SHORT SELLING AND SECURITIES LENDING:

ISSUES FOR CONSIDERATION

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INTRODUCTION

In many emerging markets, the practice of selling securities which are not owned by the seller, known as "short selling", has traditionally been a prohibited activity. This prohibition may stem from the fact that regulators in these markets hold the view that a market exists for investment, not disinvestment, and therefore short selling is seen as an unnatural, highly speculative strategy that could create excessive downward pressure on the prices of the stocks or lead to a market disruption in general. However, in the recent years several jurisdictions are beginning to realize that, properly controlled, short selling can be a very useful, even necessary, ingredient for a stable and efficient market. At the very least, the presence of short selling activity serves to counteract the bullish bias in an overheated market created by margin buying. The ability of market makers to sell short also allows them to improve the effectiveness of their performance. Furthermore, any jurisdiction which is considering the development of a derivative market of any kind would have to be aware that short selling is a common hedging strategy used by derivative dealers, which means that the development of these activities are necessarily intertwined.

Regulators who are planning to permit short selling in their securities markets need to identify where the risks lie and set out appropriate measures to control these risks. At the same time they should take care that the measures they use are not creating an unnecessary burden to market participants. Also closely linked to the issue of short selling is that of securities borrowing and lending. Even if short selling restrictions were lifted, such activity still could not take place if securities

borrowing and lending could not be facilitated. Often the problem is a consequence of tax restrictions, which need to be removed.

The purpose of this paper is to provide a guidance to those countries which are planning to permit short selling and to develop a securities lending market, as to the issues they should consider. It is not meant to be prescriptive, but rather to provide a better understanding of the subject and to assist regulators in emerging markets in the formulation of policy decisions as well as regulatory framework for such activities.

The paper consists of two main parts. The first part identifies concerns related to short selling and analyzes regulatory measures which can be used to deal with them. The second part begins by exploring securities lending from its economic and legal perspectives and its tax implication. This is followed by a discussion of risk management in securities lending, the function and regulation of lending intermediaries, and the option of centralizing lending through a central securities depository.

SHORT SELLING

Regulatory concerns

Permitting short selling can pose the following risks to the market:

(1) Possibility that small investors may be induced to make an uninformed decision to sell short, being unaware of the true nature of the risk.

(2) Possibility that the short seller would be unable to return the borrowed securities when recalled, which could affect the lender's position as well as the lender's ability to perform his obligation in other transactions with other parties (systemic effect).

(3) Risk of settlement failure in the event that a securities loan could not be arranged.

(4) Possibility of severe downward pressure on stock prices or market disruption arising from manipulative behaviors by short sellers as well as those who attempt to corner the market.

Regulatory measures which address these concerns can come in the form of reporting or disclosure requirements to create market transparency, as well as other restrictions or guidelines to give regulators some control over how the market develops, for examples, the securities that can be sold short, the types of investors permitted to sell short, or the manner in which a short sale is to be conducted.

Definition of short selling

Before setting a regulatory framework, a special attention should be given to the legal definition that determines the scope of activity called "short selling". A common definition which depends on whether or not the seller owns the securities at the time of execution of the sale may be too narrow in that it addresses the concern only for the seller's ability to settle. In order for short selling regulations to address wider concerns, such as those noted above, the definition of short selling should reflect the basic outcome of a short sale, i.e. the transaction is completed by the delivery of borrowed securities. This latter definition would include the sale of preborrowed securities, which carries all the risks of a short sale aside from settlement risk, while the first definition would exclude such transaction.

Investor protection issue: who can sell short?

Short selling as a naked strategy is a risky strategy which exposes the seller to the risk that the price may rise against him, and should be undertaken only by those who understand the nature of the risk. There are many approaches to ensure that

this is the case. The most restrictive would be to ban short selling as a trading strategy for investors and permit only market makers to sell short on the ground that the ability to undertake such transaction improves the effectiveness of their market making performance. A less restrictive and more reasonable alternative would be to permit short selling among institutional investors only, on the assumption that institutional investors are sophisticated enough to protect themselves, although such restriction may be seen as giving these investors an unfair advantage over small investors in terms of the range of strategies available to them. Another approach is to impose no restriction on the type of investor but instead to require the short selling broker to fully disclose the risk to clients beforehand.

