
SHORT SALE REFORM MEASURES

PREVENTING ILLEGAL AND UNFAIR TRADING ACTIVITIES AND
ENSURING PROTECTION FOR INVESTORS

JUNE 2024

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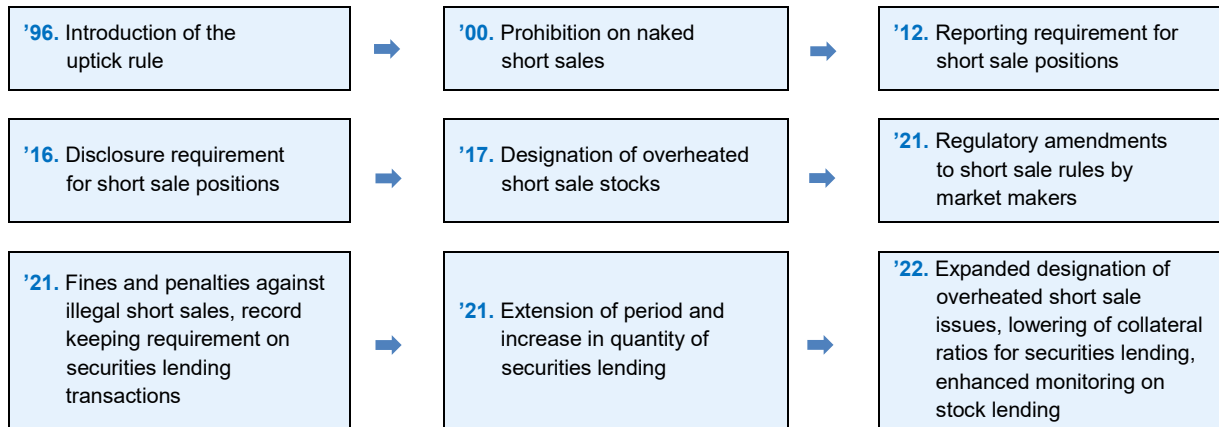
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I. BACKGROUND

The Korean government has been working to improve regulations on short selling with goals to prevent illegal short sale activities and minimize their negative effects.

<Important Steps to Upgrade Short Sale Regulations>



Despite these regulatory efforts, large-scale naked short sale activities have been uncovered repeatedly, threatening to undermine fair price formation in the market. Against this backdrop, the government imposed a temporary short sale ban of all stocks effective from November 6, 2023 to June 30, 2024.

Since then, the government and relevant authorities launched a taskforce and held a series of public discussions with various stakeholders to seek ways to bring about fundamental improvements to short sale regulations and market practices.

In the meantime, backed by improvements in macroeconomic conditions and investors' expectations about the government's capital market reform initiatives, the Korean stock market rose and foreign investors turned net buyers in recent months. From November 3, 2023 to June 12, 2024, the KOSPI rose from 2,368.3 to 2,728.2, while the KOSDAQ also increased from 782.1 to 870.7. Between November 6, 2023 and May 31, 2024, foreign investors net purchased about KRW26 trillion of Korean stocks.

After having a series of public discussions, it was found that foreign and institutional investors demand more regulatory clarity and predictability, while retail investors call for an electronic system that can thoroughly monitor short sale transactions and a limit on institutional investors' stock repayment period. Also, since retail investors make up a large share in Korean stock market when compared to the situation in other countries, it is necessary for the financial authorities to help foreign investors better understand about this peculiar characteristic in Korean stock market, which demands more rigorous regulations for short sale activities.

Against this backdrop, the government has drawn up plans to make fundamental improvements to short sale regulations, which will help to prevent the potential of illegal short sale activities disrupting market's function of fair price formation.

II. OVERVIEW OF KEY DEVELOPMENTS

[SHORT SALE BAN AND REGULATORY IMPROVEMENTS] With the detection of illegal naked short sale activities, the government decided to impose a temporary ban on short sale from November 5, 2023 until June 30 this year. With the short sale ban in place, the government outlined the direction for short sale reform plan and unveiled a draft in November 2023. Since then, the government has collected opinions and feedback through discussions with stakeholders before arriving at the finalized set of reform measures.

