

SHORT SELLING UNDER TURKISH LAW

A. Definition and Legal Basis for Regulation of Short Selling

Short selling is a trading technique used by investors who believe that the prices of securities will fall. While selling a long position is the most obvious means of avoiding losses in what is perceived to be an overpriced asset, short selling, on the other hand, offers a means not just to avoid losses but also to profit from the knowledge of overpricing.¹ Although short selling had been practiced dated back to early 17th century, when first uncovered on stocks of the Dutch East India Company², it was not until the Lehman Brothers crisis that it took the attention of the regulators from various jurisdictions.³ The panic generated by the bankruptcy of Lehman Brothers and the collapse in market prices of listed financial company securities pushed market regulators to introduce a ban on short selling as an emergency measure.⁴

In Turkey, short selling was first regulated by the Communiqué on Margin Trading, Short Sales and Lending and Borrowing of Securities, Serial V and No. 65 (hereinafter referred to as “**Communiqué**”) that came into effect in 1994 and was amended in the following years. Under the Communiqué, the short sales is defined as “...sales or placement of sale orders for capital markets instruments that are not actually owned. Satisfaction of the clearing liability by means of borrowed capital market instruments also signifies short sales”. The definition under the Communiqué also provides a hint regarding the types of the short sales, which are namely, covered, or naked short sales. In the former, the party wishing to go short borrows the shares from another person before selling them into the market and uses the borrowed shares to settle his sales.⁵ This type of covered short sales consists of two steps: at first, the short seller borrows

¹ Frank J. Fabozzi, “Short Selling: Strategies, Risks and Rewards”, p.1.

² Tuğba Çakın, “Impacts of Short Selling Restrictions on Stocks Traded at Borsa Istanbul”, p. 1

³ John Armour et al, “Principles of Financial Regulation”, p. 195

⁴ *Ibid*, p. 195

⁵ Armour et al, p. 196; Çakın, p. 7

the shares he is going to sell short, which is followed by, as a second step, closing of his position by repurchasing the shares from the market and returns it to the lender. The short seller may find these shares from broker-dealer or institutional investors.⁶ In the latter, which the market and regulators are most anxious about, the borrower sells the shares before he identifies where he will obtain them to settle the sales to which he commits.⁷ This is possible since there is a time gap, namely, settlement period, between the agreement to transfer the securities and the actual payment and transfer.⁸ In this time period, the borrower would be able to find shares to borrow to deliver them to the purchaser before the expiry of the settlement period.

The fundamental rationale under the practice of short selling would be listed as “speculation, hedging and arbitrage opportunities”. Speculation would mean that the short sellers mainly aim to sell high and buy back lower by reflecting their negative opinions the securities are overvalued. By short selling, the investors would also be able to offset their positions at derivative products in spot stock markets which would lead to manage and mitigate the risk in their portfolios. Finally, short selling would be employed by arbitrageurs to make profit from the valuation differences between the same securities on different markets which would lead to restoring the price to a level consistent with publicly available information.⁹

B. SHORT SELLING UNDER TURKISH LAW

Under Turkish Law, the short selling mainly regulated by mainly Capital Market Law No. 6362 and Communiqué (*Article 24 et seq*), the main regulatory techniques employed by the Capital Market Board would be listed as, **ban on type of shares that could not be subject to short selling, reporting/disclosure rule and temporary bans, pre-defined initial and maintenance margins, restriction on the parties, uptick rules and settlement rules.**

⁶ Armour et al, p. 196; Financial Service Authority, “Discussion Paper: Short Selling”, p.7

⁷ A Bris, WN Goetzmann, and N Zhu, ‘Efficiency and the Bear: Short Sales and Markets Around the World’ p. 1029

⁸ Armour et al, p. 197; Culp and JB Heaton, ‘The Economics of Naked Short Selling’ p. 46,

