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# New Short Sale Regulations

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*In view of the fact that depressing the market through short sale can lead to sharp drop in their stock prices of financial institutions, etc. on the stock market, the regulation governing short sale were tightened up through the Financial Systems Reform Law passed in June 1998. Regarding these short sale regulations, it was decided that their enforcement should be brought forward to October 23, 1998.*

*The regulations on short sale were originally introduced based on those prevailing in the US. However, through the current revision, the regulations have become more severe as far as securities companies are concerned.*

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## 1. The background to the tightening up of regulations on short sale

### 1) The regulations up to now

#### *(1) The thinking behind Japan's short sale regulations*

Short sale is the act of selling securities not held by the seller. The person conducting the short sale subsequently buys back the securities, and if the market price has fallen, the seller makes a profit.

Short sale is regulated by the Securities and Exchange Law because of the possibility of deliberate improper trading such as manipulation of the market by depressing the market (bear raiding), or intensifying a downward trend in the market through massive selling.

However, short purchase, or buying without using cash, may lead to unfair trading such as inciting an improper upward swing in the market or used to manipulate the market. However, there are no regulations governing short purchase.

The reasons given are as follows:

- (1) One objective of the Securities and Exchange Law is to protect the seller in the case of fund raising by the issuer of securities such as companies and to facilitate a smooth recovery of funds at the time of sale for people who have invested in securities.
- (2) The first Article of the Securities and Exchange Law seeks to ensure a smooth circulation of securities. Thus, if unrestricted short sale is carried out, as there are limits on the number of securities issued, there is a fear that delivery will not be carried out smoothly. Thus, short sale is allowed only when it is clear there will be no problem in delivery. This is the basis up which the decision to have restrictions on short sale but not on short purchase.

The actual regulations placed on short sale including the duty to disclose the transaction and price regulation. These are laid down in government and ministerial ordinances and not

in the form of laws (Securities and Exchange Law Clause 2,3,4, Article 26 "government and ministerial ordinances on short sale of securities").

Not all activities falling within the realm of short sale are subjected to regulations. For example, when selling as futures transactions or margin transaction writing, it is quite normal to sell securities without holding them. Thus, even when falling within the definition of short sale, there are other regulations, and short sale regulations do not apply to these cases. When short sale at a price higher than the market price, there is no fear of provoking a sharp fall in the market. Thus, it is not considered necessary to regulate this.

## ***(2) Short sale regulations introduced from the US***

Japan's regulations on short sale are based on those of the US Securities and Exchange Act. The US short sale regulations were introduced in 1938. At that time opinions were divided on the necessity of regulating short sale. However, in 1963, The Special Study of Securities Market <sup>1</sup> relating to the sharp fall in stock prices in May 1962, submitted to congress by the SEC stated that short sale intensified the downward trend in the market. This provided support for regulating short sale.<sup>2</sup>

The regulations on short sale existing in Japan up to now were not created in response to some actual incident. Thus, they were slightly less severe than those of the US. By way of reference, according to "Activities of the Securities and Exchange Surveillance Commission" (October 1998), an annual report issued by the Securities and Exchange Surveillance Commission, an administrative disposition (measure) recommendation was issued on infringements of short sale regulations based on the result of a survey, the first since the start of activities in 1992.<sup>3</sup>

## **2) The background to the bringing forward of short sale regulations**

Due to a lack of confidence in view of the numerous failures of securities companies and other financial institutions at the end of 1997, there was selling of the stock and corporate bonds of banks holding large amounts of bad debts and relatively weak companies in the stock market and bonds markets, and prices fell heavily and the market became unstable. (Figure 1)

In order to deal with this situation rapidly, on January 7, 1998 the Ministry of Finance announced that measures governing the stock market would be strengthened and this included a boosting on the regulations on short sale. This was one measure to ensure a fair and

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1 "Special Study of Securities Markets" H.R. Doc. No.95, 88th Cong., 1st Sess. 251 (1963)