[PUBLIC DISCUSSIONS] On November 23, 2023, the Financial Supervisory Service (FSS) and the Korea Exchange (KRX) launched a taskforce to set up an electronic monitoring system for short sale transactions.

On November 27, 2023, the FSS provided detailed explanations about introducing a limit in the extension of stock lending period for institutional investors and making adjustments to collateral ratios as well as the progress in discussions on establishing the electronic monitoring system.

In December 2023, relevant organizations including the Korea Financial Investment Association (KOFIA) and the KRX held discussions with industry groups and institutional investors on the repayment period of securities lending, collateral ratios, and making transition to an electronically processed short sale transactions system.

Between March and June this year, the FSS held public discussions in three different occasions with retail investors to gather opinions and feedback on the reform proposals.

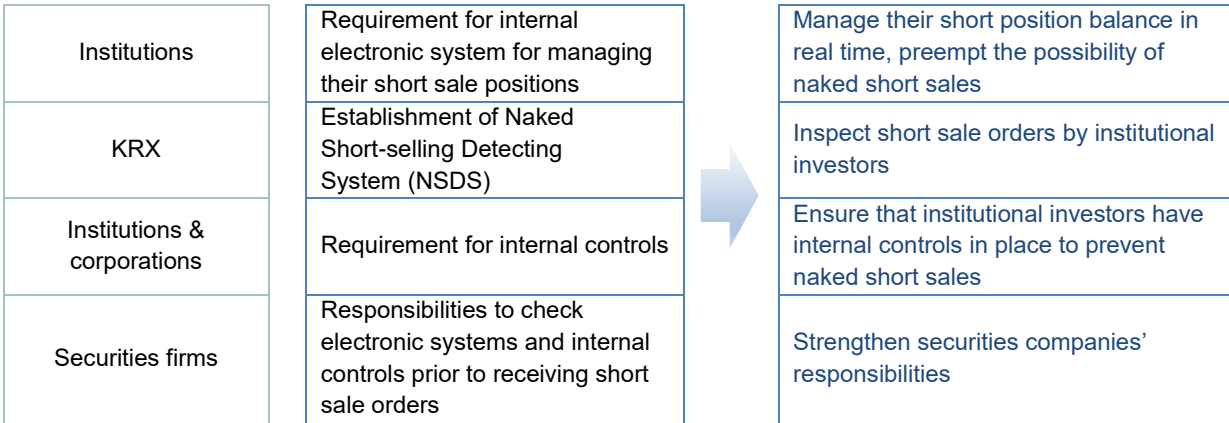
[INVESTIGATION AND INSPECTION] The FSS has been investigating 14 global investment banks and has uncovered illegal short sale practices by some of them. Two of these companies have been fined and their cases have been forwarded to the prosecutors' office, and appropriate sanctions procedures are under way for seven other companies.

Since liquidity providers have been exempted from the short sale restriction from the beginning, the FSS also carried out inspections on them and found no instances of rule-breaking where illegal short sale or profiteering activities were involved.

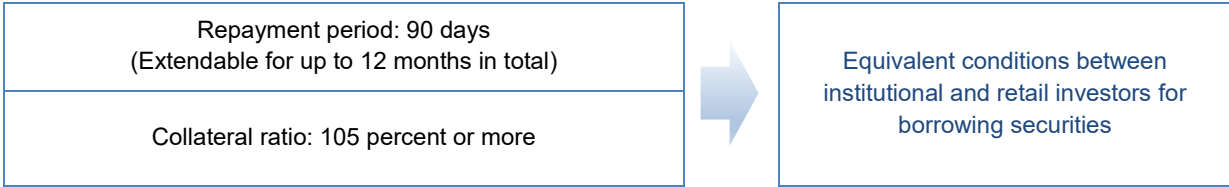
III. SHORT SALE REFORM MEASURES

The short sell reform plan consists of three parts:
 (a) **Establishing electronic processing and monitoring system** to prevent naked short sales.
 (b) **Leveling the playing field for institutional and retail investors** in their stock borrowing conditions.
 (c) **Strengthening penalties and sanctions** against illegal short sale activities.

