

IMPROVING SHORT SELLING SYSTEM AND STRENGTHENING OVERSIGHT AND PUNISHMENT FOR ILLEGAL ACTIVITIES

FSC Chairman Kim Joo-hyun presided over a joint meeting with relevant institutions¹ on July 28 and announced the measures to improve the stock short selling system and strengthen oversight and punishment on illegal short selling activities. At the meeting, participants shared the same view that investors' growing concerns about the use of short selling in illegal transactions and the ineffective oversight and punishment on illegal short sale activities need to be resolved in order to restore investors' trust in domestic stock markets.² In this regard, through joint efforts, authorities agreed to strengthen oversight, detection and punishment of illegal short selling activities and promptly pursue improvements to the short selling system to stamp out illegal short selling activities.

OVERVIEW OF THE MEETING

A joint meeting to stamp out illegal short selling activities was held on July 28 chaired by FSC Chairman Kim Joo-hyun. As investors' mistrust toward the short selling system continues to grow with recent declines in global stock markets, the meeting was held as the authorities deemed it necessary to (a) promptly address the need to bolster oversight and punishment over market disturbing activities in capital markets through illegal short selling activities and short selling-based price rigging and (b) discuss and announce the measures for bringing about prompt improvements to the short selling system to help address the issues raised by investors.

BACKGROUND

Short selling involves a sale of borrowed stocks. As an investment strategy aimed at gaining profits or avoiding losses when stock prices fall, it is an investment method generally allowed in markets across all advanced economies.³ Short selling helps to increase market liquidity and prevent formation of bubble in stock prices. However, in the wake of the COVID-19 crisis in March 2020, a short selling ban was introduced to help ease market anxieties.

Since the introduction of short selling ban, various improvements have been made on the stock short selling system as shown below.

¹ Financial Supervisory Service Governor Lee Bok-hyun, Anti-corruption force chief Shin Bong-soo of the Supreme Prosecutor's Office and Korea Exchange's Market Oversight Committee Chairman Kim Keun-ik

² President Yoon Suk Yeol's instruction on July 27.

³ The MSCI considers short selling as an assessment factor when determining a country to be a developed market.

- a) Punishment for illegal short selling activities has been strengthened from a fine to a greater level of monetary sanction as well as imposition of a criminal penalty.⁴
- b) The oversight and detection system for institutional and foreign investors' illegal short selling activities has been strengthened.⁵
- c) Short selling opportunities for individual investors have been expanded through an upgrade to the stock lending system for individual investors.⁶
- d) The volume of short selling by market makers has been reduced by more than a half through regulations on market makers.⁷

⇒ In May 2021, a partial resumption of short selling took effect on KOSPI 200 and KOSDAQ 150 shares.

Despite these measures, there have been calls for making further improvements to the short selling system. There are continuing doubts about whether illegal short selling activities are being detected effectively. There also have been complaints that the short selling conditions for individual investors are unfavorable vis-à-vis institutional and foreign investors.

⇒ Therefore, the authorities have made a reassessment on the short selling system and prepared a plan to make improvements.

DETAILS OF THE PLAN

- ※ Strengthen oversight and punishment for illegal short selling activities while making improvements to the current short selling system
 - (a) Strengthen oversight and detection of illegal short selling and seek strict punishment immediately
 - (b) Introduce a detailed reporting duty on long-term, large-scale short sellers for close scrutiny
 - (c) Expand temporary prohibition on short selling by lowering the bar for designating overheated short selling stock items
 - (d) Provide fair opportunities to individuals by lowering retail investors' margin requirement (collateral ratio)

I. STRENGTHEN OVERSIGHT AND PUNISHMENT ON ILLEGAL SHORT SELLING ACTIVITIES

Authorities will seek stronger oversight and detection while imposing strict punishment at the same time.

- a) Strengthen targeted investigation on unfair transactions linked to short selling
 - Set the theme for investigation targeting stock items after closely selecting the area where the probability of using illegal short selling is high through analyzing trends in stock prices, short selling proportion, etc.
 - Carry out targeted investigation immediately upon finding charges for engaging in illegal activities

⁴ (Greater monetary sanction) Within the amount of short selling transactions / (Criminal penalty) 1 year or more imprisonment or 3 to 5 times of unjust profits gained from illegal short selling activities

⁵ A special inspection unit has been set up at the KRX and an obligation to keep stock lending information for 5 years has been newly introduced.

