

REGULATED SHORT SELLING AND STOCK BORROWING & LENDING
IN THE COLOMBO STOCK EXCHANGE

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From the 06th of November 2023, the Colombo Stock Exchange (CSE) commenced Regulated Short Selling through a Stock Borrowing and Lending mechanism.¹ Through the introduction of Regulated Short Selling and Stock Borrowing and Lending mechanisms, the CSE has provided an opportunity for lenders and borrowers of securities to capitalise on market fluctuations. Under these mechanisms, lenders can seek to earn an additional fee-based income, while borrowers have an opportunity to make capital gains by leveraging price movements in declining markets.

To facilitate Regulated Short Selling, the CSE has introduced new rules and amended certain existing rules in the CSE Trading Rules and the Clearing House Rules of the Central Depository System (CDS).

WHAT IS REGULATED SHORT SELLING?

‘Short selling’ is the term given to the practice of selling a borrowed security with the intention of buying back the security after the price of the security has fluctuated. Typical short sells take place where an investor, who is confident that the price of a specific security will drop in the future, “borrows” that security from a broker, and sells it in the open market at its present value. The investor then buys back the security at a later date and “returns” that security to its original owner. If the price of the borrowed security is lower at the time of buying back than when the security sold it in the open market, then the investor will make a profit (price of sale net price of buy back).

By creating a system of rules to regulate trading and curtail unethical practices such as naked shorting (short selling securities that have not actually been borrowed), central exchanges can create opportunities for safer and regulated short selling, which is what the CSE has embarked on doing through the newly introduced Stock Borrowing and Lending mechanism.

STOCK BORROWING AND LENDING (SBL) IN THE CSE

The SBL mechanism was introduced as a means of facilitating regulated short selling of shares listed in the CSE. Under the SBL mechanism, Lenders can lend their shares to Borrowers for a pre-determined

¹ CSE Media Release dated 27th of October 2023, accessible at https://cdn.cse.lk/cms-internal/news/rJGSXd3J9BslvH4d_26Oct2023123032GMT_1698323432809.pdf

period of time by executing a SBL Transaction under an SBL Agreement. The key features of the SBL mechanism, as set out by the new rules to the Clearing House Rules of the CDS, are explained below.

Eligible Securities

Only Ordinary Voting Shares listed on the CSE are permitted to be lent or borrowed under the SBL mechanism.² However, such shares must also be selected and specified by the CDS – Clearing House as being eligible to be lent or borrowed under the SBL mechanism.³ Shares will be selected and specified based on a methodology published by the CDS. All shares that are selected and specified as being eligible under the SBL mechanism will be published on the CDS website from time to time.

The list of Eligible Securities for Regulated Short Selling and Stock Borrowing and Lending for the Fourth Quarter of 2023 is published on the CSE Website.⁴

SBL Transactions

Upon the conclusion of a SBL Agreement, Clearing House Members can execute SBL Transactions on behalf of Borrowers or Lenders. There are four (04) types of SBL Transactions that can be entered into:⁵

- i) A transaction where the borrowing of Eligible Securities is carried out by a Borrowing Clearing Member on behalf of a Borrower through a Designated Securities Account pursuant to a pooled borrowing order, and the lending of Eligible Securities is carried out by a Lending Clearing Member on behalf of a Lender through a Designated Securities Account pursuant to a pooled lending order.
- ii) A transaction where borrowing and lending of Eligible Securities are carried out by the Borrower and the Lender directly from their respective Client Accounts.
- iii) A transaction where the borrowing of Eligible Securities is carried out by a Borrowing Clearing Member on behalf of a Borrower through a Designated Securities Account pursuant to a pooled borrowing order and the lending of Eligible Securities is carried out by the Lender directly from his Client Account.

² Rule 7.2.1, CDS Clearing House Rules, together with the ‘Methodology for Selecting Eligible Securities for Stock Borrowing and Lending on the Central Depository System’ accessible at <https://cdn.cse.lk/pdf/sbl/Methodology+for+Eligible+Securities-SBL.pdf>.

³ Rule 7.2.2 of the CDS Clearing House Rules.

⁴ The List of Eligible Securities for RSS and SLB is published <https://cdn.cse.lk/pdf/sbl/Eligible+Securities+for+RSS+%26+SBL.PDF>

⁵ Rule 7.4, CDS Clearing House Rules.

