

**Discussion paper on  
Short Selling and Securities Lending and Borrowing**

## Executive Summary

- I.** Short selling – the sale of a security that the seller does not own – is one of the long-standing market practices, which has often been the subject of considerable debate and divergent views in most of the securities market across the world. The votaries of short selling consider it as a desirable and an essential feature of a securities market. The critics of short selling on the other hand are convinced that short selling, directly or indirectly, poses potential risks and can easily destabilise the market. 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 are enough number of traders who own the security and are able to sell it cash to take advantage of too low a futures price (*Paragraphs 1.1 and 1.2*).
- II.** It is noteworthy though, that despite the conflicting schools of thought, securities market regulators in most countries and in particular, in all developed securities markets, recognise short selling as a legitimate investment activity. Such jurisdictions also have an active market for equity derivatives which includes stock futures. Some of the jurisdictions even recognise the usefulness of naked short sales in certain circumstances and instead of prohibiting short sales; the regulators have permitted it to take place within a regulated framework.. The International Organisation 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 (*Paragraph 1.3*).
- III.** A vibrant securities market should necessarily provide for lending and borrowing of securities. Securities markets all over the world, mostly, have an active market for securities lending and borrowing scheme, which besides complimenting short selling in securities also enable the investors to earn returns on their idle securities (*Paragraph 1.4*). Vibrant securities lending and borrowing scheme is, therefore, considered necessary to provide sufficient impetus for short selling (*Paragraph 5.7*).
- IV.** Presently, there is no prohibition on short selling by retail investors. The “Institutional investors” viz. the mutual funds and the Foreign Institutional Investors (FIIs) registered with SEBI, banks and insurance companies are expressly prohibited under the respective regulations from short selling and are mandatorily required to settle on the basis of deliveries of securities owned and held by them. As they are to settle by deliveries, no margin was levied on the transactions of institutional investors (*Paragraph 3.1*).
- V.** While international securities market regulators have recognised that short selling can exacerbate market falls and lead to manipulative activities, most of the jurisdictions have also recognised short selling as a legitimate investment activity that has contributed significantly to market liquidity. International securities market regulators have, therefore, permitted short selling with adequate safeguards to prevent any abusive/manipulative market practices. Similar issues may arise in the Indian context also. Genuine short selling could exacerbate price decline but that by itself may not be construed as a manipulative activity unless there are evidences of market misconduct. However, abusive short selling practices to manipulate the price of a stock will continue to be treated as market misconduct and attract appropriate regulatory action. (*Paragraph 5.1*).
- VI.** The FSA is of the view that short selling is not in itself manipulative. Rather, [FSA] sees it 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 (*Paragraph 4.1.12*).

- VII.** In the Indian securities market, “short selling” may be defined as selling a stock which the seller does not own at the time of trade (*Paragraph 5.2*).
- VIII.** Because of the regulatory restrictions in the Indian markets which have enabled only retail investors to short sell, there is no level playing field between various classes of investors. There was a need to bridge this gap and provide equal leveraging opportunities for all classes of investors. The 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 (*Paragraph 5.3*).
- IX.** In the Indian context, naked short sales would not be permitted. All investors would be required to mandatorily honour their obligation of delivering the securities at the time of settlement. No institutional investor shall be allowed to do day- trading i.e., square off their transactions intra-day. In other words, all transactions would be grossed for institutional investors at the custodians’ level, and the institutions would be required to fulfil their obligations on a gross basis. The custodians, however, would continue to settle their deliveries on a net basis with the stock exchanges (*Paragraphs 5.4 and 5.5*).
- X.** The stock exchanges should frame a uniform penalty structure and take appropriate action against the brokers for failure to deliver securities at the time of settlement which would act as a sufficient deterrent against naked short selling. (*Paragraph 5.6*).
- XI.** As regards the stocks in which short selling may be permitted, to begin with, short selling may be permitted only in those stocks in which derivative products are available (*Paragraph 5.8*). The lending and borrowing may also be, initially, restricted only in those stocks in which derivative products are available (*Paragraph 8.4*).
- XII.** The institutional investors would be obligated to disclose upfront at the time of placement of order whether the transaction is a short sale and demonstrate their ability to borrow to the satisfaction of the broker. However, the retail investors would be permitted to make a similar disclosure before the end of the trading hours on the transaction day. (*Paragraph 5.9*)
- XIII.** All stock brokers should be mandated to maintain sufficient documentation regarding the ability of their clients to borrow and deliver the securities at the time of settlement so as to ensure sound audit trail. Such information and documents should be readily available during inspections by the stock exchanges and SEBI. In respect of institutional transactions, the brokers must satisfy themselves that the institutional clients have made sufficient arrangement for borrowing securities before executing the order for short sale. (*Paragraph 5.10*)
- XIV.** The data on scrip-wise short position is of significance, and, therefore, needed to be disclosed in the public domain. The brokers shall be mandated to collect the details on scrip-wise short sell positions, collate the data and upload it to the stock exchanges before the commencement of trading on the following trading day. The stock exchanges will then consolidate such information and disseminate the same on their websites for the information of the public to begin with, only after the close of market hours of the next trading day. Ideally, such information should be disclosed before the commencement of the market hours on the next

trading day. However, this will not be immediately possible as the brokers will be able to provide this information to the exchanges only by the beginning of the next day. In the course of time, however, after gaining sufficient experience and once the system stabilises, this requirement may be reviewed to enable disclosure of such information by the exchanges before the commencement of the market hours on the next trading day (*Paragraph 5.11*).