⁹ Çakın, p. 11



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Instruments in Scope

First, it needs to be ascertained what type of securities is capable of being traded on by short selling. Except the shares admitted to trading at the Borsa Istanbul's Sub-Market, Watch List Market or the Pre-Market Trading Platform, all the shares and fund units at Borsa Istanbul may be subject to short selling. In other words, any share admitted to trading at Borsa Istanbul's Star Market or Main Market is an eligible share for short selling, unless such share is delisted for a period longer than 5 business days or permanently. In the event that any share ceases to be eligible for short selling due to being delisted, existing positions in the concerned share is only permitted for a three-month period. According to the temporary ban imposed by CMB and later amended on 30 Jun 2020, the instruments eligible for short selling are limited with the shares in BIST 30 index. However, it shall also be noted that with the latest decisions of the CMB dated 12 Feb 2021¹⁰, the short selling restrictions for the top 50 shares on BIST 50 index is also removed. Therefore, the short selling ban for the stocks other than BIST-30 and BIST-50 Index of equity market remains in accordance with CMB's prior decisions regarding the short sale ban.

Notification of Short Positions to Authorities

Secondly, under the reporting/disclosure rules, Article 28 sets forth that,

“The brokerage house shall clearly state to the Stock Exchange that the order is a short sale order in case of receipt of a short sale order in writing or in case a brokerage house discovers that a transaction is a short sale pursuant to paragraph three of article 24 or if the brokerage house will realize such a transaction on its own account.”

As it is seen, the seller must notify its investment firm for each and every transaction qualifying as short selling, without being subject to any threshold. The notification is required to be given as the short selling order is given. In its decision dated 30 Jun 2020, CMB particularly emphasised that even where a short selling position is closed intraday, the investors are obliged to notify the investment firm of the short selling. In case of failure to issue a notice to the Stock Exchange, the Brokerage shall be responsible for any liability arising from this failure.

¹⁰ CMB's Weekly Bulletin No. 2021/7 on 11 February 2021

Temporary Bans

Regarding the temporary bans, as per article 128/1 of the Capital Market Law, CMB is authorized to take necessary measures to ensure effective, fair and robust functioning of the market and to protect the rights and interests of the investors, including but not limited to implementing restrictions on margin trading and short selling.¹¹ Within the scope of its authority, CMB adopted resolutions to temporarily restrict short selling transactions in the past (e.g., the short selling ban on all shares trading at Borsa Istanbul enforced with the CMB's decisions dated 28 February 2020 and 02 March 2020, which was further amended with CMB's resolution dated 30 Jun 2020 removing the ban for the shares in BIST 30 index and later BIST 50 index). Moreover, article 35 of the Communiqué stipulates a specific ban for investors in default. Accordingly, investors who fail to fulfil their settlement obligations or margin requirements for more than twice in any three-month period, are reported by the investment firms to Borsa Istanbul and consequently banned from executing margin trading or short selling for a period of 6 months. Investment firm may elect to not report such defaulted transactions to Borsa Istanbul if the concerned amount is equal to or less than TRY 100,000 or is less than 5% of the investor's net equity.

Initial and Maintenance Margin

The Communiqué stipulates initial and maintenance margin relating to short selling activities. According to Article 25,

“The margin in short sales is calculated by adding up the current values of the securities determined in accordance with the principles in the first paragraph of the article 13 and the revenue gained from short sale. The customer has to deposit at least 50% margin at the beginning for the transaction of short sales. The initial margin means that the securities being subject to the short sale shall be deposited in cash in the amount of its current market value or the security shall be invested in cash. The minimum margin rate of 35% is obligatory in the course of short sale actions.”

¹¹ Due to the scope of this letter, CMB's powers irrelevant to the short selling (e.g., CMB's powers with regard to market abuse) are not deliberated above.