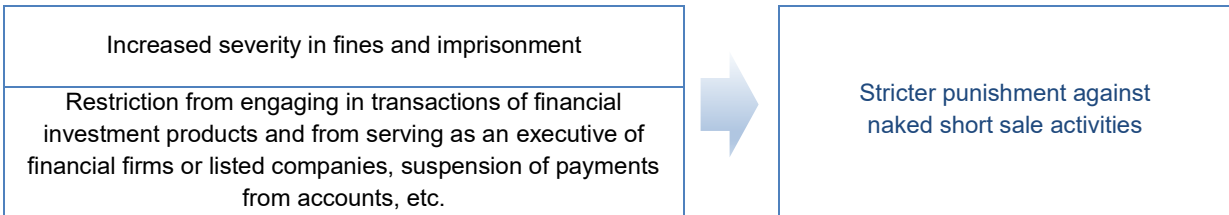
1. Preventing naked short sales



2. Leveling the playing field



3. Strengthening Penalties and Sanctions



**Eliminate illegal and unfair practices
in short sale transactions**

1. PREVENTING NAKED SHORT SALES WITH ESTABLISHMENT OF ELECTRONIC SHORT SALE PROCESSING AND MONITORING SYSTEM

Currently, for retail investors, the management of securities balance available for short sale order is simultaneously performed by securities companies that receive orders from investors. Thus, when there is insufficient balance, placing a short sale order is not possible. On the contrary, for institutional and corporate investors, the securities companies that place orders on their behalf and the custody service providers are separate entities, and institutional and corporate investors often engage in direct management of their own securities balance.

In this regard, inadequate levels of internal control standards exhibited by institutional and corporate investors create conditions prone to naked short sale activities taking place in a repeated manner. Even when they have their own internal balance management system, it remains problematic due to occasional omission of sell positions from the record and ineffective management of internal control. Securities companies are required to place short sale orders after verifying that they are covered short sales. However, the verification process remains perfunctory as they are only notified of the existence of a securities lending agreement.

Improvement Measure

All institutional and corporate investors that plan to engage in short sale will be obligated to take proper steps to prevent naked short sale activities.

[PREVENTING NAKED SHORT SALES] Institutional and corporate investors need to prepare appropriate mechanisms to prevent naked short sales.

- a) **(INSTITUTIONAL INVESTORS)** Need to set up an internal, real-time balance management system (further details on page 5).
- b) **(KRX)** Need to set up a central monitoring system (NSDS: Naked Short-selling Detecting System) (further details on page 6).
- c) **(INSTITUTIONAL AND CORPORATE INVESTORS)** Need to set up internal control standards on short sale activities (further details on page 6).

[VERIFICATION DUTY OF SECURITIES FIRMS] Securities companies will be required to check and verify institutional and corporate investors' balance management system and internal control standards every year and report findings to the FSS. Receiving short sale orders will be allowed only from those that have been verified.

[SANCTION FOR VIOLATION] When institutional and corporate investors fail to comply with the duty to prevent naked short sales, or if securities companies fail to observe

the verification duty, an administrative fine (KRW100 million) may be imposed even without the actual occurrence of naked short sale activities.

a) **(INSTITUTIONAL INVESTORS)** Should establish their own internal balance management system to prevent naked short sales in advance.

- **(SCOPE OF INSTITUTIONAL INVESTORS)** Include corporate entities that are mandated to report their short sale positions to the authority, market makers, and liquidity providers (those with net short sale position of 0.01 percent or more, even when it is for a single stock item or for one time only). As of November 2023, there are 21 foreign companies and 80 domestic companies that fit these criteria. About 92 percent or more of all short sale transactions are carried out by these entities. These companies will also be required to notify securities companies about their status as short sellers, so that the securities companies can perform their verification duty.
- **(SYSTEM REQUIREMENTS)** Institutional investors should set up their own internal electronic system to manage the balance of securities available for sale in real-time in order to ensure prevention of naked short sales in advance.