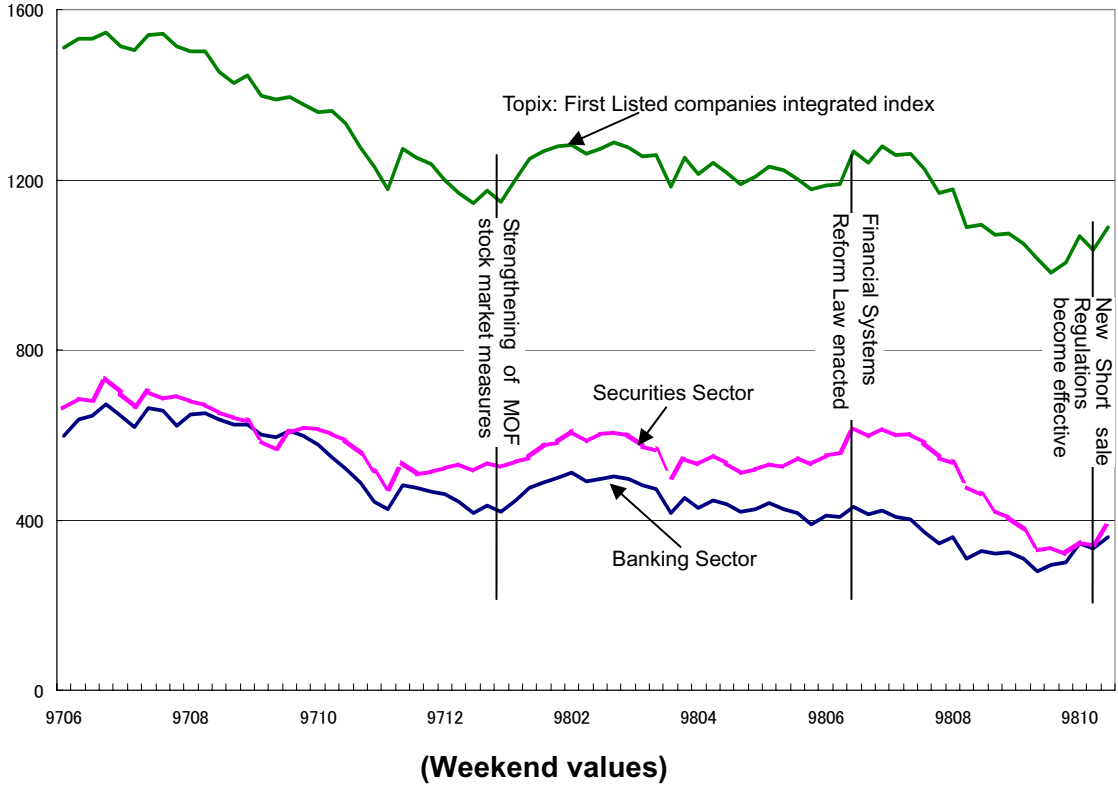
2 According to this special study, during the falls in the market from April to June 1962, non-members increased their percentage of short sale. Looking at the last few days of May when the market fell dramatically, the short sale of non-members accounted for over 50% of all short sale. On May 28, 1962, a survey was made on the trading of eight major issues. This showed that, in the case of three issues, there had been over 10,000 stocks sold short. Of these, two issues accounted for over 16% of the selling.

3 On May 26, 1998, disciplinary measures were imposed on the Tokyo Branch of ING Baring Securities. This was due to the fact that from May to December 1997 the branch did not disclose 70 cases of short sale, and in 17 cases it sold short at a price less than the latest market price. The punishment was for a partial suspension of the activities of the stock dealing division (2 days) and a partial suspension of operations involving convertible bond warrants (one week).

trustworthy market within the movement to promote a liberalization of the securities market. The tightening up of the regulations on short sale was included in the Financial Systems Reform Law in order to create and enhance fair trading rules. This Law has been designed to create free and fair financial systems as a concrete measure coming under Japan's Big Bang.<sup>4</sup>

The Financial Systems Reform Law integrates reforms in 24 related laws such as the Securities and Exchange Law and it was passed into law on June 5, 1998. In principle, it was to be enforced on December 1, 1998. However, during debates on the Financial Reconstruction Law during an extraordinary session of the Diet in the autumn of 1998, it was decided to bring forward the enforcement of the new regulations to govern short sale to October 23, 1998. The background to this decision is as follows. Based on various sources of information the stock prices of certain specific issues displayed violent fluctuations. This was thought to be due to a depression of the market caused short sale and this became an issue of importance. It was decided to act speedily to promote the creation of a fair and transparent stock market, and on a member's bill, the timing of the enforcement of the Financial Systems Reform Law was brought forward, an unprecedented occurrence.

