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Short Selling and Securities Borrowing and Lending

An Introductory Guide

Short Selling and Securities Borrowing and Lending in Saudi Arabia

In light of the Capital Market Authority's endeavor to develop the financial market and apply the best international standards and practices, in order to make the market more stable and attractive for local and foreign investors, the Authority's Board of Directors approved on March 15, 2017, the Securities Borrowing and Lending (SBL) Regulations and the Short Selling Regulations.

However, the introduction of the regulations failed short of achieving the desired objectives of development of short-selling as a product in the market. Meanwhile, new development in the financial markets (explosive growth in the Exchange Traded Fund or ETF and inclusion of Saudi Stock Exchange in the global equity benchmarks) warranted changes in the regulations to make regulatory environment in the Kingdom of Saudi Arabia more competitive with respect to regional and global comparison. Accordingly, the Authority's Board of Directors amended these regulations on 22 February 2021 and on 3 January 2022. The amendments included permitting short selling and lending securities for all investors in the market based on specific requirements. The amendments also included modifications related to the standards and requirements of these transactions.

On 3 April 2022, the Saudi Tadawul Group launched a package of new enhancements to develop the post-trade services infrastructure and increase its efficiency, including an improved mechanism for short selling activities.

Securities borrowing and lending and short selling are new concepts for a large number of investors in the Saudi market, which is largely dominated by retail investors. In order to increase investors' knowledge of these products, we present this introductory guide to give a brief overview to our valued readers about the nature of these transactions.

What Does Securities Borrowing and Lending Mean?

Securities borrowing and lending (SBL) transactions allow the lender to temporarily transfer the ownership of listed securities to a borrower, and in turn the borrower commits to return similar securities to the lender within a specified period of time.

What Are the Main Motives for SBL Transactions?

As for borrowers, the main motive is one of two things: either selling the borrowed securities to make a profit from their future depreciation or using them to settle other transactions.

The primary motive of lenders is to gain additional income on securities that they intend to hold for a long period of time, by earning return on the amount of the collateral that the borrower provides to the lender during the term of the agreement.

Broadly speaking, the SBL transaction can be entered for one of the following reasons;

- Executing the short-selling transaction whereby the participants would like to comply with the requirement of borrowing securities to avoid blank short-selling, prohibited activity in Saudi Arabia.
- Re-lending securities for various purposes
- The creation of unit of Exchange Traded Fund (ETF)
- Return of borrowed securities
- Other purposes (like resolution for any issues with settlement system in the cash market)

What Is Short Selling?

Short selling is the sale of borrowed in order to benefit from potential decline in the price of the security

What Is the Required Collateral for Borrowing Securities?

The borrower has to pay a margin, which is a percentage (50% for example) of the market value of the borrowed securities. In addition, the proceeds from selling the borrowed securities will be withheld. The margin and the withheld proceeds represent collateral for the lender, and the borrower can only use them to repurchase the borrowed securities to return them to the lender. Only after the securities are returned to the lender, the remaining amount of the collateral is released to the borrower.

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A Practical Example of Borrowing Securities for Short Selling

An investor believes that Extra's stock price will fall within a month from SAR 120 to SAR 100. The investor does not currently own the stock, but he would like to make a profit from the expected decline in its price. Thus, the investor borrowed 1,000 shares from a broker for a period of one month.

The broker requires a margin equal to 50% of the current market value of the borrowed shares. Thus, the investor has to pay a margin of SAR 60,000 (50% x SAR 120 per stock x 1,000 shares). After paying the margin and receiving the borrowed shares, the investor immediately sells them in the market for SAR 120 per share, obtaining a total of SAR 120,000. However, this amount is withheld by the broker as collateral in addition to the margin. Thus, the total value of the collateral is SAR 180,000 (margin of SAR 60,000 + short selling proceeds of SAR 120,000).

A month later, the stock price declined to SAR 100, and the investor used SAR 100,000 of the collateral to buy 1,000 shares to return them to the lender. After returning the stocks to the lender, the investor will have SAR 80,000 left:
(Margin of SAR 60,000 + short selling proceeds of SAR 120,000 - the cost of stock repurchasing of SAR 100,000)

Since the net amount paid at the start of the investment is SAR 60,000 (representing the margin), and the net amount received at the end of the investment is SAR 80,000, The investor made a profit equal to SAR 20,000, which constitutes 33% of the amount invested.

In other words, the investor sold the share for SAR 120 and then bought it for SAR 100, making a profit of SAR 20 per share, bringing his total profit to SAR 20,000 on the 1,000 shares transaction.

