

Corpsec Hotline

March 23, 2007

SHORT SELLING BY INSTITUTIONAL INVESTORS...SOON TO BE A REALITY

Short selling - the sale of security that the seller does not own - is a subject matter of longstanding debate across the global capital markets. After a series of studies, discussions and debates, Securities and Exchange Board of India ("SEBI") has, yesterday at its board meeting, finally decided to take the plunge by deciding to allow institutional investors like foreign institutional investors ("FII's") and mutual funds to participate in short-selling of securities in spot or cash market. At present institutional investors are permitted to take short position only in derivative market.

The new proposal seeks to remove the existing prohibition, which is incorporated in the SEBI regulations applicable to the FIIs and mutual funds, preventing them from engaging in short selling of stock in spot or cash market. Thus at present an institutional investor cannot sell shares unless it actually owns them. Allowing of short selling by institutional investors will enable them to borrow shares from an approved intermediary, sell it in the cash market and then buy it back from the cash market.

It is pertinent to note that, the retail investors are not subject to any such restriction and they are free to engage in short selling in both cash and derivative markets. The present move of SEBI will bring the institutional investors at par with the retail investors in this arena.

SEBI had already put in to place securities borrowing and lending mechanism way back in 1997 by way of enacting Securities Lending Scheme, 1997 ("Scheme"). The Scheme has not taken off and is almost inoperative predominantly because the SEBI regulations permit institutions like mutual funds and FIIs only to lend securities in accordance with the Scheme without any corresponding provision allowing them to borrow securities understandably because these institutional investors were not allowed to engage in short selling of stocks.

For the proposal to become a reality appropriate changes to the Scheme and relevant SEBI regulations will have to be introduced at the same time bearing in mind to keep associated costs low. However, in order for the new proposal to operate effectively, there is a need for vibrant securities lending and borrowing mechanism, which presently is lacking.

Under the new proposal it will have to be seen as to how long the institutional investors will be able to carry forward their short positions in the cash market. It also will be interesting to see if short selling will be permitted in all securities, or only in select stocks like in the case of derivatives trading. If short selling is permitted with out any restriction, it will enable the institutional investors to engage in short selling in stocks, which are not included in the derivatives trading list.

Experience of developed countries suggests that, short selling has played a significant role in controlling volatility of their capital markets and has been a catalyst in improving liquidity and depth of the capital markets. The decision to allow institutional investors to short sell, will no doubt receive a warm welcome from the institutional investors, but is also a bold and positive move by SEBI, and is a definite watershed in the evolution of Indian capital market.

Sources: [The Economic Times, March 23, 2007](#)

- [Suneet Barve](#) & [Shiju P.V.](#)

You can direct your queries or comments to the authors

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