Controlling risks to short selling brokers: the margin account

Restrictions on investors who sell short exist not only to protect investors but also to protect brokers who arrange securities loans for delivery. A client's failure to cover his short position when the securities are recalled may affect the position of the broker and lead to adverse systemic effect. A common measure to protect the brokers who make the loans is to require short sellers to open a margin account with their brokers and put up the sale proceeds and additional liquid assets as collateral. Since the value of a short seller's obligation to return the loaned securities increases as the price of securities increases, the level of equity in each short selling client's account should be monitored and marked to market as frequently as possible, and the position should be subject to a liquidation procedure when that equity falls below a required maintenance level. This mechanism forces the short seller to cut his loss while the broker has sufficient collateral to cover the value of the loan.

Ensuring a fair and orderly market

Preventing settlement failure: As a rule, the executing broker should be held responsible for making payment and delivery to the clearinghouse for every trade it has executed. In the case of a short sale, this means that prior to execution the broker must already have made arrangements to ensure that this obligation can be fulfilled, i.e. it must have located the securities (from its own portfolio or elsewhere) which can be loaned to the short selling client if necessary, or otherwise it must have confirmed that the client has made his own borrowing arrangement elsewhere. At the next level, the clearinghouse should also operate a last resort securities borrowing and lending facility for its members in order to provide an additional safeguard for the settlement system.

Transparency: In order to prevent short selling from potentially being used for manipulative purposes, regulators should provide as much transparency as possible by regularly disclosing to the public the level of short selling activity in the market, so that its effect can be anticipated and any resulting change in market condition can be fully understood. The information is also a useful input for market participants in making their trading decisions. But this information will be meaningful only if the reported activity level is a good measurement of the actual level of short selling activity in the market.

At first glance, it seems that this goal can be achieved simply by requiring all short sellers to report their transactions, or by requiring that all short sales are executed on an exchange, because exchange rule normally requires that all short selling orders are clearly marked short when they are sent for execution. However, as long as one can borrow securities freely, it will be possible for the short seller to mark his sale as a long sale but still borrow to deliver. Thus, if we remember that short sales are really sales completed by delivery of borrowed securities, we will see

that the only way to ensure that all short sales are marked as such is to monitor the lending transactions so that it would not be possible to borrow to cover a sale unless it is reported as a short sale. This is easier said than done, especially when there are many channels to borrow securities. One possible solution is to legalize only lending and borrowing through a central entity, such as a central securities depository. However, the benefit of transparency in having one centralized lending facility must be carefully assessed against the benefit of having competition among many lending intermediaries. Besides, restricting the channels for securities borrowing may turn out to be ineffective, since investors can always borrow offshore.

In the end, regulators may have to accept that there is a trade-off between transparency and other regulatory goals. If short selling is illegal or frowned upon, or if short selling rules become an unnecessary burden to market participants, the activity will still take place but will go unreported. On the other hand if rules are reasonable, market participants should prefer to conduct the activity through proper channels and transparency should not be an unrealistic goal.

Preventing market disruption: Measures commonly used by regulators for this purpose generally fall under one of these three categories: outright ban in relation to less liquid securities, price rules, and circuit breakers.

Outright ban from short selling less liquid securities: The idea behind a ban on short sales of less liquid securities is that there is greater potential for short sellers to manipulate the market in these securities, so short selling should be limited to only securities with large market capitalization and high turnover, which would be more difficult to manipulate or corner. However, although using size and liquidity criteria in deciding which securities can be sold short may help minimize

the possibility of a market disruption, applying an outright restriction can also hinder market development in other areas, for instance, the performance of market makers in illiquid securities. An alternative to a black and white restriction may be to combine size and liquidity criteria with measures in other dimensions. For example, regulators may choose to permit short selling for illiquid securities but only for a more restrictive list of market participants or under more stringent rules than in the case of liquid securities.

Price rules are generally designed so that a short sale cannot create a negative impact on market prices on its own. The most commonly known is the rule that requires all short sales to be made at a price higher than the last sale or last different sale, also known as the uptick rule or the zero-plus tick rule. In effect, the rule means that a short sale must be done on an uptick in a falling market, and on a zero tick or above otherwise. Hence, short sellers cannot create price declines, although they can profit from them.

The problem with the uptick rule is that it can make short selling virtually impossible in a falling market if the trading mechanism is a pure matching system with no market maker or specialist. This is because investors wishing to sell short would be forced to quote a price higher than the market is willing to pay. An alternative would be to shift the reference point from last sale (or last different sale) to current quotations, such as current best ask. Under this alternative the ask price quoted by the short seller would be no less than the the lowest ask price among other sellers. In this case short sellers may contribute to price declines, but not any more than what could be created by existing long sellers in the market.