<Guidelines for Internal Electronic System>

Institutional investors are required to set up internal electronic system to <ul style="list-style-type: none"> - compute real-time balance of stocks available for short sale; - block short sale orders exceeding the balance of stocks in real-time; - send notification to the division in charge of overseeing short sale activities if short sale orders exceed the balance of borrowed stocks; - establish mechanisms to prevent errors and double-check if handwritten changes are made to the balance of stocks available for short sale; - keep the records of securities lending agreements, including date, stocks, quantities, etc.; and - compute and submit data to KRX's NSDS. 		
[1st Layer] Short sale trading	[2nd Layer] Shortfall in net short position	[3rd Layer] Securities lending
Short sale transactions data & real-time net short position available	An approval required from an internal securities lending department to borrow stocks.	Real-time data on securities lending and repayment available
Prevent short sale orders exceeding net short position	Prevent short sale orders prior to getting approval	Prevent short sale orders exceeding net short position

b) **(KRX)** Should establish a central monitoring and detection system to perform inspections on all short sale orders submitted from institutional investors after their placement.

- **(CENTRAL MONITORING SYSTEM)** The KRX will establish the NSDS (Naked Short-selling Detecting System), which will function as a central monitoring platform that can detect institutional investors' illegal short sale activities ex post facto. The KRX will compare the data on net short position balance and over-the-counter (OTC) transactions routed by institutional investors with its own transactions record to carry out comprehensive inspections on naked short sale activities within three days from the time orders are placed. The NSDS will also provide an independent aggregation on daily net short positions, which will help to verify the validity of balance management systems operated by institutional investors.

- **(TRANSACTION REPORTING)** Institutional investors should report their net short positions before market opening and the records of OTC transactions to the KRX within two days of transactions. To facilitate comparison by the KRX, institutional investors should receive short selling institutions' IDs from the FSS and present these IDs when placing short sale orders.

c) **(ALL INSTITUTIONAL AND CORPORATE INVESTORS)** Should establish internal control standards intended to prevent naked short sales.

- **(INTERNAL CONTROL)** Institutional and corporate investors need to prepare their own internal control standards designed to prevent errors in the operation of internal balance management systems and to prevent naked short sales.

<Guidelines for Internal Control Standards>

Under the guidelines, institutional or corporate investors shall

- designate a division which has no conflict of interest with short sale activities to oversee and monitor short sale activities within the organization;
- check whether there is a possibility of violating short selling rules prior to placing their short sale orders;
- compute their balance of short stocks and prevent placing short-selling orders exceeding their short balance;
- verify the correctness of data on their short balance at the end of each business day on a daily basis;
- empower the division designated to oversee short sale activities to limit access of other divisions to the electronic system in case that the organization operates their own balance management system;
- keep the records of internal control activities for five years and submit the data to the authorities upon request.
- If borrowed stocks are paid to securities firms in advance, they may apply eased standards for their internal controls—e.g. designations of supervising department, inspection, and record keeping requirements.

<Measures to Prevent Naked Short Sales>

	Institutional investors (with 0.01% or more of net short positions, MMs & LPs) ※ 92% or more of total short sale trades	Corporate investors	[Exemption] Pre-payment of borrowed stocks
Institutional investors' internal electronic system for their net short balances + KRX's NSDS	O	X	X
Internal control standards	O	O	Eased standards
Verification by securities firms	O	O	O

The FSS will provide detailed guidelines in advance regarding the establishment of institutional investors' internal balance management system, internal control standards, and the securities firms' verification duty. At the same time, the FSC will pursue a revision of relevant legislation to establish legal foundations for these requirements. The NSDS will be established by the end of March 2025, and institutional investors will become subject to the mandatory reporting duty through a revision of legislation.

2. LEVELING THE PLAYING FIELD

Before engaging in covered short sales, institutional investors borrow stocks from lending institutions in OTC transactions, while retail investors mostly borrow stocks from securities companies. The uneven and disparate conditions for borrowing stocks currently in place for institutional investors and retail investors have been pointed out as a problem of an unlevel or unfavorable playing field for retail investors.

Improvement Measure

The period for repaying borrowed stocks will be made identical for both institutional and retail investors for 90-days each time for up to 12 months, and the cash collateral ratio will also be made same for both types of investors at 105 percent.

[REPAYMENT PERIOD] Institutional investors' repayment period for borrowed stocks (for placing short sale orders only) will be limited to maximum 12 months with 90-day extension each time. Retail investors are subject to the same repayment period rules on their borrowed stocks. Institutional investors' stock borrowing for purposes other than short sale transactions (e.g. ETF creation) will not be subject to this repayment period restriction.

