing securities. Short selling is not allowed
Peru	Not allowed	Not allowed	No	Offshore lending is prohibited. Lima Stock Exchange is considering allowing new activities such as securities lending, short selling, and new repo trades in the future.
Philippines	Allowed in 1998	Allowed in 1998	No	Although the SEC has approved the rules on SBL and short selling, the rules are not yet clearly defined in the market.
Poland	Allowed in 2000	Before 1990	No	Neither the full legal nor operational framework have been established.
Portugal	Before 1990	Before 1990	Yes	Securities lending is allowed and practised. BVLV charges 10 b.p. annualized over the initial value (maximum days for calculation is 45) for this service.

Singapore	Not allowed	Before 1990	Yes	Onshore lending is limited while offshore lending is active.
Slovak Republic	Not allowed	Not allowed	No	Securities lending and borrowing is not allowed under the Securities Act.
South Africa	Before 1990	Before 1990	Yes	Short selling is allowed in JSE.
South Korea	Not allowed	Before 1990	No	Securities lending and borrowing has not been active to date.
Spain	Allowed in 1992	Allowed in 1992	No	Securities lending and short selling have been available since 1992. Since July 1994, SCLV has been acting as principal for the lending pool formed by the daily bids from the clearing members. The load must be reported to the SCLV within two working days of the sale date.
Sweden	Allowed in 1991	Allowed in 1991	Yes	Widely practised.
Switzerland	Before 1990	Before 1990	Yes	Securities lending is legal in Switzerland and there are no restrictions on who may borrow or lend. There is no central lending facility and no stamp duties apply to securities lending.
Taiwan	Not allowed	Not allowed	No	Foreign investors are prohibited from borrowing securities on-shore and can only lend securities on-shore to brokers to cover their fails.
Thailand	Allowed in 1997	Allowed in 1999	Yes	Short selling is very limited after being allowed in 1999.
Turkey	Before 1990	Allowed in 1996	No	Securities lending is not widely practised.
United Kingdom	Before 1990	Before 1990	Yes	Short selling is active in the UK.
United States	Before 1990	Before 1990	Yes	
Venezuela	Not allowed	Not allowed	No	Securities lending is not specifically prohibited or provided for under current regulations. Free transfers of securities between different beneficial owners cannot be done without executing a trade on the exchange. Offshore lending is generally not practised.
Zimbabwe	Not allowed	Not allowed	No	

Source: IOSCO

Note: Several changes in the rules governing short selling are being made in the period following July/September 2008. This table presents a general illustration of how the practice of short selling is treated in various jurisdictions. It is important to update the areas of practice as per the current guidelines.

Annexure IV

Examples of Short Selling

The examples below illustrate some of the main uses of short selling. They are presented in simplified form and do not include, for example, any assessment of transaction costs. The final example illustrates the market risk to which a short seller is exposed.

1. Short selling on the view that a security is over-valued

An investor takes the view that the shares of Company A are over-valued. He short-sells 10,000 shares at the market price of €15 a share. The investor completes the sale by delivering borrowed stock, enabling him to realise sale proceeds of €150,000.

Subsequently, the investor is proved right in his judgement and the price falls. He decides to close out his position when the price falls to €10. He then buys 10,000 shares (at €10 a share), for which he pays €100,000 in total. He uses these shares to close out his stock borrowing obligations and is left with a gross profit of €50,000, before any transaction costs.

2. Short selling as part of a long/short strategy

An investor, possibly uncertain about the likely trend of the market, in general, decides to pursue a strategy that aims to capitalize solely on changes in the relative pricing of securities.

The investor decides that the shares of Company A are likely to outperform those of Company B, irrespective of how the market as a whole performs.

He invests \$200,000 in Company A and goes short of shares worth \$200,000 in Company B.

Over the next few weeks, Company A's share price rises 10% and that of Company B rises 2.5%. On closing the position, the investor thus realises a \$20,000 (i.e., 10%) profit on his long position in company A, but loses \$5,000 (i.e., 2.5%) on closing out the short position in company B.

Overall, the investor realises a gross profit of \$15,000 gross, before any transaction costs. If both share prices had fallen rather than risen, the investor would still make a profit provided the price of Company B's shares fall by more than that of Company A's. For instance, if the price of Company A's shares fell 2.5% (creating a loss of \$5,000) but that of Company B's fell 10% (creating a profit of \$20,000), the overall profit would also be \$15,000.

3. Hedge of a short derivative

A securities firm sells an investor a put option in the shares of company A, giving the investor the right to sell the securities firm 100,000 shares at £10 a share at some point during the next 90 days. The shares are currently priced at £11 and the investor has paid 25p a share for the option – in total £25,000. If the price falls and the investor exercises its option, the firm will lose money if it cannot resell the shares for more than £9.75 – its purchase price, less the 25p a share it has received as premium.

Suppose in this case the Company A is affected by unexpectedly bad news and that the share price starts falling, exposing the investment firm to an increasing likelihood that the customer will find it attractive to exercise its 'put'. To protect itself, the investment firm goes short 100,000 shares in Company A when the price reaches £10. It borrows the shares to deliver to the buyer and the sale realises £1 million. Shortly after, the investor exercises his option and requires the investment firm to buy his 100,000 shares at £10 a share – for £1 million in total. The investment firm uses these shares to return to the stock lender and is left with its £25,000 intact (before expenses).

4. Arbitrage

An investor notices that a convertible loan stock with the right to convert into ten shares of Company A for every €100 nominal of convertible is selling at only €95 per €100 nominal and that the shares of Company A are trading at €10 a share. Even though the convertible appears cheap, the investor does not know if the shares will rise or fall before he can convert. However, he can 'lock in' a profit regardless of the movement of prices by buying the cheap asset and selling the dear one.

He, therefore, invests €95,000 in buying €100,000 nominal of the convertible and simultaneously short-sells 10,000 shares—the number of shares into which his convertible holding will convert—at the current market price of €10 a share. Since at that time he has no shares to deliver, he needs to borrow them. On delivery, he realises the sale proceeds of €100,000.

When the investor subsequently exercises his conversion rights and takes delivery of 10,000 shares, he uses these shares to close out his borrowing, leaving him with a 'guaranteed' €5,000 profit (before expenses).

5. A bear squeeze

In this case, an investor takes the view that Company A will report worse earnings than the market expects and that its shares, currently priced at £5.00, are overvalued. He short-sells 100,000 shares at that price, realising £500,000. The price initially weakens to £4.75 as rumours circulate that the stock is being short-sold. New speculation that the company may be vulnerable to takeover suddenly reverses the trend. The more professional market operators also know that any short-sellers will want to close out their positions and will need to chase the price higher to do so. They see that they can make money 'squeezing the bear'. The price rises over the next few days to £5.50 and the short-seller completes the close-out of his short position by purchasing 100,000 shares at an average price of £5.25 – or £525,000 in total. His loss before expenses, therefore, totals £25,000, but might have grown still larger if he had not closed out and a bid battle for the company had commenced.

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