Price rules do not necessarily have to apply across the board. For instance, players in the debt markets, which are usually large and difficult to manipulate and

where trading is not centralized, may find that price rules are unnecessary and can even become a burden to market development. Even within the same equity market, regulators may find that the application of price rules can be more appropriate for only small or illiquid securities rather than for the entire market.

Circuit breakers are measures used to limit the the impact of short selling on the market by putting a temporary stop to such activity when the impact or potential impact reaches a certain level. They can be price driven or volume driven. Price driven measures are similar to those operating in the normal case, e.g. a price floor for the day or a halt-trading level, but the price band for short selling may be narrower than regular trading. A volume driven circuit breaker, on the other hand, focuses on the potential impact of short selling and is triggered when the level of aggregate open short in the market reaches a certain limit. The aim of a volume driven circuit breaker is not to limit price impact, but rather to prevent the accumulation of open shorts to the degree that the short sellers can become the victims of a corner.

It should be noted that measures applicable to trading such as price rules or circuit breakers can be enforced only for short sales that are made on-exchange. Regulators permitting short selling off-exchange cannot hope to rely on these rules to limit the impact on the market.

SECURITIES LENDING

The use of securities lending transactions can make a significant contribution to the efficiency of the capital market. Short selling would not be possible unless the seller can borrow securities to deliver. Even where short selling is not permitted, there may be an occasional need to borrow to cover fail settlement. From the lender's perspective, securities lending offers the opportunity to increase income by

permitting securities held in his account to be lent for a fee. If the collateral is cash, the lender has in effect obtained temporary financing by using the loaned securities as collateral. In this respect a securities loan against cash collateral is equivalent to a sale and repurchase (repo) agreement, which is used to obtain short term financing.

Legal perspective of securities lending and tax implication

While the economic objective of securities lending is that of a loan, namely that the securities should pass from the lender to the borrower for a limited period of time and eventually return to the lender, legally the transaction involves a transfer of title from the lender to the borrower, who in turn has the obligation to make the opposite title transfer to the lender at some point in the future. Thus the transaction is actually a combination of spot disposition and forward acquisition for the lender, and vice versa for the borrower. This transfer of title allows the borrower to use the securities to fulfill his delivery obligation arising from a sale. Similarly, the passing of collateral from the borrower to the lender usually takes the form of a legal transfer of title as well, because it ensures that the lender has full control of the collateral asset. The terms "lender", "borrower", and other language reflecting the nature of a loan are simply market convention.

A consequence of this title transfer is its tax implication. Unless special provisions are made in the tax law, each transfer of securities or collateral assets between the lender and the borrower would constitute a sale and trigger a tax liability for the relevant party. In order to make lending and borrowing possible, the relevant tax authorities need to grant tax exemptions on transfers of securities and collaterals between the lender and the borrower. Even where short selling or securities lending is not at all prohibited, tax liability (whether in the form of a capital gains tax or a transaction tax or transfer duty) can be the major reason why

lending and short selling do not take place. The converse of this is that the decision to grant tax liberalization is not just a matter of revenue collection; it is equivalent to a policy decision to permit short sales.

Another problem related to the title transfer occurs when the securities on loan pay a dividend or interest. Since the income must go to the holder of record and not to the lender, the borrower must compensate the lender with an equivalent amount. If the tax treatment of such substitute payment is different from that of the actual dividend or interest income, it may discourage lending activity altogether, or create an unnecessary incentive for lending, depending on which treatment is more advantageous. It may also result in a concentration of recalls of loaned securities near the dividend or interest payment date, which may lead further to a greater possibility of a market corner.

Managing risks in securities lending

Losses in securities lending can be attributed to one of the following causes: (1) counterparty default, and (2) losses incurred in the handling of collateral asset.

Counterparty risk

Although title to the securities is transferred from the lender to the borrower, the lender is still entitled to all the economic benefits of owning the securities, and as long as the borrower does not fail to return the securities or to provide the lender with appropriate substitute payment to make the lender whole when there are corporate entitlements, the lender's position and exposure in such securities has not changed. However, if the borrower fails to fulfill its obligation, the lender may find himself in a different position from what has been anticipated, and his losses may even lead to wider consequences. Thus, it is important that proper measures are taken to manage the risk of counterparty failure.

Losses arising from counterparty failure can be minimized if the lender takes the following precautions:

(1) Careful choice of counterparty: The lender should assess the creditworthiness and establish an appropriate level of credit limit for each borrower.

(2) High level of collateralization: The lender should require the borrower to post and maintain collateral sufficient to cover the value of the securities on loan, with an additional margin as a cushion for the possibility that the market value of the loaned securities may rise relative to the market value of the collateral. The values of the loaned securities and the collateral should be marked to market as frequently as possible, and the borrower should be required to put up additional collateral to make up for any shortfalls that arise.