[COLLATERAL RATIO] Retail investors' cash collateral ratio will be lowered from the current level of 120 percent to 105 percent, which is the same level currently

observed for institutional investors' cash collateral ratio. However, retail investors' stock (KOSPI200) collateral ratio will be kept at the same level as now at 120 percent, which is still more favorable compared with the stock collateral ratio of 135 percent currently in place for institutional investors.

<Stock Borrowing Conditions>

		Repayment period		Collateral ratio	
		As is	To be	As is	To be
Institution		No limit Callable upon lenders' recall	90 days (Extendable for up to 12 months) Callable upon lenders' recall	Cash 105% Stock 135% ↑	Cash 105% Stock 135% ↑
		90 days (Extendable for up to 12 months) Non-callable	90 days (Extendable for up to 12 months) Non-callable*	Cash 120% ↑ Stock 120% ↑	Cash 105% KOSPI200 120%*

* More favorable terms for retail investors

3. STRENGTHENING PENALTIES AND SANCTIONS

Since after November 2023, the authorities detected illegal short sale activities carried out by nine global investment banks in the scale of about KRW200 billion. For two of these companies, the authorities imposed penalty surcharges in December 2023 and their wrongdoings have been reported to the prosecutors' office to bring formal charges in April 2024. For the other seven companies, appropriate sanctions procedures are currently under way.

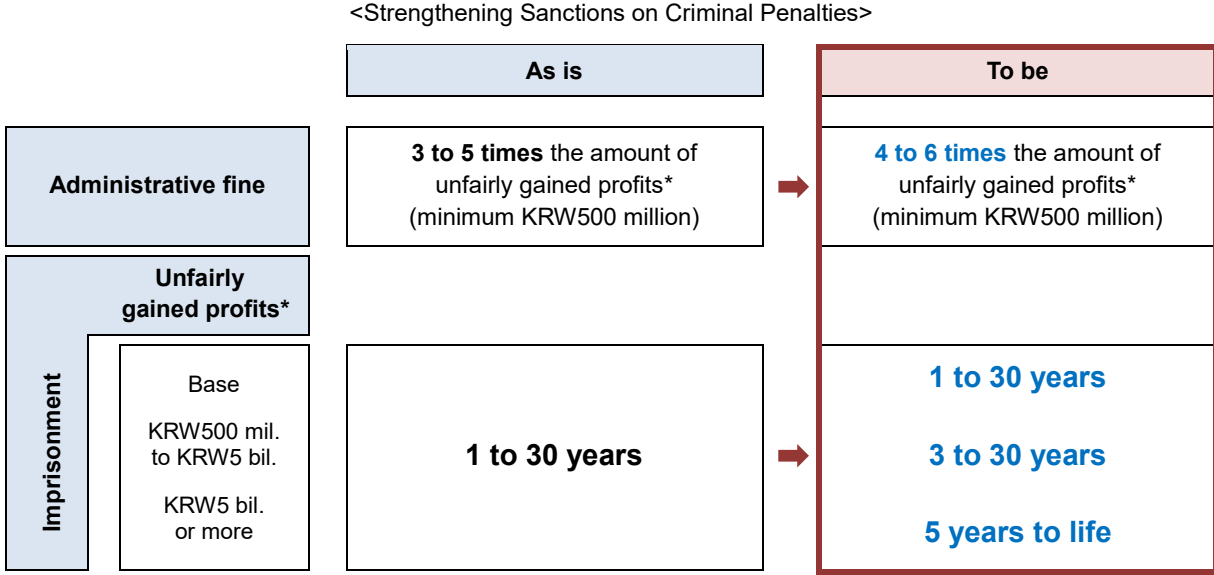
As naked short sale activities are being uncovered in a persistent and repeated way, it is necessary to bolster penalties and sanctions while making consistent efforts to detect the occurrence of illegal practices.

Improvement Measure

The severity of monetary penalties will be strengthened and imposing aggravated penalties will be made possible. A restriction to trade financial investment products and a suspension of payment on accounts will be newly introduced.

[DETECTION] The investigation on illegal short sale activities of top 14 global investment banks will continue to be carried out, with 9 companies already found to have engaged in illegal trading activities.

[PENALTIES] The level of fines that can be imposed will be increased (fines on unfair trading activities will be raised as well) and the aggravated punishment newly introduced for illegal short sale activities (aggravated punishment is already available for unfair trading activities).