⁶ Stocks for lending available for individual investors expanded (from KRW40 billion to KRW2.4 trillion) and more securities firms are providing stock lending service to individual investors.

⁷ Restricting market makers' short selling to only in essential cases and overhauling the market makers' transaction items to encourage short selling of low liquidity shares.

- b) Pursue prompt investigation on naked short selling activities
 - Have planned inspection on short selling regularly and promptly carry out investigation on suspicious cases
 - Review the appropriateness⁸ of the process of placing short sale orders at securities firms (including foreign securities firms) and check for naked short selling violations
- c) Carry out strict investigation and punishment
 - Set up a real-time monitoring sharing system between the KRX's market monitoring committee and the FSS's illegal short selling monitoring data for detecting illegal activities in a timely manner and pursue prompt investigation
 - Make use of the fast-track investigation process⁹ centered around the joint investigation unit set up at Seoul Southern District Prosecutor's Office to impose strict punishment (imposing high levels of fines for corporate entities) that is commensurate with the severity of the crime when the level of damage is severe and seek forfeiture¹⁰ of illegal profits and concealed properties gained through illegal short selling
- d) Set up and expand illegal short sale investigation teams
 - Enhance organizational capacity at the Korea Exchange and Financial Supervisory Service to strengthen detection of illegal short selling activities¹¹
 - Make qualitative improvements to investigating illegal short sale activities and operate a response system that allows an immediate investigation and punishment of illegal short selling activities

II. STRENGTHEN MONITORING OVER STOCK LENDING TRANSACTIONS

Authorities will prepare a close monitoring system on stock lending transactions which will be used to inspect illegal short selling activities.

- a) Introduce an obligation to report to the financial authorities 90 days after stock lending takes place for short selling purpose (revision to the regulation on financial investment business required)¹²
- b) Require to have stock lending information (stock lending balance at opening and closing) included when filing a report for large-scale short positions (revision to the regulation on financial investment business required)¹³

III. EXPAND THE APPLICATION OF OVERHEATED SHORT SELLING STOCK DESIGNATION

Authorities will bolster the application of the overheated short selling stock designation system by introducing new criteria for designating overheated short selling stock items (revision to the operating rules of the Korea Exchange required).

⁸ Whether they check stock borrowing upon receiving short sale orders, repayment demand for loaned stocks, total return swap (TRS) contract, etc.

⁹ Switching to a fast-track investigation at an early stage allows timely and compulsive investigation possible.

¹⁰ Focus on returning criminal proceeds and recovering damages through confiscation and prohibition of selling assets linked to criminal investigation.

¹¹ KRX: (As of now) 1 department, 2 teams, 13 individuals (monitoring team and inspection team) → (To be changed) 1 department, 3 teams, 17 individuals (newly establish a planning and inspection team)
FSS: (As of now) short selling investigation unit (led by the head of derivatives investigation team) → (To be changed) newly establish a short selling investigation team

¹² To be used in as a lead in suspicious transactions of unfair trading activities such as price manipulation.

¹³ To be used to see whether the net short sale position on a given day is larger than the growth in stock lending balance in which case it will become subject to inspection.

- a) Designate a stock item as an overheated short selling stock item when the proportion of short orders is 30 percent or more even when the price drop (3% or more) and the increase in the amount of short selling transactions (twice or more) remain low¹⁴

<Improvements to the Standards for Designating Overheated Short Selling Stocks>

Market	Short selling proportion	Stock Price decline rate	Amount increase in short selling transactions**	Short selling proportion for preceding 40 days
All ^(new)	30% or more	3% or more	Twice or more	
KOSPI	3 times or more of short selling proportion for KOSPI stocks in the preceding quarter*	5% ~ 10%	6 times or more	-
	-	10% or more		
KOSDAQ	3 times or more of short selling proportion for KOSDAQ 150 stocks in the preceding quarter*	5% ~ 10%	5 times or more	-
	-	10% or more		-
	-	-		5% or more

* When an individual stock item's short selling proportion exceeds 20 percent, it meets the short selling proportion criteria.