The quality of collateral is also extremely important. The collateral should be high quality and easy to liquidate. Commonly used are cash, governments and high quality corporate bonds, and letters of credit issued by prime banks. Equities are less common. In this regard, it is already in the interest of the lender to require high quality collateral, even without prescription from the regulators. However, in the case of the lender being a financial institution, regulators may wish to ensure the financial soundness of the firm by prescribing what collaterals are acceptable, or by using other measures. For example, capital charges for counterparty risk may be designed to create an incentive for the lending financial institution to maintain sufficient, high quality collateral at all time.

(3) Well-structured lending agreement: No matter how much collateral has been posted, if the lending agreement is poorly structured, the lender may find that he actually has no control over the collateral at the time of borrower's default, especially in the event of bankruptcy. It is therefore in the interest of the lender to

ensure that the lending agreement does provide the protection he needs. The agreement should take the legal form that gives the lender full control over the collateral. Structuring the collateral as a pledge allows the lender prior claim on the collateral, but the process of liquidating the pledged collateral may be cumbersome, and the lender does not have the flexibility to transfer or make any other use of the collateral asset. In most instances, the preferred form of collateral would be a legal transfer of title in the collateral asset from the borrower to the lender, who in turn has the obligation to make the opposite title transfer to the borrower when the loan is terminated and the securities returned. In other words, the lender would be deemed to have made a spot acquisition and a forward disposition of the "collateral" asset.

The lending agreement should clearly specify the rights and duties of each party with respect to income or substitute payments to be paid. In addition, it should provide for clear default procedures, including the setting-off of obligations between the parties at the time of default to minimize the remaining exposure. Procedures for disputes should also be included. Regulators should not recognize or allow financial institutions under their supervision to undertake or arrange any lending transaction without proper written agreement addressing these important issues. In the overseas lending market, participants have made a joint effort in creating master agreements which are accepted internationally. However, emerging markets wishing to adopt such agreements should ensure that they are not inconsistent with their own law regarding commercial contracts.

Risk in the handling of collateral asset

Cash collateral

The advantage of cash collateral is that it is the most liquid form of collateral, which makes it easy to mark to market the loan against. Settlement with cash is

also more efficient than other types of collateral. That is why cash is the preferred form of collateral. However, lending income from securities loan collateralized by cash does not take the form of fee paid by the borrower to the lender. The cash collateral is like a temporary financing which the securities lender has obtained from the borrower, and the lending income comes from the return on the lender's reinvestment of this collateral, in excess of the rate promised to the borrower as rebate.

Instead of receiving a guaranteed income, the lender bears the risk from cash reinvestment, which, like any investment, includes market risk as well as credit risk. Even if the lender puts all the cash collateral in government securities, he will still be exposed to interest rate risk if there is a mismatch between the duration or repricing period of the chosen investment and that of the financing. To prevent losses, lenders should be encouraged to use conservative cash management guidelines, which takes into account not only issuer's credit but also the risk and reward of the available instruments. Also in the case of agency lending, there should be a written agreement in place between the agent and the end client on what reinvestment vehicles are acceptable and on other investment parameters.

Non-cash collateral

Reinvestment risk is not an issue when a securities loan is collateralized by a letter of credit or other non-cash asset, and if the lender chooses liquid, high quality collateral, puts it in safekeeping and marks to market against the loan value daily, the transaction should be of little risk. However, since the borrower has transferred the title in the collateral asset to the lender, it is technically possible for the lender to transfer that asset to someone else, under a sale or another loan agreement. The lender is then exposed to the risk that he cannot return the collateral to the borrower when it is recalled or when the loan is terminated, or that this on-lending of

collateral may incur a loss. If he sells the collateral asset, he has created a short position in that asset, which carries the usual risk of any short sale.

The role of securities lending intermediaries

Since good practice in securities lending requires the capacity to perform credit analysis as well as the support of good settlement and control systems and legal expertise, it is difficult for an average investor to participate in the lending market directly. A financial intermediary can fill this gap by arranging securities loan and providing the necessary risk management service for his clients. By making it possible for would-be lenders to participate, the presence and activity of securities lending intermediaries should result in greater market liquidity and efficiency.