**Figure 1 Banking and Securities Sectors stock price indexes by sector on TSE**



Source: Nomura Research Institute

4 In addition to the review of the regulations on short sale, other items decided included confiscation and additional payments imposed in the case of unlawful or dishonest gain, unlawful or dishonest transaction acts, circulating rumors, manipulating the market, insider trading and other unfair trading.

## 2. New Short Sale Regulations

In line with the bringing forward of the enforcement of the new short sale regulations, reforms on the Cabinet orders of the Securities and Exchange Law and ministerial ordinances on the short sale of securities were promulgated on October 13, 1998.<sup>5</sup>

Notification was given to full members of TSE and members of the Securities Dealers Association of Japan on the reforms on short sale in the new regulations.

### 1) New Securities and Exchange Law and government and ministerial ordinances

#### *(1) An expansion of the application of the regulations on short sale*

In addition to governing the selling of securities not owned, the New Securities and Exchange Law has been expanded to cover areas such as selling borrowed securities and cases where it is not clear that the seller can immediately deliver the securities after selling them. (Excluding borrowed securities) (Clause 1-1, Article 162 of the New Securities and Exchange Law and the Cabinet Order of the Securities and Exchange Law Clause 2, Article 26). The former Cabinet Order Clause 2-2, Article 26) included the following; selling could be engaged in when the seller had securities and had the will to disclose the intention to sell. Thus, the sale could take place if the customer engaged in selling held the securities, and after their sale, could immediately deliver them to members without any let or hindrance and with no charge, and when this was known in advance by the member. This has been eliminated in the new reforms.

Regarding concrete regulations governing short sale, in addition to the duty of disclosure (declaration) when undertaking short sale and the restrictions of the price in short sale, additional regulations have been added including the duty of the customer to disclose (declare) the trade and the duty of the securities firm to confirm this transaction. (Cabinet Order Clause 3,4, Article 26). That is to say, in addition to the securities companies, the customers themselves must make clear if the trading is in the form of short sale or not, and the securities firms must check to see if the entrusted consignment trading is short sale or not.

The securities firms must not engage in short sale at a lower price than the most recently announced price on the stock exchange or in OTC trading. The customers must not instruct securities firms to effect short sale at a price lower than the most recently announced price. In this case, if selling takes place after the ex-dividend or rights-off of securities, short sale at the most recently announced price is calculated by subtracting the price of dividend and rights from the price prior to ex-dividend or rights-off. (Cabinet Order Clause 4-3, Article 26)

When the regulations on short sale are infringed upon, a fine of 300,000 yen or less is imposed, as has been the case up to now. (New Securities and Exchange Law Clause 2-2 Article 208)

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<sup>5</sup> Ministerial ordinances on new short sale regulations were further amended on November 20, 1998. (Enforced on December 1, 1998)

## ***(2) Trading operations which are not covered by short sale restrictions***

The following transactions were not covered by ministerial ordinances on declaration and confirmation duties (Cabinet Order Clause 3-5, Article 26) as well as restrictions on short sale prices: (Cabinet Order Clause 4-4, Article 26) (Table 1)

There are no restrictions on declaration and confirmation duties as well as restrictions of short sale prices in the securities market in the following cases:

- 1) Securities futures transactions
- 2) Margin transactions
- 3) Transactions on the day of issue
- 4) Loan transactions (On their own account, stock exchange members engage in settlement trading in securities borrowed from securities finance firms using the stock exchange settlement mechanism.)
- 5) Arbitrage selling conducted in stock price index futures trading
- 6) Regarding the short sale of stock certificates issued by foreign companies listed on Japanese stock exchanges, there are no restrictions when stock certificates for this are bought on a foreign securities market
- 7) The trading of bonds excluding convertible corporate bonds and corporate bonds with warrants.

In line with the revision of government and ministerial ordinances on short sale 5) above has been removed from the exemption category (trading in which only the price restrictions are not applied). Regarding 6) above, foreign investment securities have been included in stock certificates.

The following are additional trades exempted from the regulations.

- 8) Selling of securities for which the purchase settlement has not yet been carried out (in selling settlements, those purchased securities are used)
- 9) In the sale of lent out securities (excluding borrowed securities), if prior to settlement, they have clearly been returned
- 10) Selling at the stock exchange outside of a session
- 11) Selling of ex-rights convertible bonds and corporate bonds with warrants

The following are trades in which the duties of declaration and confirmation exist, but the price restrictions are not applied.

