

OPINION

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Short Selling Resumption in Korea: Regulatory Reform and Market Implications

Short selling of listed stocks is set to resume on March 31, 2025. Since short selling became a prevalent trading practice in Korea in the 2000s, there have been four complete short-selling bans in the Korean market. While the bans imposed in 2008, 2011, and 2020 were primarily aimed at stabilizing the market amid severe financial crises, the 2023 ban differs significantly in that its primary objective was regulatory reform, particularly for the eradication of naked short selling.

Following the full short-selling prohibition in November 2023, financial authorities and market infrastructure institutions introduced a series of regulatory improvements to prevent naked short selling and reduce the short-selling accessibility gap between institutional and retail investors. One of the most notable regulatory changes is the mandatory implementation of a naked short-selling prevention system for corporations engaging in short selling and broker-dealers processing short-sale orders. Additionally, the Korea Exchange (KRX) has established the Naked Short-Selling Detection System (NSDS), marking a significant improvement in market oversight infrastructure. Another key reform measure is the standardization of the repayment period for stock lending (90 days, extendable up to 12 months) and the collateral ratio (105%) for both retail and institutional investors, significantly enhancing retail investors' ability to engage in short selling.

Like margin trading, short selling is merely a neutral trading mechanism with limited impact on stock prices. Banning short sales does not drive stock prices higher, nor does its resumption necessarily lead to market declines. While short selling serves as a tool for executing investment decisions, market price movements are ultimately determined by corporate financial information and investor sentiment.

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

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Given the long-standing efforts to improve short-selling regulations since the pre-COVID-19 period, the full resumption of short selling represents a necessary step toward the advancement of Korea's capital markets. If the short-selling ban persists despite regulatory improvements and market rationalization efforts, it could undermine Korea's international financial credibility. Thus, it is crucial to closely monitor the effectiveness of these regulatory enhancements and identify and address any remaining loopholes in the short selling system.

Short selling of listed stocks is scheduled to resume on March 31, 2025. A long-standing subject of intense debate in Korea's stock market, short selling was fully prohibited from November 5, 2023, as part of regulatory reform aimed at eradicating naked short selling. As a result, short selling transactions have been halted for approximately 17 months.

The perception of short selling in Korea remains deeply polarized. Academia and industry professionals generally acknowledge its positive role in the market, arguing that short selling enhances price efficiency, prevents asset bubbles, and increases market liquidity. However, retail investors overwhelmingly hold negative views, contending that short selling contributes to stock price declines and is susceptible to unfair trading practices. This stark divergence has resulted in a prolonged and unproductive debate over whether short selling should be maintained or banned, with no clear resolution in sight.

Against this backdrop, the Korean government has continuously pursued regulatory improvements to address retail investors' concerns over short selling. Disclosure requirements for short-selling transactions have been established, and penalties for illegal short-selling practices have been significantly tightened, making Korea's regulations for short selling breaches among the strictest globally. Furthermore, new regulatory amendments have been introduced to level the playing field for retail investors, granting them access to short selling under conditions previously reserved for institutional and foreign investors. A short-selling monitoring system is also set to be adopted to track stock lending balances and prevent naked short selling. In the run-up to the resumption of short selling, this article examines the key regulatory reform measures that have been implemented, and analyzes their potential impact on the market.