- XV.** The transactions executed by all institutional investors may be margined similar to the transactions executed by the retail investors. The institutional investors should also have the same flexibilities as regards the manner and type of collateral, similar to retail investors, subject to other applicable regulations (*Paragraph 5.12*).
- XVI.** A vibrant securities lending and borrowing scheme is, therefore, considered necessary to provide sufficient impetus for covered short selling. (*Paragraph 5.7*) In this context, the securities lending scheme of 1997 (SLS, 1997) was inoperative and was not active in the Indian securities market.
- XVII.** Pursuant to the recommendations of the erstwhile SMAC in 2003, SEBI had specified the operational modalities for Clearing Corporation/House of the stock exchanges to borrow and lend securities for the limited purpose of handling settlement shortages. However, the stock exchanges are in the process of putting in place, the necessary systems for dispensing off the auction mechanism and are, therefore, yet to operationalise the process of securities lending and borrowing for handling settlement shortages (*Paragraphs 6.4 and 6.5*)
- XVIII.** While the present scheme of lending and borrowing securities in the Indian securities market by the clearing corporation/house (CC/CH) of the stock exchanges for handling settlement shortages addresses the need for lending and borrowing in a limited way, there is no scope for investors to capitalize on the demand for their securities in the market and thus, earn a return on the same by lending such securities. The scope of the existing securities lending and borrowing scheme must be widened into a full-fledged lending and borrowing scheme enabling participation of all classes of investors, including retail investors. (*Paragraph 6.7*).
- XIX.** While introduction of such a scheme was necessary in the present context of the market, a phased and cautious approach would be appropriate in the initial stages. (*Paragraph 6.7*).
- XX.** World over, securities lending and borrowing transactions were, by and large, over-the-counter (OTC) contractual obligations executed between lenders and borrowers. It was also observed that international securities market regulators do not directly regulate the lending and borrowing transactions. In various international markets, entities like the custodians and depositories run the lending and borrowing scheme and have their own screens for meeting the demand and supply of securities from their clients (*Paragraphs 7.1*).
- XXI.** The introduction of a full-fledged securities lending and borrowing scheme should be simultaneous with the introduction of short selling by the institutional investors. (*Paragraph 5.7*).
- XXII.** The CC/CH of the exchanges should act as Approved Intermediaries (AIs) for the limited purpose of lending/borrowing securities for meeting settlement shortages and the stock exchanges should go ahead with the operationalisation of the close-out procedure for handling settlement shortages and dispense of the auction mechanism. Apart from the lending and borrowing of securities by CC/CH for settlement shortages, a full fledged securities lending and

borrowing scheme should be introduced by SEBI/Stock exchanges through the AIs route. (*Paragraphs 8.2 and 8.3*).

- XXIII.** A cautious approach should be adopted, while permitting entities to act as AIs for securities lending and borrowing scheme. In the first stage, only custodians, Banks and FIs may be registered as AIs for the purpose of lending and borrowing of securities. The securities lending and borrowing should be, initially, restricted only in those stocks in which derivative products are available. (*Paragraph 8.4*).
- XXIV.** The lending and borrowing transactions may be executed on an automated, screen-based platform which offers the demand and supply of securities for lending/borrowing on a real-time basis along with the facility of matching the demand with the supply. Any trading member/investor who wishes to borrow securities may borrow the same through the screen provided by the exchanges. The stock exchanges should undertake the risk management of such lending/borrowing transactions and the CC/CH should guarantee the return of the securities by the borrower to the lender by being the central counter party and should, thus, provide guarantee for counter-party risk. The stock exchanges would jointly work out and put in place uniform modalities for securities lending and borrowing which will also include the manner in which the securities borrowed will be returned to the lender and as the manner in which the exchanges will provide the guarantee. (*Paragraphs 8.5 and 8.6*).
- XXV.** With a view to align the agreements between the various parties to a lending/borrowing transaction, such transactions could be formalized in terms of robust lending and borrowing agreements on the lines of the model agreements provided by the Pan-Asian Securities Lender's Association (PASLA) which obligate the borrowers to return the securities to the AI and agreements between the AI and the lender which enable the AI to allot the lender's securities to the borrowers at a screen determined price (*Paragraph 8.7*).

## Section I Background

- 1.1 *Short selling – the sale of a security that the seller does not own – is one of the long-standing market practices, which has often been the subject of considerable debate and divergent views in most of the securities market across the world. 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 over valued stocks. In their view, the restrictions on short selling distort efficient price discovery, gives promoters the unfettered freedom to manipulate prices, and favours 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 sales. 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 are enough number of traders who own the security and are able to sell it cash to take advantage of too low a futures price.*
- 1.2 *The critics of short selling on the other hand are convinced that short selling, directly or indirectly, poses potential risks and can easily destabilise the market. They believe that short selling can quite facilely exacerbate declining trend in share prices, increase share price volatility, and force the price of individual stocks down to levels which 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.*
- 1.3 *It is noteworthy though, that despite the conflicting schools of thought, securities market regulators in most countries and in particular, in all developed securities markets, recognise short selling as a legitimate investment activity. Such jurisdictions also have an active market for equity derivatives which includes stock futures. Some of the jurisdictions even recognise the usefulness of naked short sales in certain circumstances and instead of prohibiting short sales; the regulators have permitted it to take place within a regulated framework. The International Organisation 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.*
- 1.4 *Another feature common to most major securities markets is lending and borrowing of securities. A vibrant market for securities lending and borrowing not only compliments short selling in securities, but also enables the investors to earn returns on their idle securities.*
- 1.5 *SEBI reviews its regulatory policies periodically. The policy on short sales and securities lending and borrowing were last reviewed by the Secondary Market*

Advisory Committee (SMAC) in 2003. In view of the further developments taking place in the market structure since then, in terms of institutionalisation of the market, participation of the retail investors, enhanced participation by the foreign institutional investors, expansion of the derivatives market, another review was considered necessary. Accordingly when the SMAC was reconstituted under the Chairmanship of Professor P.G. Apte, Director of the Indian Institute of Management, Bangalore, SEBI had sought the views of the SMAC, on the twin subjects of short selling and securities lending and borrowing.

- 1.6 This Discussion Paper is based on the deliberations of the Secondary Market Advisory Committee. It reviews the present policy on short selling and securities lending and borrowing in India, examines the international practices and how securities market regulators in other countries have viewed these and assesses the relevant issues of regulatory concern in the context of market confidence and investor protection.
- 1.7 SEBI has been following a policy of extensive public consultation and debate before formulating and implementing any new regulation. In accordance with this policy, this Discussion Paper of the SMAC is being made available on SEBI's web site at [www.sebi.gov.in](http://www.sebi.gov.in) for public comments.
- 1.8 All comments on this Discussion Paper should reach SEBI at the following address by or may be sent by e mail to [shortsales-slb@sebi.gov.in](mailto:shortsales-slb@sebi.gov.in) by Friday, the 20<sup>th</sup> January 2006.
- Mr. V.S. Sundaresan, General Manager,  
Securities and Exchange Board of India  
29th Floor, World Trade Centre, Centre 1  
Cuffe Parade, Mumbai 400005

## **Section II Structure of the Paper**

- 2.1 In Section III, we examine the evolution of present policy and practice of short selling in India. In Section IV, we consider the international practices and regulatory position on short selling. In Section V, we deliberate on the issues related to short sales and give recommendations. In Section VI, we discuss the present regulation and practice of securities lending and borrowing in India and the need for review. In Section VII, we discuss the policies followed by international securities market regulators on securities lending and borrowing. In Section VIII, we examine the various options for introducing securities lending and borrowing and recommend the revised regulatory framework.