- 1) Arbitrage selling conducted in stock price index futures trading
- 2) Hedge trading
- 3) Selling of securities which do not make up a full lot
- 4) Selling of securities to effect a leveling out of price with other stock markets  
(Ministerial Ordinance on Short Sale Article 1 and 3)

Regarding selling in the area of OTC trading, the rules are the almost same as selling on the stock markets. However, in the case of market making carried out by members of the Securities Dealers Association of Japan, the duty of declaration and price restrictions do not apply (Ministerial ordinance on Short Sale Clause 5 Article 2). Short sale in the area of

market making is trading as follows. Members (market makers) with the duty of constantly making quotations (selling and buying) regarding designated issues in the area of OTC trades securities undertake short sale on their own decision based on the quotation for selling. At the same time, this applies in the case of members of the Securities Dealers Association of Japan undertaking short sale on their own decision in the area of settlement trading using OTC securities borrowed from a securities financing firm using the settlement organization of the applicable Securities Dealers Association (Ministerial ordinances on short sale Clause 4, Article 2).

**Table 1 Trading exempted from the new short sale regulations**

Trading exempted from short sale regulations	Declaration/ Confirmation	Price restriction
Securities futures trading	No	No
Margin transactions	No	No
Transactions on the day of issue	No	No
Loan transactions	No	No
In the case of the short sale of stock certificates issued by foreign companies bought on a foreign securities market	No	No
Trading of bonds excluding convertible corporate bonds and corporate bonds with warrants	No	No
Selling of securities for which the purchase settlement has not yet been carried out	No	No
<u>Selling at the stock exchange outside of a session</u>	No	No
<u>Sale of lent out securities, when they have clearly been returned prior to settlement</u>	<u>No</u>	<u>No</u>
<u>Selling of ex-rights convertible bonds and corporate bonds with warrants</u>	No	No
<u>Market making trading (Note)</u>	<u>No</u>	<u>No</u>
Arbitrage selling conducted in stock price index futures trading	<u>Yes</u>	No
<u>Hedge trading</u>	Yes	No
Selling of securities which do not make up a full lot	Yes	No
Selling of securities to effect a leveling out of price with other stock markets	Yes	No

Note 1 Underlines items are those which have been revised (As of November 20, 1998)

Note 2 This concerns selling in OTC trading. Apart from this, both selling in the securities market and selling in the OTC market are subject to regulations.

Source: Nomura Research Institute

## 2) Regulations of Tokyo Stock Exchange (TSE) and Securities Dealers Association of Japan

### (1) Review of regulations of TSE

In line with the revision of short sale regulations, on October 20, 1998 TSE made some revisions to its operational regulations.

The changes are as follows:

In addition to member securities firms, the customers must clearly indicate if selling is short sale or not. When requesting the trading of securities, the customers must order the

member securities firm to undertake short sale. (Article 6 of standing rules of entrustment contract)

Regarding the entrustment orders on the trading market, the member securities firms of TSE must confirm if this is short sale or not. The member must also clearly indicate to TSE if this is short sale or not. That is to say, when conducting short sale, the order form must state "short sale".

1 - Trading that is subject to the price regulations

Regarding the price when short sale is being carried out, the transaction must not be carried out at a price which is lower than the most recently announced price for the issue by the stock exchange. The following transactions have additionally been exempted from the price regulations: selling for which the settlement has not yet been completed for the purchase on a different stock exchange, trading out of session (large lot or basket trading, closing price trading, and trading to effect a correction of mistakes), selling of stock certificate for which a request has been made to convert from convertible bonds, selling relating to hedging in the area of stock price index futures, and arbitrage selling in the area of stock option trading and hedging selling in the area of stock option trading.

2 - Items covered by the listed securities short sale report

When full members of the stock exchange engage in short sale, they must report the details of the transaction to the stock exchange using the listed securities short sale report by the day following the day of the transaction. (Article 72 of the operational regulations of TSE, Article 43 of the operational enforcement regulations of TSE, etc.) The following are entered on the listed securities short sale report. The name of the issue, the time of the contract execution, the number of stocks sold, the contract price, on own account or on entrustment by customer, and the order reception number.