History of short-selling bans in Korea

The Korean stock market has undergone repeated cycles of short-selling bans and resumptions. Since short selling became a common practice in the 2000s, there have been four instances of full-scale prohibitions. The first ban was implemented on October 1, 2008, immediately following the collapse of Lehman Brothers, a major US investment bank. This ban was introduced in response to extreme market turmoil triggered by the global financial crisis, aiming to ease investor anxiety and stabilize the market. As market conditions improved, the ban was lifted after approximately eight months, and short selling resumed on May 31, 2009. The second ban was imposed on August 11, 2011, during the eurozone crisis. Since the market shock from the European crisis was less severe than the 2008 global financial crisis, the ban lasted for a shorter period. As the market regained stability rapidly, short selling was reinstated after nearly three months, on November 9, 2011. The third ban was introduced on March 16, 2020, amid the Covid-19 pandemic-driven market crash. This prohibition remained in effect for about 14 months, making it the longest short-selling ban at the time. However, unlike previous bans, when short selling was reinstated on May 3, 2021, it was only partially lifted. Instead of resuming short selling across all listed stocks, regulatory authorities permitted it only for the 350 stocks included in the KOSPI 200 and KOSDAQ 150 indices, while maintaining the ban on approximately 2,000 other stocks. The fourth ban was imposed on November 5, 2023, as previously mentioned. Since short selling had already been prohibited for around 2,000 stocks, the remaining 350 stocks, which had been eligible for short selling after the third ban was lifted, were also subject to the ban again. The previous three bans were implemented in response to severe financial crises with the goal of stabilizing markets and alleviating investor concerns. In contrast, the 2023 ban was primarily aimed at regulatory reform, particularly eradicating naked short selling and enhancing the short-selling system. The regulatory overhaul required significant infrastructure development and regulatory amendments, which contributed to extending the suspension period to approximately 17 months, making it the longest short-selling ban in Korea's history.

Key regulatory improvements before and after the full short-selling ban

Prior to the complete short-selling ban imposed in November 2023, key regulatory measures had been introduced, including the mandatory disclosure of short sale positions and

the designation of overheated short-selling stocks. The short sale position disclosure system, introduced in 2016, was designed to identify major market participants engaging in large-scale short selling.¹⁾ This system requires investors to report or publicly disclose their short positions based on the ratio of net short sale positions to total shares outstanding. Specifically, if an investor's net short position exceeds 0.01% of a company's total outstanding shares, they must report the position to regulatory authorities. If the net short position exceeds 0.5%, the short seller must publicly disclose both the position and their identity.²⁾ The primary purpose of this disclosure system is to increase market transparency and prevent potential market abuses by ensuring that short-selling activity and positions are publicly accessible.

The designation of overheated short-selling stocks, introduced in March 2017, serves as a mechanism to curb excessive short selling and sharp price declines. Under this regulation, stocks that experience abnormal increases in short selling activity and significant price drops are classified as overheated short-selling stocks at the end of each trading day. These stocks are then subject to a one-day short-selling prohibition on the following trading day.³⁾ Initially, stocks were classified as overheated if they met criteria related to price declines relative to the previous day's closing price, short-selling ratio on a given trading day, and short-selling ratio relative to the 40-day average. In July 2022, these criteria were relaxed to ensure a more proactive regulatory response to market shocks.⁴⁾ If a stock's short-selling ratio exceeds 30%, it can be designated as an overheated short-selling stock even if price declines (3% or higher) or short-selling value increases (2x or more) remain moderate. Additionally, if a stock falls under the overheated short-selling stock category and experiences a further 5% decline on the restricted trading day, the short-selling ban is automatically extended for an additional trading day.

Another significant regulatory reform measure implemented before the November 2023 short-selling ban was the introduction of stricter penalties for illegal short-selling activities. Prior to December 2020, violations such as naked short selling were punishable only by fines.

1) Financial Services Commission (FSC), Short-selling regulatory reform plan, press release, November 13, 2013.

2) Article 180-2 (Reporting on Net Positions) and Article 180-3 (Public Disclosure of Net Positions) of the Financial Investment Services and Capital Markets Act (FSCMA); Article 208-2 (Reporting on Net Positions) & Article 208-3 (Public Disclosure of Net Positions) of the FSCMA Enforcement Decree.

3) FSC, Improvements to the short-selling and disclosure systems, press release, November 10, 2016.

4) FSC, Joint Announcement by related agencies: Measures to strengthen detection and penalties for illegal short selling and improve related systems, press release attachment, July 28, 2022.