## **Section III Present Practice and Regulatory Policy on Short Sales in the Indian Securities Market**

- 3.1 *At present, there is no prohibition on short selling by retail investors. The "Institutional investors" viz. the Foreign Institutional Investors (FIIs) and the mutual funds registered with SEBI, banks and insurance companies are expressly prohibited under the respective regulations or statutes from short selling and are mandatorily required to settle on the basis of deliveries of securities owned and held by them. As*

they are required to settle by deliveries, no margin was levied on the transactions of the institutional investors.

- 3.2 For example, regulation 15(3)(a) of the SEBI (Foreign Institutional Investors) Regulations, 1995 provides that *“The Foreign Institutional Investor shall transact business only on the basis of taking and giving deliveries of securities bought and sold and shall not engage in short selling of securities”*. Similarly for the Mutual Funds, regulation 45 of the SEBI (Mutual Funds) Regulations, 1996, provides that *“The funds of a scheme shall not in any manner be used in option trading or in short selling or carry forward transactions: provided that mutual funds shall enter into derivatives transactions in a recognised stock exchange for the purpose of hedging and portfolio balancing in accordance with the guidelines issued by the Board”*. As far as the Insurance Companies are concerned, the IRDA vide circular No. IRDA/CIR/INV/062/Jan/05 dated January 17, 2005 has provided that the stock market transactions of all the insurers have to result in delivery. The NRIs intending to trade on the stock exchanges in India, are required to comply with the requirement of the Portfolio Investment Scheme (PIS) which requires in terms of Schedule 3 to Notification No FEMA 20/2000-RB dated 3rd May 2000, that the NRI investors to take delivery of the shares purchased and give delivery of the shares sold by them. These restrictions have been historically in place, because it was considered prudent and desirable that in the initial stages of market development when the stock exchanges followed account period settlement of ranging from 14 to 7 days and had different settlement cycles, the long term investors, rather than speculators and delivery based trades needed to be encouraged;
- 3.3 At present there is also no distinction between naked and covered short sales in any regulation or any statute governing the securities market. In the absence of any officially approved securities lending and borrowing mechanism being in place at present, it cannot be said with certainty the extent to which individual investors short sell, in a settlement. Naked short sales would show up as settlement shortages. But there may be other valid reasons for settlement shortages as well. But settlement shortages at the stock exchanges under the conditions of rolling settlement have itself been very low (in the region of 0.4% of the settlement turnover) and shortages are completed by the exchanges through auctions without any difficulty. In the absence of any analysis on settlement shortages therefore, it would be difficult to reach any definite conclusion on the extent of naked short sales in the market at present. While the auction itself is a penalty for failure to deliver securities, the stock exchanges also have a system of levying additional penalties to act as deterrent for those brokers who frequently fail to deliver. As a result, there are no unsettled outstanding positions and naked short sales even if it takes place have not posed any threat to market stability.
- 3.4 The issue of short sales was first deliberated by SEBI in 1996 when SEBI had constituted a Committee under the chairmanship of Shri B D Shah, Chairman GIC. Any discussion on short sales should begin with the definition of short sale. Accordingly, the B D Shah Committee, had defined short sale as *“selling of the shares without having the physical possession of the shares unless it is either for squaring-up of an earlier purchase in the same settlement of the same stock exchange or against the pending deliveries from the same stock exchange pertaining to previous settlements”*.



- 3.5 Pursuant to the recommendations of the B D Shah Committee, in order to address the issue of the lack of transparency then existing in the stock exchanges, all member brokers of stock exchanges were required to submit their scrip-wise net short sale position to the exchange at the end of each trading day in respect of 60 actively traded scrips with effect from November 29, 1996. Subsequently, the disclosure was extended to include the net long positions also.
- 3.6 Thereafter, as a response to the market volatility in 1998, SEBI had temporarily banned short sales from June 17, 1998 and required that the net outstanding sale position at the end of any trading day in each security must result in delivery. This restriction was withdrawn subsequently.
- 3.7 Ban on short sales was reintroduced in March 2001, following extreme conditions of market volatility. SEBI advised the stock exchanges that all sales transactions effective from March 8, 2001 shall be backed by delivery unless a sale transactions was preceded by a purchase position of at least an equivalent amount in the name of the same client in the same or any other exchange. This was applicable to the proprietary trading by members as well as all for scrips in which other deferral products were available. With the introduction of the rolling settlement in 414 scrips from July 2, 2001, and discontinuation of all deferral products, SEBI withdrew the restrictions on short sales with effect from July 2, 2001.

That the issue of short sales and the need for clear policy in this regard was also highlighted in Para no. 9.158 of the report of the Joint Parliamentary Committee on Stock Market Scam and matters relating thereto (JPC). In its report submitted in December 2002, the JPC had observed “.....that SEBI must look into these issues seriously and expeditiously formulate a clear policy taking all aspects into account.” that SEBI should expeditiously formulate a clear policy in this regard.

- 3.8 In the light of the above, the issue of short sale was again reviewed by the SMAC in 2003. The SMAC had then noted that in the context of the changes in the market micro structure that was brought about through the introduction of rolling settlement, shortening of settlement cycle to T+2 and the availability of derivatives products as well as the absence of deferral products, the recommendation of the B.D. Shah Committee, including the definition of short selling as above, may no longer be valid. It was also of the view that it would not be meaningful any longer to track short sales at the time of sale, as the gap between the trade and settlement has narrowed substantially. Besides, it was equally not feasible to ascertain at the time of sale if one is selling short, as millions of transactions are effected everyday.
- 3.9 The SMAC had then also noted that in the US, the then existing regulations allowed relatively unrestricted short selling in an advancing market while preventing short sellers from accelerating a declining market. The regulation used tick-test, a formula for defining price for permissible as well as non-permissible short-selling. The defined price automatically takes into account the prevailing market condition. It permits short selling at (i) a price above the price at which the immediately preceding sale was effected (plus tick), or (ii) the last sale price if it is higher than the last different price

(zero plus tick). Every short-sale transaction needed to be disclosed upfront to the dealing broker who is held responsible for ensuring that the transaction does not violate the tick test. All this meant that short-selling cannot take place surreptitiously in US. Further, regulation did not require the regulators to prove short-seller's intent or motive. But the SMAC had also noted that tick test could only work in a quote driven system as in the US which relies on the market maker, and not on an order driven market as in India.