* For violations committed after January 9, 2024, the method for calculating unfairly gained profits has been put into law, so that there is more effectiveness in punishment.

[SANCTIONS] When found to have engaged in illegal short sale or unfair trading activities, the wrongdoer will be restricted from trading financial investment products or from serving as an executive of a financial company or listed company. A suspension of payments from accounts will also be introduced as part of sanctions.

4. OTHER REFORM MEASURES

Currently, if an investor’s net short position is 0.5 percent or more of total issuance volume, the investor’s net short position is disclosed. However, if the net short position is 0.01 percent or more (excluded when the amount is below KRW100 million) or KRW1 billion and above, the investor’s net short position is reported to the FSS.

In the case of capital increase with consideration, acquisition of new shares is prohibited if the investor has engaged in short selling of the same company’s shares after its new share issuance plan is made public but prior to the announcement of its issue price. This restriction has been in place since April 2021 to prevent arbitrage transactions.

However, it is necessary to expand the disclosure requirement on net short positions to strengthen transparency. Similar to the case of capital increase, arbitrage transaction is also possible with convertible bonds (CBs) and bonds with warrants

(BWs), the convertible prices of which are determined based on market prices. Nonetheless, relevant regulation has been lacking thus far.

Improvement Measure

Information disclosure on net short positions will be expanded, and the same kind of restriction will be placed on the acquisition of CBs and BWs for short sellers.

[DISCLOSURE] The disclosure requirement on net short positions will be enhanced to the level of filing a mandatory report. If an investor's net short position is 0.01 percent or more (excluded when the amount is below KRW100 million), or KRW1 billion and above, the investor's net short position will be automatically disclosed.

[CB AND BW] Short sellers will be prohibited from acquiring CBs or BWs of a company if they engaged in short sale of same company stocks after the company disclosed its CB or BW issuance plan but prior to the announcement of its issue price.

IV. IMPLEMENTATION SCHEDULE

[REVISION OF LEGISLATION] The FSC will promptly introduce an amendment proposal intended to complete revision of legislation within this year. For the measures that can be implemented without revising the legislation, such as lowering the collateral ratio for retail investors and strengthening the disclosure standards on net short positions, the FSC will seek revision of subordinate regulations and begin implementation in the third quarter of this year.

[PREPARATION IN ADVANCE] Authorities will prepare guidelines and work to overhaul and establish relevant systems in advance to ensure thorough preparation by the first quarter of 2025. First, the FSS will provide guidelines on institutional investors' electronic short sale management system and internal control standards to ensure preparation for implementation within this year. Second, the process for establishing a central monitoring system (NSDS) at the KRX, which started in June this year, will be completed by the first quarter of 2025. Third, the stock lending institutions' system overhaul intended to limit institutional investors' stock repayment period will be carried out in the third quarter of this year.

<i>1. Preventing Naked Short Sales through electronic monitoring and management systems</i>			
(1-1) Internal control standards	Guidelines by FSS	Q3 2024	Revision of the FSCMA
(1-2) Short balance management system	Guidelines by FSS	Q3 2024	
(1-3) Verification duty by securities firms	Guidelines by FSS	Q3 2024	
(1-4) Central monitoring system (NSDS)	Establishment by KRX	Q1 2025	Revision of the FSCMA
<i>2. Leveling the Playing Field for institutional and retail investors</i>			
(2-1) 90-day limit (extendable for up to 12 months) on repayment period	System overhaul for lending institutions	Q3 2024	Revision of the FSCMA
(2-2) Lowering retail investors' collateral ratio	Revision of relevant regulations	Q3 2024	
<i>3. Strengthening Penalties and Sanctions on Illegal Short Sale Activities</i>			
(3-1) Investigation & inspection	FSS investigation	Ongoing	
(3-2) Increasing monetary penalties and introducing aggravated penalties	-		Revision of the FSCMA
(3-3) Diversifying sanctions measures	-		Revision of the FSCMA
<i>4. Other Reform Measures</i>			
(4-1) Tightening standards for disclosure of net short positions	Revision of the Enforcement Decree	Q3 2024	
(4-2) Restricting acquisition of CBs and BWs	-		Revision of the FSCMA