However, concerns were raised that monetary fines alone were insufficient to deter illegal short-selling practices, prompting the government to amend the Financial Investment Services and Capital Markets Act (FSCMA) to introduce criminal penalties alongside penalty surcharges. Under the revised FSCMA, primary criminal penalties include a minimum of one year of imprisonment, or a fine of at least three to five times the amount of proceeds gained or losses avoided through illegal short selling.⁵⁾ Additionally, penalty surcharges are now imposed based on the total value of illegal short-selling transactions,⁶⁾ rather than being calculated solely from estimated proceeds gained from the breaches. This distinction makes the revised penalties significantly stricter compared to traditional fines, which were typically calculated solely based on the financial gains derived from misconduct.

Following the full short-selling ban in November 2023, financial authorities and market infrastructure institutions implemented a series of structural improvements to eliminate naked short selling and reduce the short-selling accessibility gap between institutional and retail investors. One of the notable regulatory changes is the mandatory implementation of a naked short-selling prevention system for corporations engaging in short selling and broker-dealers handling short-selling orders. Effective March 31, 2025, entities subject to these new regulations must track short-selling positions by stock and implement an electronic monitoring system capable of blocking naked short selling transactions. These requirements apply to market makers and liquidity providers, as well as corporations holding net short positions of at least 0.01% (excluding amounts under KRW 100 million) or KRW 1 billion or more.⁷⁾ For compliance, affected corporations must establish internal control standards covering: employee roles and responsibilities related to short selling; short-selling position monitoring mechanisms; recordkeeping of short sales for at least five years; and an electronic short-selling compliance system. On top of that, these corporations must submit daily short-selling position reports by stock and lending balance data to the Korea Exchange (KRX) through the Naked Short-Selling Detection System (NSDS) within two business days of each trading session. They are also required to provide documentation upon request, allowing broker-dealers to verify compliance with naked short-selling prevention measures, and must notify their respective broker-dealers that they are subject to the mandatory establishment of the electronic short-selling monitoring

5) Article 443 (Penal Provisions), Paragraph 1, Subparagraph 10 of the FSCMA.

6) Article 429-3 (Penalty Surcharges for Unlawful Short Sale), Paragraph 1 of the FSCMA.

7) Newly established Article 208-7 (Preventive Measures Against Naked Short Selling) of the FSCMA Enforcement Decree.

system. Institutional investors that pre-deposit borrowed stocks into their accounts before placing short-sale orders, thereby eliminating the risk of naked short selling, will be exempt from the system implementation requirement. Moreover, broker-dealers responsible for processing short-selling orders must conduct annual and pre-transaction compliance checks every 12 months to verify that client corporations have implemented the necessary naked short-selling prevention measures. The results of these inspections must be reported to the Financial Supervisory Service (FSS) within one month.

The establishment of the NSDS by the KRX represents a significant infrastructure improvement in Korea's stock market. This system, designed to detect naked short selling by comparing investors' stock lending balances with their transaction records, is set to come into effect on March 31, 2025. Following the government's announcement of short-selling regulatory reform on June 13, 2024, the KRX initiated the development of the NSDS in July 2024. Over the subsequent six months, the system underwent development, internal testing, and external testing before reaching completion. The NSDS is designed to prevent naked short selling by integrating with institutional investors' internal short position management systems. These internal systems enable real-time monitoring of available short-selling balances, aiming to internally prevent naked short selling practices. The NSDS will receive short position data from institutional investors and compare it with all trading records to detect instances of naked short selling.

Another key regulatory reform change involves narrowing the gap in short-selling accessibility between institutional and retail investors. Starting March 31, 2025, the maximum repayment period for borrowed stocks under stock lending agreements will be capped at 90 days. If an extension is granted, the total repayment period cannot exceed 12 months.⁸⁾ However, if a stock cannot be repurchased from the stock market at the time of repayment due to a trading suspension or other restrictions, the repayment deadline will be extended to three business days after the restriction is lifted. Additionally, the collateral ratio for stock lending in short selling for retail investors will be reduced to 105%, matching the level currently applied to institutional investors.⁹⁾ By standardizing stock repayment periods and collateral requirements for both institutional and retail investors, this reform measure is expected to significantly

8) Newly established Article 208-6 (Repayment Period for Stock Lending in Covered Short Selling) of the FSCMA Enforcement Decree.