- iv) A transaction where the borrowing of Eligible Securities is carried out by the Borrower directly from his Client Account and the lending of Eligible Securities is carried out by a Lending Clearing Member on behalf of a Lenders through a Designated Securities Account pursuant to a pooled lending order.

SBL Agreements

Clearing House Members of the CDS – Clearing House that wish to enter into BSL Transactions can enter into a SBL Agreement with Borrowers or Lenders, and open a Designated Securities Account to that effect.⁶ Such a SBL Agreement would set out the terms on which Clearing Members execute SBL Transactions on behalf of a Borrower or the Lender.

Margins and Collateral

Borrowing Clearing Member are required to satisfy margin requirements for SBL Transactions, which would be computed based on a formula determined by the CDS – Clearing House and published on the CDS website from time to time.⁷ The total margin requirement that must be satisfied would comprise of:

- i) a minimum margin requirement;
- ii) an additional margin requirement, where the minimum margin requirement is insufficient for a transaction; and,
- iii) a daily margin requirement.

Upon executing a SBL Transaction, a Borrowing Clearing Member is required to furnish collateral to the CDS – Clearing House to fulfil and maintain the margin requirements, by furnishing:

- i) cash;
- ii) an irrevocable and unconditional bank guarantee obtained from a licensed commercial bank; or,
- iii) collateral securities owned by the Borrower or the Borrowing Clearing Member.⁸

⁶ Rule 7.1.3, CDS Clearing House Rules.

⁷ Rule 7.5, CDS Clearing House Rules.

⁸ Ibid.

The list of Eligible Collateral Securities for Regulated Short Selling and Stock Borrowing and Lending for the Fourth Quarter of 2023 is published on the CSE Website.⁹

REGULATED SHORT SELLING IN THE CSE

In order for a regulated short sell of shares listed in the CSE to take place, one of the following criteria must mandatorily be satisfied:

- i) The short seller should have borrowed the shares through an SBL Transaction prior to the short sale; or,
- ii) The short seller must credit the securities required to settle the Short Sell Transaction in full by the end of transaction date (T) by borrowing the required amount of securities through an SBL Transaction.¹⁰

Accordingly, every short sell of shares listed in the CSE is required to be pursuant to an underlying SBL Transaction. Failure to comply with these requirements shall constitute a breach of the CSE Trading Rules, which is punishable by a fine of LKR 100,000.00 (and compounded for subsequent breaches).¹¹ Additionally, a failure to credit the securities required to settle the Short Sell Transaction in full by the end of transaction date (as contemplated under the second mandatory requirement) would entail the short seller being required to purchase the shares required to settle the Transaction via the Buy-in Board or other mechanism on the day immediately following the Transaction (T+1).¹²

Executing Short Sell Orders

In order to make a short sell, a Borrower can enter a Short Sell Order on the Automated Trading System of the CSE. Short Sell Orders are mandatorily required to, among other things:

- i) be placed as limit orders;
- ii) be entered during the Regular Trading Session; and,
- iii) not carried to the next Market Day.¹³

⁹ The List of Eligible Collateral Securities for RSS and SLB is published <https://cdn.cse.lk/pdf/sbl/Eligible+Securities+for+collateral+in+SBL.PDF>

¹⁰ Rule 16(1)(II), CSE Trading Rules.

¹¹ Rule 16.6(I) read with Rule 16.7, CSE Trading Rules.

¹² Rule 16.6(II), CSE Trading Rules.

¹³ Rule 16.2, CSE Trading Rules.

Upon the Short Sell Order matching with a buy order, a Short Sell Transaction can be executed, provided that the price of the Short Sell Order complies with the Uptick Rule.

Uptick Rule

If the price of a share involved in a Short Sell Order declines by 10% from the previous closing price, Short Sell Orders in respect of such shares shall be entered to the system at least one tick size above its last traded price.¹⁴ Any Short Sell Order placed at a price equivalent to or less than the last traded price of the security shall be rejected. If the price of a share declines by 20% or more from the previous closing price, no Short Sell Transactions in respect of such shares will be permitted.¹⁵

To access more information about Regulated Short Selling and the Stock Borrowing and Lending mechanism of the CSE, please visit: <https://www.cse.lk/pages/rss-sbl/rss-sbl.component.html>.

This brief is intended for informational purposes only and should not, under any circumstances, be used or construed as legal or trading advice in any manner or form.

¹⁴ Rule 16.3, CSE Trading Rules.

¹⁵ Rule 16.4, CSE Trading Rules.