- 3.10 The SMAC was, therefore, then of the view that a more prudent approach in the Indian context would be to define short sales as *“failure to deliver securities at the time of settlement”* and monitor short sales at the time of delivery. *Accordingly, the erstwhile SMAC recommended in 2003, that short sales be defined as failure to deliver securities at the time of settlement and that it should be monitored at the time of delivery in the settlement. It also recommended that short sales should be regulated by putting in place a sound and efficient securities lending and borrowing mechanism which would entail borrowing of securities by the clearing corporation / house for meeting settlement shortfalls.*

#### **Section IV International practices in Short Selling**

##### **4.1 Policy on short sales adopted by the Financial Services Authority (FSA) of UK**

*(Source : FSA website [www.fsa.org](http://www.fsa.org) )*

- 4.1.1 The issue of short sales has been extensively debated in the UK. In October 2002, the FSA had brought out a Discussion Paper No. 17 on the subject of “Short Selling”, which articulated the views of FSA on the subject.
- 4.1.2 On *“the utility of short selling”* the FSA is in favour of allowing short selling as traditionally it has benefited the market by *“accelerating price corrections in overvalued securities or accommodate[ing] abnormal buying pressure which would otherwise over inflate a security's price”*. FSA considers this function may be even more important in a market increasingly dominated by large, longer-term investors and index funds.
- 4.1.3 Similarly, FSA also considers that *“short selling also benefits the market as a support for trading that corrects pricing anomalies. Without the opportunity for arbitrageurs to lock in a profit by going short of the ‘overvalued’ instrument at the same time as going long of the ‘undervalued’ instrument, the efficiency of the price correcting process is correspondingly greatly reduced”*.
- 4.1.4 FSA has also cited *“a third, more practical, benefit of short selling has been that market making and intermediary liquidity provision has traditionally played a central part in the UK market structure. Any attempt to restrict the freedom of liquidity providers to go short would, in effect, have made that role impossible. Applied in full, it would, for example, have prevented market makers satisfying customer buy orders except out of inventory”*.
- 4.1.5 According to FSA, *“any effective restriction on cash market hedging through short sales would potentially increase the costs of risk management and would seriously*

---

*Secondary Market Advisory Committee of SEBI*

*Discussion Paper on Short Selling and Securities Lending and Borrowing*

*constrain the use of derivatives. The efficient working of the market in ‘downside protection’, whether through the use of put options, or equivalent instruments, depends on the ability of the sellers of the protection to hedge their exposures by opening a matching short position elsewhere, often in the underlying cash securities”.*

4.1.6 In conclusion FSA is of the view that “in facilitating all the above trading strategies, short selling adds to pricing efficiency by bringing additional trading opportunities and liquidity to the market in general”. Hence FSA sees “no case for prohibiting short selling – indeed no major financial market does so – nor for introducing constraints for the purpose of deterring use of the practice”.

4.1.7 FSA also recognises “that [short selling] may also bring some potential risks. This is why a number of countries consider it necessary, in their specific environment and circumstances, to impose various controls on short selling”. In broad terms, FSA has assessed the “potential risks of short sales” as follows:-

*“First, there is a set of market risks that arise from the way in which short sales add weight to the supply of long sale orders in the market. This does not automatically lead to disorderly or manipulative trading, but may increase the potential for both. Short selling may also increase short-term volatility in share prices. A further market risk may arise from any settlement disruption for ‘naked’ shorts and any consequent failure to deliver.*

*Second, there are potential risks within the chain of the short selling process. These relate to the settlement process and efficient risk management in the operation of the securities lending market”.*

4.1.8 The FSA also assessed that the causes of potential risk of disorderly trading. According to FSA, the risk of disorderly trading “arises, for example, essentially from the incremental weight of sell orders generated by short sales overwhelming current buy-side interest and causing an accelerated fall in a share’s price and an increase in price volatility in the short term. The particular concern here is that this can happen very quickly, leaving little or no time for potential buyers to assess the new position and take action that might otherwise stabilise the price and dampen volatility”.

4.1.9 FSA noted that a number of foreign jurisdictions addressed this specific issue through the use of ‘tick’ rules, whose basic purpose was to prevent a short sale being made at a price below the last traded price and aimed at reduction of the speed of a downtrend by preventing short sellers using sequential trades to clear current buying interest at progressively lower prices. The UK Exchanges did not adopt the tick rules even when it was a quote driven market operated by market makers or nor following the introduction and expansion of order book trading. Besides the FSA had also “some concerns about ‘tick’ rules, particularly about the potential complexity of creating exemptions to those rules, since short selling rules may require exemptions for certain market participants. Even more importantly, we have not seen a strong case showing that tick rules curb share price volatility or soften market declines. For example, at least as far as this year is concerned, countries operating tick rules, such as the US, have not seen less steep market falls or significantly reduced volatility than the UK”.

- 4.1.10 On the issue of “*market manipulation*”, FSA recognised that there was a “*strong perception in some quarters that short selling is an essentially manipulative activity, used largely to drive down prices*”. But FSA also regarded that “*significant part of short selling in today’s markets is driven by a variety of trading strategies that have nothing to do with what is commonly known as the ‘bear raid’*”.
- 4.1.11 *FSA is of the view “that short selling is not in itself manipulative. Rather, [FSA] sees it 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. Where it occurs in relation to any investment traded on a UK Recognised Investment Exchange or OFEX, abusive short selling, just like any other form of market abuse, is caught under the market abuse regime and the Code of Market Conduct”.*
- 4.1.12 *FSA has outlined some of the conditions under which short selling undertaken, whether or not in collusion with other short sellers, for the purpose of positioning the price of a security at a distorted level would amount to market abuse. For example, if an investor, or a group of investors, holds a short position in a particular security and then circulates false or misleading information, e.g. possibly in the form of a rumour, about the issuer of that security to depress the price of the security in order to profit from the short position, he would likely be in breach of the market abuse regime. This regime carries unlimited fines in UK.*
- 4.1.13 FSA is of the view that the present regime provides sufficient tools for dealing with abusive short selling and, where FSA has hard evidence of market abuse, FSA will be prepared to investigate.
- 4.1.14 *On the concerns that ‘naked’ short sellers may cause disruption in settlements the FSA had noted that “a number of countries set certain requirements such as short sellers must borrow securities ahead of the sale or have arrangements in place that will enable them to make delivery of the securities”. This was not required in UK as according to FSA, the Recognised Investment Exchanges and Recognised Clearing Houses “have rules on settlement which ensure that it is orderly and timely and that rights to benefits (for example, dividends) are protected throughout the settlement process. These rules also impose penalties in some instances for frequent non-delivery, and provide for buying-in the securities in question when delivery is delayed. Overall settlement performance in the UK is good and where settlement failures do occur the Recognised Investment Exchanges and Recognised Clearing Houses have arrangements to deal with them”.*
- 4.1.15 FSA was not convinced that market confidence would benefit from direct controls on short selling, although they did recognise that short selling is a matter of concern to some issuers and market users. According to FSA, this concern appears to derive, at least in part, from the opacity that surrounds short sales. FSA believes that short sales may contain potentially important information which, if public, would tend to enable other market users to make better informed investment decisions. Hence FSA supported disclosure was a key factor in facilitating efficient markets, otherwise “some market participants have information on short positions and stock borrowing figures,

while others do not, leaving those with the information in a privileged position”. FSA is of the view “that short sales do contain information of value to other market users. While we accept that the motivation behind short sales varies, many sales (other than pure arbitrage sales) do in some respects reflect a view that a security is intrinsically overvalued, even when that view is based more on relative than absolute overvaluation. It also recognises that the fact that a short sale must, by definition, lead to a purchase of an equivalent number of the same securities makes it technically different from other transactions in a way that may be of material significance to other market users’ investment decisions”.