Securities lending intermediaries play a role not only in bringing liquidity and efficiency to the market, but also in managing risks in the system, since as financial institutions they are in a better position than most people to analyze and manage risks, whether from an operational or legal standpoint. For this reason, regulators may require securities lending and borrowing to be done with, or arranged through, financial intermediaries who are subject to regulatory (or self regulatory) oversight in terms of their financial well-being. On the other hand, the requirement to go through intermediaries may lead to greater cost and less efficiency, and may be an unnecessary burden where both parties are sophisticated and financially sound.

Regulation of securities lending intermediaries

The objectives of regulating securities lending intermediaries are to promote sound and fair practices and maintain market integrity. To meet these objectives, regulations need to focus on two important aspects: how intermediaries control their risks, and how they treat their clients.

Risk control

From the analysis in the section on managing risks in securities lending, we see that counterparty choice, level of collateralization, and lending agreement are key to the soundness of the operation. There are a number of regulatory approaches to ensure that intermediaries act prudently. One approach may be for regulators to prescribe directly the parameters of lending operation, e.g. impose a limit on single counterparty exposure, stipulate the types and minimum level of collateral, or require the lending agreement to meet certain standards. Another approach is to use existing supervisory measures as an incentive for sound practice. For example, a higher capital charge for counterparty risk may be required for transactions with counterparties of lower creditworthiness, for excessive concentration in counterparty exposure, and for insufficiently collateralized loans. Finally, top management of the firms should be responsible for establishing and reviewing risk control policies, and the organizational structure of the firms should ensure that the control function (enforcing credit limits and monitoring net exposures) is performed independently of the business unit.

Client treatment

An intermediary holding client securities should be able to lend them only where the client has given clear and express consent in writing. The intermediary has a duty to look after the interest of its clients and to treat each of them fairly. How loans are allocated among clients should be based upon a fair and transparent scheme. The reinvestment of cash collateral should be done conservatively and in accordance with a written agreement between the intermediary and the client.

If the intermediary firm also has its own proprietary portfolio, which may give rise to the need to lend or borrow securities for the proprietary trading desk, further measures are necessary to prevent conflict between proprietary and client lending

and borrowing. Proprietary accounts should be managed under a separate division from the division that services the clients. Segregation of client assets from the assets of the intermediary should be strictly enforced. And if the client lending division wishes to provide lending or borrowing service to the proprietary trading desk, the proprietary desk should be treated as another client and should not be given any priority or advantage over other clients.

Purpose test for securities lending or borrowing

In addition to regulation on risk control and client treatment, it is quite common for regulators to permit or recognize as valid only securities loans which are made for some specific purposes, such as for the borrower to settle a sale, or to replace another valid loan, or to on lend to another borrower in a valid loan. One explanation for this condition may be that regulators would like to discourage the holding of borrowed securities over time, because it may lead to a greater possibility of a market corner. Another explanation is that this purpose test should make it more difficult to borrow securities to settle an unreported short sale. However, the purpose test itself is also very difficult to enforce, because it is almost impossible for regulators to keep track of all the lending transactions. Borrowers can always move offshore if domestic regulations are too restrictive. Another alternative for lenders and borrowers is to structure their loans as repurchase agreements, which are not subject to any purpose test. So while the purpose test seems like a good rule to protect market integrity, it is probably not very effective.

Centralizing lending through a central securities depository

In a new securities lending market where only few participants are willing or able to come up with adequate control system to operate as a securities lending intermediary, a central securities depository is in a unique position to lend support to the development of this market. It has information on the availability of

securities which enables it to operate as a central lending intermediary for members. Participants who do not have the capacity to perform extensive credit analysis may also feel more comfortable with the central securities depository as their counterparty. Finally it is easier to monitor lending transactions if the lending channel is centralized somewhere.

On the other hand, in markets where financial institutions have the capabilities to operate as securities lending intermediaries, centralizing lending through the central securities depository is not necessary. Having only one lending facility without competition may even lead to inefficiencies and greater costs for investors.

CONCLUSION

The difficulty in setting short selling and securities lending regulatory framework is that there may be many objectives that regulators wish to accomplish, e.g. transparency in the trading market, investor protection, proper risk control by market participants, and prevention of market disruption. The choice of regulatory approach for each objective is also an important issue, because it is possible that a regulation used for one objective may interfere with another objective. For example, banning short sales or imposing very strict execution rules can drive the transactions off-market where they are no longer transparent.

The challenge for regulators is to come up with adequate measures to maintain market integrity without creating an unnecessary burden for participants. This requires an understanding of how the market works, where the risks lie, which regulatory objectives are important, and which objectives are unrealistic or can be compromised. What this paper hopes to have accomplished is to provide a frame of thought that regulators can use to explore these issues further on their own towards such understanding.