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Japan to normalize short-selling regulations

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Executive Summary

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Japan's Financial Services Agency has unveiled plans to rescind the emergency short-selling restrictions imposed during the 2008 financial crisis and replace them with revised permanent regulations. Its proposed revisions are timely and sensible. They should help to improve market liquidity and price formation.

Emergency short-selling restrictions have remained in effect in Japan

In March 2013, Japan's Financial Services Agency (FSA) released a draft of revised short-selling regulations. In Japan, short-selling restrictions were tightened as an emergency measure in response to the market turmoil triggered by Lehman Brothers' September 2008 collapse. These emergency restrictions are still in effect, having been extended 12 times. With the recently released revised regulations slated to take effect in November, regulation of short-selling in Japanese markets is set to finally return to normal.

Short selling is an investment technique whereby an investor borrows from a third party securities that he does not currently own and sells them in the aim of repurchasing them later at a lower price. When a security is sold short, its market price reflects the investment opinion of investors that do not own the security in the cash market. Short selling also enhances market liquidity by increasing sell orders.

It thus fulfills a legitimate economic function but it can also trigger steep price declines if certain stocks are heavily sold short within a short timeframe. Such intensive short-selling can cause market dislocations and would likely constitute unfair market manipulation. At the time of the 2008 financial crisis in particular, rampant speculative short-selling was seen as a problem in markets throughout the world. Many countries banned short selling of designated stocks.

Even before the 2008 crisis, Japan had required flagging and verification of short sales and adopted an "uptick rule" prohibiting short sales unless the sale was executed at a price above the immediately preceding trade's execution price. In

2008, Japan imposed a ban on naked short-selling (selling securities short without having borrowed and actually taken possession of the securities) and reporting/disclosure requirements for short positions that exceed certain size thresholds.

American and European countries subsequently rescinded their emergency short-selling restrictions and revised their permanent regulations. Japan, by contrast, has failed to do so, partly due to unforeseen circumstances in the form of the catastrophic earthquake of March 11, 2011.

Content of revised regulations

Following are the major points of the revised regulations proposed by the FSA.

(1)The reporting and disclosure requirements imposed as an emergency measure in 2008 would be made permanent. Short sellers would be required to report any short positions that exceed 0.2% of a stock's issued shares and publicly disclose any short positions that exceed 0.5% of the issued share count. They would also be required to report changes in short positions whenever a previously reported short position increases to above 0.3%, 0.4%, or 0.5%, or is reduced below 0.2%, of the issued share count. Additionally, short sellers would be required to publicly disclose whenever a previously reported 0.5%-or-larger position is reduced below 0.5%.

(2)The price restrictions on short selling that were permanently in effect before 2008 would be revised to make the previous uptick rule subject to a trigger. Specifically, the uptick rule would be triggered when a stock trades at a price more than 10% below its closing price on the previous trading day. Once the uptick rule is triggered, it would remain in effect until the close of trading on following trading day. This regulation would apply to not only stock exchanges but also proprietary trading systems (PTS) currently exempt from the uptick rule.

(3)The naked short-selling ban imposed as an emergency measure in 2008 would become permanent and apply to trading on PTSs also.

(4)The scope of short-sale flagging and verification requirements and regulation of short selling in connection with seasoned equity offerings (Japan's version of US Regulation M, adopted in 2011) would be expanded to encompass trading on PTSs.

Reforms should strengthen market function

Investor confidence has recently been resurgent in the Japanese equity market, with stocks rallying sharply in the wake of November 2012 general election, inauguration of the second Abe Cabinet, and growing optimism with respect to "Abenomics," the new Cabinet's economic policy. In light of such, the revised short-selling regulations are timely.

They are also well-balanced. While basically affirming short-selling's economic significance, the revised regulations recognize that short selling can cause market dislocations if markets are unstable. Additionally, they were drafted with the benefit of hindsight vis-à-vis US and European regulatory reforms in the aftermath of the financial crisis. In particular, the fact that the formerly always-in-effect uptick rule would be triggered into effect only when prices have fallen sharply should greatly improve the Japanese market liquidity and price formation.

In Japan, there is deep-seated support for artificial intervention in the markets, including frequent advocacy of measures to prop up stock prices through such means as establishing public entities to buy stocks. Short selling tends to be

Exhibit: Comparison of existing short-selling regulations and proposed revisions

	Existing regulations	Revisions
Short-sale flagging/verification requirements	Short sellers must notify broker if sell order is for short sale and broker must verify	Applicability to be expanded to PTS trades
Price restrictions (uptick rule)	Short sales always prohibited unless sale price is higher than immediately preceding trade's execution price	Uptick rule to apply only to stocks down more than 10% from previous day's closing price and remain in effect only through next trading day
Naked short-selling ban	Temporary ban (emergency measure)	Permanent ban
Position reporting/disclosure requirements	Short positions must be reported/disclosed if they exceed 0.25% of issued share count (emergency measure)	Short positions must be reported if they exceed 0.2%, and publicly disclosed if they exceed 0.5%, of issued share count (permanent measure)
Short-selling restrictions related to equity offerings	Ban against using newly issued shares to cover short positions initiated after announcement of equity offering	Applicability to be expanded to PTS trades

Source: NRI

frowned upon on the grounds that it destabilizes markets. However, excessive restriction of short selling, which entails buying back shorted shares at a later date, can paradoxically accelerate market declines. The FSA's revised short-selling regulations should facilitate fair short-selling and contribute to strengthening market function.

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