- 4.1.16 While advocating greater disclosures the FSA felt “that to be useful, the benefits of disclosure must outweigh any disadvantages. On this point, there may be strong limitations on what is achieved by greater transparency on a cost benefit basis”.
- 4.1.17 It is interesting to note that the feed back received by FSA on the Discussion Paper for most part confirmed the views of FSA.
- 4.1.18 In the final analysis, FSA therefore recognises that short selling is a legitimate investment activity that plays an important role in supporting efficient markets and that significant changes to the existing regulatory regime were not warranted. FSA is also of the view that there is no case for prohibiting or introducing artificial constraints on short selling. However, it recognised that increased transparency surrounding short selling would be helpful, as long as the information provided would be useful and its benefits would outweigh any disadvantages, i.e. that it should be useful; should not be overly burdensome to produce; and should not unduly breach commercial confidentiality.
- 4.1.19 FSA favored the publication by CREST Co of data on settlement failures in individual securities, which according to FSA would be helpful information to the market and will indicate settlement pressure building in particular securities. FSA also considered measures to notify market participants and warn investors in circumstances where settlement problems are building in particular illiquid securities, as notifying the market may alleviate some pressure on the securities in question. Warning investors will enable them to make informed decisions about whether or not to buy securities experiencing high levels of settlement failure.

**Box I : A comparative study of the global market practices in short selling**

- Securities market regulators world-wide have, by and large, while recognizing the potential risks of short selling have considered it as a legitimate investment activity and permitted short selling transactions in their respective jurisdiction subject to certain conditions; However, short selling transactions that are executed with the objective of price manipulation or distortion is seen as an abusive market practice.
- Most markets do not impose any restrictions on short selling and allow it for any security. There are others in which short selling is allowed in designated securities.
- The UK FSA recognises that short selling in bear market conditions and during high levels of market volatility but, nevertheless, considers short selling as a legitimate professional

investment activity which plays an important role in supporting efficient markets. (*refer paragraph 4.1*)

- The US SEC has recently done away with the age old down tick rule first adopted in 1938 and introduced– Regulation SHO as a pilot project for the entire market for 1 year. (*refer paragraph 4.2*)
- The SEC is of the view that although the vast majority of short sales are legal, abusive short sale practices are illegal.
- It is not uncommon that trades remain unsettled on the stock exchanges in the US. The SEC recognises a tolerance level of unsettled trades for five consecutive settlements, before taking action under SHO.
- Many emerging markets like Hong Kong, Korea, Japan, Singapore e.t.c. have also permitted short selling in their jurisdictions on certain designated securities subject to disclosure of such transactions and tick rules which prohibit short selling transactions during a falling market. (*refer paragraph 4.3*)
- Certain jurisdictions prohibit short selling during specific corporate activities like acquisitions/takeovers, new issuances, strategic policy announcements e.t.c.

#### 4.2 ***Policy on short sales adopted by the Securities Exchange Commission of US***

(Source: SEC website [www.sec.gov](http://www.sec.gov).)

- 4.2.1 In the US, the SEC since January 2005, has done away with the age old down tick rule first adopted by the SEC in 1938, and has put in place, 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. The "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 date delivery is due before effecting a short sale order in any equity security. (This "locate" must be made and documented prior to effecting the short sale) while 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").
- 4.2.2 Regulation SHO defines a short sale as the sale of a stock that the investor does not own (or that he will borrow for delivery). The SEC noted that short sellers believe the price of the stock will fall, or are seeking to hedge against potential price volatility in securities that they own. If the price of the stock drops, short sellers buy the stock at the lower price and make a profit. If the price of the stock rises, short sellers will incur a loss. Short selling is used for many purposes, including to profit from an expected downward price movement, to provide liquidity in response to unanticipated buyer demand, or to hedge the risk of a long position in the same security or a related security.
- 4.2.3 It is not uncommon that trades remain unsettled on the stock exchanges in the US. The SEC recognises 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 sales and failed settlements and circulation of counterfeit shares in a number of listed securities of small cap and in "pink sheet" companies. According to DTCC's estimates on a daily basis nearly 24,000 transactions of value \$ 6bn (as a % of total trades, it is 1.5% of dollar volume) fail to deliver for more than 13 settlements. Such securities are classified as threshold securities by SEC under the new SHO regulation (source: DTCC web site)
- 4.2.4 The SEC is of the view that although the vast majority of short sales are legal, abusive short sale 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 sales effected to manipulate the price of a stock are prohibited.
- 4.2.5 Regulation SHO defines "naked" short sale as a sale in which the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period. As a result, the seller fails to deliver securities to the buyer when delivery is due is known as a "failure to deliver" or "fail." It also

notes that failure to deliver may result from either a short or a long sale. There may be legitimate reasons for a failure to deliver. For example, human or mechanical errors or processing delays can result from transferring securities in physical certificate rather than book-entry form, thus causing a failure to deliver on a long sale within the normal three-day settlement period. A fail may also result from naked short selling. For example, market makers who sell short thinly traded, illiquid stock in response to customer demand may encounter difficulty in obtaining securities when the time for delivery arrives. Hence, naked short selling is not necessarily a violation of the federal securities laws or the SEC's rules.

4.2.6 The SEC recognises that in certain circumstances, naked short selling contributes to market liquidity. For example, broker-dealers who make a market in a security generally stand ready to buy and sell the security on a regular and continuous basis at a publicly quoted price, even when there are no other buyers or sellers. Thus, market makers must sell a security to a buyer even when there are temporary shortages of that security available in the market. This may occur, for example, if there is a sudden surge in buying interest in that security, or if few investors are selling the security at that time.