Article 30 introduced a restriction on the parties who may be engage with short selling. In accordance with this Article,

“The members of the board of directors of the company issuing capital market instrument and their executives and the shareholders of the company owning 10% or higher rate of shares of the company as well as those discovered to act jointly with them and their spouses and those under their guardianship are banned from effecting short sales of capital market instrument of the said company.”

There is also an uptick rule under the Communiqué which requires that;

“In cases where a brokerage house executes a short sale on behalf of its customer or on its own account, the short sale shall be executed at a price higher than the price at which the last trade of a security subject to short sale is executed. However, short sale may be affected at the price at which the last trade was executed, if such price is above the next preceding price.”

In 2011, Capital Markets Board of Turkey transferred its authority on implementing up-tick rule to Board of Borsa İstanbul. In accordance with the Borsa Istanbul Announcement, under the Equity Market Operations Procedures and Principles (UUE) dated 01/03/2016 and numbered 02.UUE.01, the uptick rule which is applied on short selling of shares (except BIST 100 shares) and Investment Fund participation certificates shall also be applied on short selling of BIST 100 shares from 14/08/2018. Accordingly, short selling shall be executed at a price higher than the last traded price of the security which includes BIST 100 shares (*currently only for BIST 30 index and later BIST 50 index*) and all instruments available for short selling. However, short selling may be executed at the last traded price if the last price of the security is higher than the previous price.

Penalties

Under the Capital Markets Law, the penalty scheme is also regulated. Breach of the short-selling regulations or any decision of the CMB on this regard is subject to Article 103 of the Capital Market Law. This Article,

- Authorizes CMB to impose an administrative penalty between TRY 51,236 and TRY 640,442¹², unless a benefit has been obtained due to the concerned breach, in which case the amount of penalty cannot be less than twice of this benefit.
- Authorizes CMB to impose against legal persons a penalty in the amount of 1% of the gross sales revenue or 20% of the profit before tax, whichever is higher, considering material importance of the breach or the number of aggravated investors. However, the amount of penalty calculated according to the sales revenue or the profit before tax cannot be less than the minimum amount specified in the above paragraph.
- In the event the breach is committed more than once, CMB increases the penalty to be imposed by twice. In any case, the amount of penalty for recurring breaches cannot be less than three times of the benefit obtained or loss caused due to the concerned breach.

Article 105 further regulates the application of the administrative penalties. Before imposing a penalty, the defence of the breaching party shall need to be heard. However, in case the breaching party does not submit its defence within 30 days starting from the notification of the letter requesting the defence, it shall be deemed to waive its right.

Legal Remedies

Under paragraph 4 of the Article 105, the breaching party is entitled to appeal to administrative justice process against the administrative fines imposed in accordance with the Article 103. Therefore, the breaching party is able to bring a lawsuit against the penalties imposed by the CMB, in accordance with Procedures of Administrative Justice Act, No. 2577.

¹² The penalty amounts are revalued by CMB every year, and these are the amounts updated for 2021.



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According to Article 11 of this Act,

“Before filing an administrative action, the concerned persons may request from the higher authority, or in the absence of the higher authority, from the authority which has performed the procedure within the time limit for filing an administrative action, abolishment, withdrawal, amendment of the administrative procedure, or the performance of a new procedure. This application shall suspend the time limit for filing an administrative action that has started.

2. If no answer is given within sixty days, the request shall be deemed to have been dismissed”.

As it is seen, an optional application may be submitted to request the cancellation, revocation or amendment of the administrative decision, *i.e.*, administrative fines. Provided that the CMB does not respond within 60 days following the application, the request is deemed to be rejected. Administrative lawsuits can be filed within the term of litigation upon the expiry of this sixty-day period.

However, it is also possible to file a law suit directly 60 days following the decision of the CMB without further application to the CMB.

The legal consequence of the annulment decision by the Court on the administrative proceeding is to bring back the status to its position before the proceeding. In terms of administrative fines, the administrative fine shall be removed or if it is collected, then it shall be remanded.