In addition, the following has become excluded from regulations: selling for which the settlement has not yet been completed for the purchase on a different stock exchange. However, the following have become subject to reporting: arbitrage-selling relating to stock price index futures. (not subject to price regulations) (Table 2)

**Table 2 Transaction exempted from reporting on the listed securities short sale report**

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| <ul style="list-style-type: none"><li>• Margin transactions</li><li>• Transaction on the day of issue</li><li>• Own account margin selling</li><li>• Bonds (excluding convertible bonds and warrant bonds)</li><li>• Selling in the case of own account trading of listed foreign stocks in line with purchase on the stock market in the home country with the object of ensuring smooth distribution and selling to fill a buy order</li><li>• Selling prior to settlement</li><li>• Out of session trading (Large lot, basket trading, etc.)</li><li>• Selling of stock certificate when a request has been made to convert a convertible bond</li></ul> |
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***(2) Revision of the regulations of the Securities Dealers Association of Japan***

On October 21, the Securities Dealers Association of Japan made partial revisions of its regulations regarding "trading of OTC securities and other transactions" (Fair practice rule No.

1) and "regulations regarding securities employees" (Fair practice rule No. 8) in response to new short sale regulations.

Members of the Securities Dealers Association of Japan undertaking OTC trading of OTC securities are subject to almost the same regulations as apply on the stock exchange. That is to say, regarding OTC trading, members must clearly indicate if the trading is short sale or not. They must submit a report on the details of the short sale to the association by the day following the selling day on the designated form (Clause 7, Article 20 and Article 31). A newly established regulation is that when a member receives an OTC trading order from a customer, on each occasion, the member must confirm if this is a short sale order or not (Clause 2-8, Article 4).

Employees of securities firms must not engage in the following prohibited short sale acts. This has been added to (Fair practice rule No. 8 section on prohibited acts).

- They must not accept an order without confirming if it is for short sale or not when they receive a securities sell order from customers. (Clause 3-36, Article 9) -- This excludes trading defined in the Ministerial Ordinances on Short Sale Articles 1 and 2
- When an order is received from a customer for short sale, they must not undertake the short sale at a price which is lower than the most recently announced selling price by the stock exchange or the Association. (Clause 3-37, Article 9) -- This excludes trading defined in the Ministerial Ordinances on Short Sale Articles 3 and 4
- When an order is received for short sale from a customer and this is entrusted to another member, the member must not instruct the other member to undertake the short sale at a price which is lower than the most recently announced selling price by the stock exchange or the Association. (Clause 3-38, Article 9) -- This excludes trading defined in the Ministerial Ordinances on Short Sale Articles 3 and 4.

### **3. Conclusion**

In terms of actual operations, there is some concern regarding the new short sale regulations. That is to, say, there is concern over to what extent domestic securities companies must confirm that any sell orders they receive from customers are for short sell or not. In particular, when they receive an order for selling from an overseas investor, it is difficult to accurately determine if the securities are borrowed or owned by the seller. Regarding this, it is necessary to have a clearly defined legal definition of the obligation of the securities firm employees to determine if a sale is short sale or not taking into account the load on the daily operations of securities companies.

In view of the strengthening of regulations on short sale and the intention to apply these regulations strictly, it is hoped that it will become more difficult to engage in unfair trading through methods such as manipulation of the market and circulating rumors. However, excessive regulation may well impair or diminish functions to improve the liquidity of the market and the function of preventing a sharp fall in the market due to short covering (repurchasing). Short sale is just one means available to people who seek to engage in unfair trading practices such as market manipulation.

Market manipulation and circulation of rumors are acts that are very difficult to define (abstract acts). Thus, although in principle, there should be regulations to control market



manipulation etc., as this is difficult to realize, there is a tendency to rely on regulating governing short sale as it is possible to effect blanket concrete measures, and this gives rise for concern. Regarding market manipulation, a new regulation has been introduced including the confiscation of profits made in this way and this is an area where intensive surveillance is in effect on the part of the Securities and Exchange Surveillance Commission. However, it is desirable to achieve a more balanced position regarding unfair trading.<sup>6</sup>

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6 On October 7, 1998, the Securities and Exchange Surveillance Commission issued a document entitled "Intensification of Surveillance Systems". This document gives instructions for an intensification of surveillance of acts involving distortion of price forming functions in the market such as circulation of rumors and stock price manipulation, etc.