4.3 ***Policy on short sales adopted by the Hong Kong Securities and Futures Commission***  
(Source : HKSFC website [www.sfc.hk/sfc/](http://www.sfc.hk/sfc/))

In Hong Kong, short selling has been permitted in certain designated securities, like those that were part of the benchmark indices or those in which futures and options have been made available, in which the seller has the unconditional right to vest the security in the purchaser by virtue of securities borrowing and lending agreement or has confirmation from the counterparty that the counterparty has the security available to lend to him. Further, the tick rule has been specified, i.e., it cannot be effected below the best current ask price. At the time of inputting the order, the HKSFC requires the investors to communicate to the broker dealers that it is a short selling transaction.

## **Section V      Deliberations and Recommendations of the SMAC on short selling**

5.1 The Committee noted that *while international securities market regulators have recognised that short selling can exacerbate market falls and may lead to manipulative activities, short selling has not been prohibited. Indeed most of the jurisdictions have recognised short selling as a legitimate investment activity that has contributed significantly to market liquidity. International securities market regulators have, therefore, permitted short selling with adequate safeguards to prevent any abusive/manipulative market practices. The Committee recognised that similar issues may arise in the Indian context also. 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.*

### *Definition of short sales*

5.2 The SMAC noted that the commonly used definition of short sales in international jurisdictions and in finance literature is "*sale of a stock by an investor which he does*



not own”. It also noted that in market parlance the world over, “*naked short sale*” is “*a transaction in which the seller neither owns nor borrows the securities in time to make delivery to the buyer within the settlement period*” and as a result fails to deliver securities when required. In other words, naked short sales results in failure to deliver, while a “covered short sale” is understood as a transaction in which the seller may or may not have securities at the time of sale, but have made arrangements for borrowing securities prior to sale and honours the obligation of delivery at settlement. *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.*

*Short selling by institutional investors*

- 5.3 The Committee took note of the policy and practices in short sales in various jurisdictions and was of the view that it would be necessary to enunciate a clear policy on short sales which would be in sync with the present stage of market developments and the regulatory reforms in India. *The Committee, therefore, recommended that the 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.*

*Covered Vs. naked short sales*

- 5.4 The Committee noted that most of the international securities market regulators have prohibited naked short selling and required the client to have documentary evidence of borrowing/tie-up with lenders before executing the sale transaction. The Committee was of the view that while the investors may be permitted to do short selling, settlements should take place only on delivery basis.. In case of failure to settle, the stock exchanges should levy stringent financial penalties which would act as deterrent for naked short sales. The Committee noted that this was in consonance with international regulatory practice. *The Committee, therefore, recommended that in the Indian securities market, naked short selling should not be permitted and accordingly, all investors would be required to mandatorily honour the obligation of delivering the securities at the time of settlement.*

*Prohibition of day-trading by institutional investors*

- 5.5 The Committee was however of the view that even if short sales are permitted for the institutional investors, they should not indulge in day trading. *The Committee, therefore, recommended that no institutional investors shall be allowed to do day trading i.e., square off their transactions intra-day. In other words, all transactions would be grossed for institutional investors at the custodians’ level, and the institutions would be required to fulfill their obligations on a gross basis. The custodians, however, would continue to settle their deliveries on a net basis with the stock exchanges.*

*Penalty structure for naked short selling*

- 5.6 The Committee felt that the stock exchanges should be required to closely monitor settlement shortages to check the reasons therefor, such as, genuine shortages, naked short sales, etc. and impose stiff penalties to act as deterrent for naked short sales. *The Committee, therefore, recommended that the stock exchanges should frame a uniform penalty structure and take appropriate action against the brokers for failure to deliver*

*securities at the time of settlement which would act as a sufficient deterrent against naked short selling.*

*Need for securities lending and borrowing*

- 5.7 The Committee noted that the securities markets in which short selling is freely allowed also has a vibrant securities lending and borrowing scheme. In the absence of vibrant market for securities lending and borrowing, short selling may not work effectively. *The Committee, therefore, 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 securities lending and borrowing scheme should be simultaneous with the introduction of short selling by the institutional investors.*

*Designated stocks*

- 5.8 The Committee noted that while many international jurisdictions permit short sales in any security, certain jurisdictions permit short sales only in designated securities which include securities in which derivatives products were available, those which were constituents of the major market indices etc. The underlying principle for the restriction seems to be to ensure that market participants do not misuse short selling to distort the prices of illiquid stocks which are normally more prone to volatility and manipulation. The Committee also noted that so far SEBI has been following a phased approach when introducing any new policy. Such a phased approach has been useful. *The Committee therefore, recommended that to begin with, short selling may be permitted only in those stocks in which derivative products are available. The Committee also recommended that the list of stocks that are eligible for short selling transactions may be reviewed by SEBI from time to time.*

*Designation of a “short” transaction*

- 5.9 The Committee noted that securities market regulators world-wide have mandated that the clients designate a transaction as a short sales at the time of placement of order. In the Indian context, since the retail investors are allowed to square-off their positions intra-day and the institutional investors are prohibited from day-trading, the Committee felt the need to have a differential reporting mechanism between the retail and institutional investors. *The Committee, therefore, recommended that the institutional investors would be obligated to disclose upfront at the time of placement of order whether the transaction is a short sale and demonstrate their ability to borrow to the satisfaction of the broker. However, the retail investors would be permitted to make a similar disclosure before the end of the trading hours on the transaction day.*

*Documentation of the short selling transactions by the brokers*

- 5.10 The Committee re-iterated the need to have sufficient audit trail of short selling transactions. The Committee also noted that internationally where covered short sales are permitted, the clients are required to make prior arrangements for borrowing securities before effecting short sales. *The Committee therefore, recommended that all stock brokers should be mandated to maintain sufficient documentation regarding the ability of their clients to borrow and deliver the securities at the time of settlement so as to ensure sound audit trail. Such information and documents should be readily available during inspections by the stock exchanges and SEBI. In respect of*

*institutional transactions, the brokers must satisfy themselves that the institutional clients have made sufficient arrangement for borrowing securities before executing the order for short sale.*

*Disclosure of details regarding short selling transactions*

- 5.11 As regards disclosure of transaction as “short” at the time of order entry and the dissemination of short position in each stock at the end of the day, the Committee felt that it would be desirable to identify a transaction as a short sale at the time of trade itself. However, the stock exchanges were of the view that it would not be practically possible to identify a transaction as short on a real time basis at the time of trade and disseminate the same to the market, as it would entail enormous stress on their systems. But information on short sales should be disclosed to the market. However, considering the significance of the data on scrip-wise short position and the need for the availability of the data in the public domain, *the Committee, recommended that the brokers shall be mandated to collect the details on scrip-wise short sell positions, collate the data and upload it to the stock exchanges before the commencement of trading on the following trading day. The stock exchanges will then consolidate such information and disseminate the same on their websites for the information of the public to begin with only after the close of market hours on the next trading day. Ideally, such information should be disclosed before the commencement of the market hours on the next trading day.* However, this will not be immediately possible as the brokers will be able to provide this information to the exchanges only by the beginning of the next day. In the course of time, however, after gaining sufficient experience and once the system stabilises, this requirement may be reviewed to enable disclosure of such information by the exchanges before the commencement of the market hours on the next trading day.