9) Regulation on Financial Investment Business, Article 4-25 (Collateral Ratios, etc.).

improve retail investors' access to short selling.

Expected impact of short-selling regulatory reform and potential market changes

The 17-month-long short-selling regulatory reform and infrastructure enhancements, implemented following the November 2023 short-selling ban, are anticipated to bring significant structural changes to the stock market, particularly when combined with the pre-existing regulatory tightening measures. Among the most critical regulatory shifts is the mandatory implementation of short-selling position management systems for institutional investors and broker-dealers handling short-selling orders. This requirement aims to automate the monitoring of stock lending balances and short-selling execution through internal control systems, effectively eliminating the risk of naked short selling caused by inventory errors. Furthermore, if these internal systems are integrated with the KRX's NSDS for post-transaction surveillance, institutional investors' stock lending balances and short-selling activities will be subject to even more rigorous oversight.

The adjustments to the maximum repayment period for stock lending and the collateral requirements will enhance retail investors' access to short selling, thereby improving fairness between institutional and retail investors. Retail investors have long argued that they faced unfavorable conditions in repayment periods and collateral requirements compared to institutional investors. Under the new regulatory framework, retail investors will now be subject to the same repayment period (90 days, extendable up to 12 months) and collateral ratio (105%) as institutional investors. This reform enables retail investors to engage in short selling under the same conditions as institutional investors. Given that Korean retail investors typically exhibit a strong preference for short-term trading and heavily utilize margin financing, their short-selling activity is expected to gradually increase. However, challenges remain, as retail investors have limited experience with short selling and funding for credit-based stock lending services is currently insufficient.

It is undeniable that retail investors in Korea still have significant distrust toward short selling. However, as is the case with margin trading, short selling is merely a neutral trading mechanism with limited impact on stock prices. Prohibiting short selling does not drive stock prices higher, nor does its resumption necessarily lead to stock price declines. Despite the complete short-selling ban in 2024, the KOSPI and KOSDAQ markets experienced considerable

declines. The KOSPI index fell from 2,669.81 points on January 2 to 2,399.49 points on December 30, an annual decline of 270.32 points (-10.1%). The KOSDAQ index declined from 878.93 points to 678.19 points over the same period, representing an annual drop of 200.74 points (-22.8%). Among major Asian markets, the Korean stock market posted the weakest performance, suggesting that the short-selling ban was ineffective in driving up stock prices. Short selling is merely a transaction execution tool dependent on investment decisions, while market movements are ultimately determined by corporate financial information and investor sentiment. Contrary to concerns from some investors, the full resumption of short selling is unlikely to cause significant market disruptions. Considering that the short-selling ban has not led to a significant market rally, there is no justification to assume that lifting the ban will trigger substantial market declines.

Like most financial mechanisms, short-selling has both positive and negative aspects. If properly regulated, it enhances market efficiency; if misused, it can lead to unintended side effects. Rather than imposing an outright prohibition, a more rational approach would be to minimize its risks while maximizing its benefits. Given the long-standing regulatory improvements in short selling, implemented particularly since the pre-COVID-19 period, and the benefits of short selling, fully reinstating the mechanism represents a necessary step toward advancing Korea's financial markets. If the short-selling ban persists despite ongoing regulatory reforms and market rationalization efforts, it could undermine Korea's international financial credibility. It is well recognized that the short-selling prohibition presents a major obstacle to Korea's inclusion in the MSCI Developed Market Index. Rather than engaging in an unproductive debate over short selling, policymakers and market participants should evaluate the effectiveness of recent regulatory reforms and focus on identifying and addressing potential regulatory loopholes in the short selling system.