** Short selling transaction amount for a stock item on that day / average short selling transaction amount for preceding 40 days

- b) Automatically extend and carry over the application of short selling ban until next day when stock prices decline 5 percent or more while short selling ban is in place (ongoing)¹⁵

IV. PROVIDE RETAIL INVESTORS WITH FAIR OPPORTUNITIES FOR SHORT SELLING

Authorities will work to provide fair opportunities to individual investors by lowering margin requirement (collateral ratio), etc.

- a) Lower individual investors' margin requirement (collateral ratio) from 140 percent currently to 120 percent (revision to the regulation of financial investment business required)
- Taking into account comprehensive factors such as the soundness management¹⁶ of securities firms, individual credit risk and overseas cases (e.g. 120% in Japan) where individual stock lending and borrowing takes place regularly
- b) Stock lending and borrowing with no restrictions of repayment period already available for professional investors (including individual investors)¹⁷ → Promote

¹⁴ (Simulation) Number of stock items designated as overheated short selling items to be increased from 690 to 785 a year (+95 items, +13.8%).

¹⁵ (Simulation) Number of days designated as overheated short selling stock items to be increased from 690 to 796 days (+106 days, +15.4%).

¹⁶ The maximum average stock price increase for two days for the top 10 short selling items (5 KOSPI stock items and 5 KOSDAQ stock items, as of March 13, 2020) over a month was +17.8% → Taking into account the need to establish a minimum level of buffer

¹⁷ KRW50 million or more in financial investment products and one of the following (have KRW100 million or more in annual income, KRW500 million or more in assets or a accountant license)

stock lending transactions for professional investors through securities firms¹⁸

FURTHER PLAN

In order to help improve public trust on the short selling system, authorities will promptly implement the specific measures. In particular, the measures to strengthen oversight and punishment on illegal short selling will be implemented as soon as possible while the measures requiring revision to existing regulations will be carried out with a goal to begin implementation within this year.¹⁹

Policy task	Required measure	Schedule
I. STRENGTHEN OVERSIGHT AND PUNISHMENT ON ILLEGAL SHORT SELLING		
- Strengthen targeted investigation on illegal short sale transaction activities	-	Immediately
- Promptly investigate naked short selling activities	-	Immediately
- Carry out strict investigation and punishment	-	Immediately
- Enhance organizational capacity at KRX and FSS	- Set up new division at KRX - Set up new division at FSS	Already set up In 2023
II. STRENGTHEN MONITORING OVER STOCK LENDING TRANSACTIONS		
- Introduce a reporting obligation for 90 days or more of stock lending	- Revision to the regulation of financial investment business	Q4 2022
- Require to include stock lending information when filing a report for large-scale short positions	- Revision to the regulation of financial investment business	Q4 2022
III. EXPAND THE APPLICATION OF OVERHEATED SHORT SELLING STOCK DESIGNATION		
- Make improvements to the overheated short selling stock designation system	- Revision to the operating rules of the Korea Exchange	Q3 2022
IV. PROVIDE FAIR OPPORTUNITIES TO RETAIL INVESTORS		
- Lower individual short sellers' margin requirement (collateral ratio)	- Revision to the regulation of financial investment business - Making changes to securities firms' network systems	Q4 2022 Q4 2022
- Promoting stock lending to professional investors	-	Ongoing

※ After gathering opinions from market participants, authorities will also decide on whether to introduce a market-based approach (linked to market indexes) for the suspension and resumption of all short selling activities, which is currently decided under the discretion of the FSC, thereby increasing predictability in the market.

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¹⁸ e.g. When there is a shortage in stocks for lending from a securities firm, the Korea Securities Finance Corporation will provide stocks for lending.

¹⁹ (Q3 2021) Making improvement to the designation of overheated short selling stock system
(Q4 2021) Introducing a reporting requirement for long-term, large-scale short sellers and lowering individual short sellers' margin requirement (collateral ratio)