*Margining of institutional trades*

- 5.12 On the related issue of margining of institutional trades, the Committee was of the view that the issue of margining the institutional trades should not be treated independently from the issue of short selling, since permitting short selling without margining the institutional trades would amount to providing additional leverage to institutional investors. It was also discussed as to whether institutional trades could be margined only with respect to those stocks in which short selling is permitted. However, this would result in segregation of the market. The Committee was of the view that instead of a piece-meal basis, there was a need to take a holistic view in the matter. *The Committee, therefore, recommended that transactions executed by all institutional investors should be margined similar to the transactions executed by the retail investors. In any case, the institutional transactions are margined in the derivative market and now even in the primary market. The Committee also recommended that the institutional investors should also have the same flexibilities as regards the manner and type of collateral, similar to retail investors, subject to other applicable regulations.*

## **Section VI Present Practice and Regulatory Policy on Securities Lending and Borrowing in the Indian Securities Market**

### **6.1 Securities Lending Scheme, 1997**

SEBI vide circular dated May 07, 1997 specified the “Securities Lending Scheme of 1997 (SLS, 1997)”. The Scheme of 1997 laid down the modalities for lending and borrowing of securities through an Approved Intermediary (AI). A lender, under an agreement with the AI can lend his securities to the AI with the guarantee that the AI shall return the equivalent securities of the same class and type. A borrower can also borrow from the AI on the specified terms of the AI and shall also return the equivalent securities of the same class and type. The AI is the complete interface between the borrower and the lender. The salient features of the SLS, 1997 are outlined in the table below.

**Box II : Salient Features of the Securities Lending Scheme, 1997 (refer paragraph 6.1)**

- 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 e.t.c.
- 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 e.t.c.
- 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.

- 6.2 Based on the features of the scheme, Ministry of Finance, Department of Revenue (Central Board of Direct Taxes (CBDT) vide their circular No. 751 dated February 10, 1997 clarified that the transactions of lending of shares or any other securities under the Securities Lending Scheme would not result in “transfer” for the purpose of attracting the provision relating to the capital gains under the Income Tax Act.

- 6.3 However, the SLS, 1997 is presently inoperative and there is no market for securities lending and borrowing in the true sense. The erstwhile Secondary Market Advisory Committee (SMAC) had reviewed the matter of securities lending and borrowing in 2003 and 2004. The SMAC had then noted the observation of the JPC in this regard, especially in relation to deferral products.
- 6.4 The erstwhile SMAC had recommended that only clearing corporations and clearing houses should be allowed to lend and borrow securities to meet settlement shortages. Such borrowing would in other words help meet delivery requirement even for naked short sales. *Pursuant to the recommendations of the SMAC in 2003 and 2004, SEBI vide circulars dated March 19, 2004 and March 4, 2005 had provided the operational modalities for Clearing Corporation/House to borrow and lend securities for the limited purpose of handling settlement shortages.* Accordingly, no entity other than Clearing Corporation/Clearing House has been registered as an Approved Intermediaries (AIs) and borrow and lend securities under the scheme. NSCCL, the clearing corporation of NSE and BOISL, the clearing house of BSE have been registered as AIs for the purpose of borrowing and lending securities to handle settlement shortages. NSCCL and BOISL have tied up with the depositories to operationalise the securities lending and borrowing scheme. Individual investors would be able to lend their idle securities. Pursuant to identification of securities shortages after pay-in, the depositories would communicate the list of members who have an intention to lend securities to the clearing corporation/house. Based on the requirement of securities, the clearing corporation/house would match the extent of settlement shortages with the availability of securities, borrow the securities on behalf of the default members, allot the same to the lenders on a random basis and communicate the same back to the depositories.
- 6.5 The BSE and NSE are in the process of putting in place the necessary systems and are expected to discontinue the auction mechanism and handle the settlement shortages by borrowing and lending securities. In case the clearing corporation/house is unable to borrow, the transaction would be closed out. *This mechanism has not yet been implemented by the Clearing Corporation/House of the stock exchanges.*
- 6.6 *While recommending the above, the erstwhile SMAC also noted that given the past excesses of the ALBM and BLESS, it was not in favour of any exchange traded securities lending and borrowing scheme except for meeting settlement shortages. It also noted introduction of a full fledged SLB scheme may be examined based on the experience derived from the limited lending and borrowing for meeting settlement shortages. The SMAC then was of the view that extreme caution should be exercised in allowing a liberal securities lending scheme.*
- Need for further review*
- 6.7 *While the present scheme of lending and borrowing securities in the Indian securities market by the clearing corporation/house of the stock exchanges for handling settlement shortages addresses the need for lending and borrowing in a limited way, there is no scope for investors to capitalize on the demand for their securities in the market and thus, earn a return by lending such securities. Hence, the scope of the existing securities lending and borrowing scheme must be widened into a full-fledged*

*lending and borrowing scheme enabling participation of all classes of investors, including retail investors. Further, a full fledged securities lending and borrowing scheme is a significant regulatory reform in any securities market to facilitate other market reforms like physical settlement in the derivatives markets. Besides lending and borrowing of securities is necessary for covering short positions in the market. Without lending and borrowing, the policy on short sales cannot be implemented and physical settlement of stock derivatives cannot also take place. In the light of the aforesaid factors, the issue of reviewing the regulatory policy on securities lending and borrowing was taken up for deliberation by the present Committee. The Committee is however of the view that while introduction of such a scheme was necessary in the present context of the market, a phased and cautious approach would be appropriate in the initial stages.*

## **Section VII International practices in securities lending and borrowing**

- 7.1 *In most markets, the securities lending and borrowing transactions are by and large, over-the-counter (OTC) contractual obligations executed between lenders and borrowers and securities market regulators do not directly regulate the lending and borrowing transactions. The schemes for securities lending and borrowing are by entities like the custodians and depositories who have their own screens for meeting the demand and supply of securities from their clients. For example the State Street, Bank of New York, Depositories Trust & Clearing Corp. (DTCC), CrestCo, Korean Securities Depository Association (KSDA) run the securities lending and borrowing for their clients who register with them through the electronic trading screen which matches the demand and supply for the designated securities.*

### **Box III : A comparative study of the global market practices in securities lending and borrowing**

- Internationally, SLB is an OTC market functioning based on bi-lateral contractual agreements between the participants; The transactions are, by and large, privately negotiated transactions which are conducted “over-the-counter” outside the centralized trading platform. Pan Asian Securities Lender’s Association (PASLA) has provided globally accepted model standard agreements for this purpose
- Securities market regulators world-wide are not generally seen to be directly involved in regulation of securities lending transactions
- Periodical reports on the lending and borrowing transactions are submitted to entities like central banks, clearing corporations, depositories, revenue authorities etc.
- In some emerging market jurisdictions like Hong Kong, Korea, Singapore e.t.c., the depositories and custodians provide an electronic platform for execution of securities lending and borrowing transactions.