The investment can be summarized in the following table:

Beginning of Investment	-60,000
End of Investment	80,000
Profit	20,000

On the other hand, if the stock's price increased, contrary to the investor's expectation, and reached SAR 150, the investor would use SAR 100,000 of the collateral to buy 1,000 shares to return them to the lender. On deal close, the investor will have SAR 30,000 left:
(Margin of SAR 60,000 + short selling proceeds of SAR 120,000 - the cost of stock repurchasing of SAR 150,000)

This means that the investor has lost SAR 30,000 in this transaction, as he invested SAR 60,000 at the beginning of the deal, and only redeemed SAR 30,000 at the end of the deal, incurring a loss of 50% of the investment total value.
In other words, the investor sold the share for SAR 120 and then bought it for SAR 150, incurring a loss of SAR 30 per share, bringing his total loss to SAR 20,000 on the 1,000 shares transaction.

This scenario can be summarized in the following table:

Beginning of Investment	-60,000
End of Investment	30,000
Loss	-30,000

Key Controls of the Securities Borrowing and Lending and Short Selling Regulations

The Securities Borrowing and Lending Regulations and the Short Selling Regulations have set a number of controls to protect investors and maintain market stability, orderliness and integrity. Some of these controls are summarized in the following:

First: Key Controls of the Securities Borrowing and Lending Regulations:

- The parties to the transaction shall make a written and binding agreement that includes, at least, the names of all relevant parties, the duration of the agreement, the securities subject to the agreement, acceptable collaterals, voting rights, dividend distribution, the rights of each party in cases of default, and recall rights, if any.

Second: Key Controls of the Short Selling Regulations:

- The transfer of the securities from the lender's account to the borrower's short selling account shall be completed before executing the sale transaction, unless the seller has an exercisable and unconditional rights to borrow, in which case, the seller has to obtain confirmation from the lender that the securities are available and reserved for delivery.

- The selling price of the security shall be higher than the price of the best bid of that security.

- The short ratio to Average Daily Traded Volume of the relevant security (total net short positions / Average Daily Traded Volume of the last 60 days) must not exceed 10 days.

- The total net short positions shall not exceed 10% of the free floated securities of the relevant securities.

Third: Eligible Participants

- For SBL transaction, only qualified participants/ investors are allowed to be part of the lending and borrowing transaction. In case a non-qualified participant would like to participate in the SBL activity, following two conditions needs to be satisfied:

  a. In case of lending, the participant needs to appoint Lending Agent

  b. For borrowing of securities, a Custody Member of Broker needs to be engaged

- For short-selling of securities, any market participants who is eligible to trade in the market is also eligible to enter into short-selling transaction the person meets the other requirement associated with the short-selling.

Fourth: Eligibility of Security

- The Short-selling and SBL activity can be conducted only in the eligibility securities as defined by the regulations and the Depository Center.

Main Risks of Short Selling

1.The Risk of Rising Prices:
Investors short sell securities when they believe that their prices will decrease during a certain period of time. However, there is no guarantee of this as the price of the security may rise during this period, subjecting the investors to incur losses on their investments.

It is worth noting that the profit in this type of transaction is limited, as the profit comes from the decrease in the price of the security, and the price cannot drop below zero. In contrast, the loss is unlimited, as there is no limit to how much the stock price can rise.

2. Settlement and Delivery Risks:
The agreement should be settled on its expiry date, at which time the investor must purchase the borrowed securities and deliver them to the lender, who in turn shall return the collateral to the borrower. Here appears the risks of one of the parties failing to meet their obligation.

3. Regulatory Risk:
During market turmoil, the risk of a ban on short-selling or forced unwinding of short-selling positions increases significantly as the regulator aims to stabilize the market. This can potentially limit the profit from the short-selling position/s and force the investors to forgo returns for the risk.

4. Margin Requirement:
The change in margin requirement during times of market volatility adds a burden on the investor. In the worst-case scenario, this can lead to the forced unwinding of the positions, resulting in forgoing of potential profits.

About Tharaa

Tharaa Financial Center (Tharaa) is a research outfit affiliated with Prince Sultan University. Tharaa aims to support the financial markets as an independent outfit for capital market research, training of finance professionals, and promotion of investor education. In this regard, Tharaa focuses on two major areas, (i) publication of analytical, in-depth, and value-added investment research on public equities in KSA, and (ii) thematic ideas on key issues relevant to policymakers, investors, and the general public. Tharaa is staffed by well-qualified market professionals with extensive experience in investment research, private equity, investment banking, and asset management.

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