## **Section VIII Deliberations and recommendations of the SMAC on securities lending and borrowing**

- 8.1 In the light of the foregoing discussions the SMAC was of the view that there was clear need for introduction of a full fledged lending and borrowing scheme in the Indian securities market beyond what was recommended earlier. Having agreed upon the need for full fledged securities lending and borrowing scheme, the Committee took note of the aforesaid international practices in this regard and deliberated on the various operational modalities that may be feasible for recommending a regulatory framework for the lending and borrowing scheme for the Indian securities market.

*Lending and borrowing of securities by clearing corporation/house for meeting settlement shortages*

- 8.2 On the issue of Clearing Corporation/House (CC/CH) of the stock exchanges lending and borrowing securities for the limited purpose of handling settlement shortages, the Committee noted that though the CC/CH have been registered with SEBI as AIs for the limited purpose of lending/borrowing securities for meeting settlement shortages, the same has not yet been operationalised. *The Committee, felt that the scheme should continue and emphasized that the clearing corporation/house of the stock exchanges should act as AIs for the limited purpose of lending/borrowing securities for meeting settlement shortages and the stock exchanges should go immediately implement the close-out procedure for handling settlement shortages and dispense of the auction mechanism.*

*Need for a full fledged securities lending and borrowing scheme through the AI route*

- 8.3 The Committee was of the view that the lending and borrowing by the CC/CH only served a limited purpose and *a full fledged lending and borrowing scheme that was open for all market participants was necessary for the Indian securities market. The Committee therefore recommended that apart from the lending and borrowing of securities by CC/CH for settlement shortages, a full fledged securities lending and borrowing scheme should be introduced by SEBI along with the Stock exchanges through the Approved Intermediaries (AIs) route .*

- 8.4 The Committee however preferred a cautious approach while permitting entities to act as AIs for securities lending and borrowing scheme. The Committee, therefore, recommended that *in the first stage, only custodians, Banks and FIs may be registered as AIs for the purpose of lending and borrowing of securities.* Since it has been proposed to permit short selling in certain specific securities, *the Committee recommended that securities lending and borrowing may also be, initially, restricted only in those stocks in which derivative products are available.*

*Execution of lending and borrowing transaction*

- 8.5 The lending and borrowing transactions are internationally executed pre-dominantly an OTC market, or in house by the global custodians or depositories. But such OTC markets suffer from lack of transparency and thus do not address the need for centralized dissemination of information of such lending and borrowing transactions. The Committee was, therefore, of the view that in order that it would be desirable to allow securities lending and borrowing through an automated, screen-based platform which would electronically match the demand and supply of securities. This would be transparent and enable an audit trail of transactions in the process of securities lending and borrowing, besides giving the advantages of speedier execution, and fair and

automated discovery of prices. *The Committee, therefore, recommended that the lending and borrowing transactions may be executed on an automated, screen-based platform which enables real time matching of the demand and supply. Any trading member/investor who wishes to borrow securities may borrow the securities through the screen.*

*Risk management and settlement of lending and borrowing transactions*

- 8.6 The NSE and BSE have suggested that they may be given the opportunity to provide this separate trading platform considering their proven expertise in automating the transactions in the normal market. If the securities lending and borrowing was to be done through the stock exchanges it would be necessary to define their role. The risk management and settlement of lending and borrowing transactions was equally important. While agreeing with the proposal of the stock exchanges, the Committee recommended that the settlement of the lending and borrowing transactions executed through the separate platform should be done independent of the settlement of normal market transactions and should not be aggregated or mixed with the normal market settlement. *The Committee also recommended that the Stock exchanges shall undertake the risk management of such lending/borrowing transactions. As a part of the risk management, the clearing corporation/house should guarantee the return of the securities by the borrower to the lender by being the central counter party and shall, thus, provide guarantee for counter-party risk. The Committee further recommended that the stock exchanges would jointly work out and put in place uniform modalities for securities lending and borrowing which will also include the manner in which the securities borrowed will be returned to the lender and the manner in which the exchanges will provide the guarantee.*

*Standardization of lending & borrowing agreements*

- 8.7 The Committee noted that international experience shows that securities markets which had an active securities lending and borrowing scheme, had also framed their agreements between the various parties which were similar or variants of model agreements provided by the Pan Asian Securities Lender's Association (PASLA). With a view to align the model agreements in the Indian securities market with the internationally accepted standards, *the Committee recommended that the lending and borrowing transactions could be formalized in terms of robust lending and borrowing agreements on the lines of the model agreements provided by PASLA which obligate the borrowers to return the securities to the AI and agreements between the AI and the lender which enable the AI to allot the lender's securities to the borrowers at a screen determined price.*

*Disclosure of lending and borrowing transactions*

- 8.8 The Committee felt that adequate disclosure of the lending and borrowing transactions to the market was necessary to gauge the demand and supply of the securities and enable the investors to make suitable investment decisions. *The Committee, therefore, recommended that the stock exchanges shall disseminate the information on such lending and borrowing transactions to the general public.*

*Tax exemptions for the lending & borrowing transactions*



- 8.9 The Committee noted that in the case of SEBI's first scheme on securities lending and borrowing introduced in 1997, the transactions executed under the scheme were not treated as "transfer of securities" and were exempted from taxation. *The Committee recommended that such tax exemptions should be made available for the transactions executed under the revised scheme also.* The Committee, therefore, urged SEBI to take up the matter of tax exemption with CBDT.

*Amendments to necessary Regulations*

- 8.10 *The Committee also noted that SEBI may need to amend the SEBI (Custodians) Regulations, 1996 suitably so as to recognise the role of custodians as AIs under the securities lending and borrowing scheme and enable them to lend and borrow securities as per the aforesaid regulatory framework.*

\*\*\*\*\*