

## RECOMMENDATION NO. 8

### Customer due diligence in connection with short selling

*This translation is provided for informational purposes only and may not be entirely accurate or complete. In the event of any discrepancies with the original Norwegian text, the Norwegian version shall prevail and take precedence over the English translation.*

This recommendation was adopted by the Board of Directors of the Norwegian Securities Dealers Association on 12 May 2009. Revised and adopted by the Board of Directors on 13 June 2017. Revised by the Board of Directors on 24 April 2024.

# 1 Introduction

Regulation (EU) No 236/2012 on short selling and certain aspects of credit default swaps (the "Short Selling Regulation"), along with corresponding Commission regulations, has been incorporated into Norwegian law through the Securities Trading Act (No. Verdipapirhandelloven) section 3-5 and the Securities Trading Regulations (No. Verdipapirforskriften) sections 3-5 et seq. The Short Selling Regulation imposes a duty on investors to report significant net short positions in shares listed on a regulated market or MTF, government debt, and credit default swaps.

The regulation further prohibits **uncovered** short selling of shares, government bonds, and credit default swaps. A short sale is considered covered if the investor, either through a loan or purchase agreement, has secured the ability to deliver on the settlement date.

Investment firms must not knowingly facilitate clients engaging in uncovered short selling. Such facilitation may be subject to criminal penalties under the Securities Trading Act. Moreover, in the event of a violation of the Short Selling Regulation, the Financial Supervisory Authority may impose penalties, pursuant to section 21-2 of the Securities Trading Act.

In the interest of market integrity, certain situations may trigger a duty for investment firms to conduct investigations, requiring the firm or broker to perform specific checks to comply with conduct of business rules. Additionally, investment firms may have a vested interest in ensuring compliance with delivery deadlines. Under Regulation (EU) No 909/2014, implemented in the Regulation on Central Securities Depositories and Securities Settlement section 1 (1), Central Securities Depositories can impose penalties on settlement participants who fail to deliver by the set settlement time.

This recommendation highlights situations where the investment firm (broker) should conduct specific investigations before executing a sale.

## 2 Broker's Duty to Investigate Potential Short Selling by Clients - indicators

In practice, a broker is not required to ensure that every client has access to the relevant shares for every order before executing a sale. However, the investment firm may have a certain duty of care that could require the broker to make a specific assessment before executing a sales order. Below are various indicators that may warrant increased diligence by the broker and potentially lead to further investigation to clarify whether the client is short selling.

- *The broker knows or has reason to believe the client has previously engaged in uncovered short selling, for instance, because the settlement department has informed or previously informed them that the client failed to deliver sold shares on the settlement date.*



- *Deviations from the client's established trading patterns. For example, the client places sell orders in a completely different industry than usual or for significantly larger volumes than typically traded.*
- *The client asks the broker to consolidate ("warehouse") sales transactions, which may indicate the client will be unable to deliver on the settlement date.*
- *The client repeatedly sells and subsequently buys back the same shares intraday.*
- *The client attempts to borrow shares but is unable to obtain a loan, then places a sell order for the same shares.*
- *Borrowing availability for the shares in question is limited, for instance, because shareholders are recalling loaned shares ahead of a general meeting.*
- *The share being sold is experiencing a temporary price increase.*  
Temporary price increases may occur due to (i) shareholder disputes among potential buyers or (ii) shareholder disputes with positioning ahead of a general meeting.
- *Specific company events known to the broker and extraordinary issuer events.*  
For instance, if the issuer of the shares is increasing share capital without registering the issuance with the Company Register. Brokers should exercise particular diligence if (i) the issuance involves significant dilution and the order size is substantial relative to the registered share capital and/or (ii) subscription rights in the issuance are trading significantly lower than expected market prices. The broker's degree of diligence will be influenced by their knowledge of the specific financial instrument.
- *Conditions requiring disclosure of an approved prospectus for trading newly issued shares.*  
Even if new share capital is registered in the Company Register, selling these newly issued shares may constitute uncovered short selling if the new shares are not tradable until the prospectus is published.
- *Order size in volume (both individually and in relation to the total number of shares issued by the company).*  
Particularly large sell orders in a company will usually require further investigations by the broker. This applies to both unusually large individual orders and the receipt of a high number of sell orders that collectively represent a large sales volume relative to the total number of shares issued by the company.
- *Other circumstances that may raise questions about the availability of the shares, including extraordinary market conditions.*  
If extraordinary market conditions exist concerning the trading of a share, and specific circumstances indicate that the broker or firm understands or should understand that the availability of the shares is limited, this suggests the broker should exercise caution when executing the sales order.

If there are indications of short selling, the broker should, in any case, ask the client whether they are short selling. If the client confirms that it is a short sale, the question arises whether the client has access to the shares in question, cf. section 4.



Even if the client denies short selling upon inquiry, the investment firm/broker may still have additional duties of investigation, cf. section 4.

### 3 Additional control measures

Whether the broker should conduct further investigations to determine if the client is engaging in short selling must be assessed on a case-by-case basis. If the broker is unsure about which investigations should be conducted, they must terminate the conversation and consult their immediate supervisor and/or the compliance department within the investment firm before executing the sales order. Additional control measures<sup>1</sup> may include the following:

- *Control Questions to the Client*  
The control questions asked on a recorded telephone line should cover the following: 1) whether the client has access to the shares, 2) where the shares are held, 3) the quantity of shares, and, if applicable, 4) the expected delivery date. If the client's confirmation does not appear sufficient given the circumstances and the client cannot document access to the shares, the broker should normally require the client to ask the lender of the shares or another relevant party to contact the broker directly to confirm access to the shares.
- *Review of the Client's Securities Account*  
If the investment firm acts as the account operator for the client, the broker may review the client's holdings in their VPS account or examine the client's purchases over the past three days through the investment firm. If the investment firm is not the account operator for the client, the broker may request that the client's account operator, custodian, or broker at another investment firm contact the broker to confirm that the client has previously purchased the shares.
- *Inquiry with the Settlement Department Regarding Previous Delivery Failures*  
If there are indications of short selling and the broker has no prior experience with the client, the broker should consult settlement department to determine whether there have been any previous issues with the client regarding failed deliveries.

If the broker, after conducting further investigations, still finds indications that the client is engaging in short selling and determines it is not prudent to rely on the client's confirmations — including cases where the client cannot document ownership or control of the shares related to the sales order — the broker must refrain<sup>2</sup> from executing the trade.

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<sup>1</sup> The starting point is the control possibilities that normally actually exist. An investment firm does not have access to a client's securities account unless the firm itself is the account operator for the client's securities account or has a power of attorney. Furthermore, such transparency does not provide anything other than a snapshot and is not a reliable indicator of the client's access to the shares in question. Relevant measures must also be considered in light of the time available to the estate agent in market situations where the price picture can change considerably over time.

<sup>2</sup> The client may then place a sell order through the investment firm that the client uses as account operator or the firm where the client has purchased the shares covering the sell order in the last two days.



## 4 Requirement for Client Access and Ensuring Delivery by the Firm

This issue does not arise where the broker has purchased the shares on behalf of the client, established a loan facility<sup>3</sup>, assisted in arranging a loan, or where the client unprompted provides documentation of access to the shares. Such documentation may, for example, include (i) confirmation of a share loan<sup>4</sup> or (ii) confirmation of delivery under an exercised option or similar.

If the broker's experience with the client is satisfactory, the client has a consistent history of timely delivery, and there are no indications of difficulties in borrowing shares in the market, the broker should be able to rely on the client's confirmation of access to the shares and execute the sales order. However, if circumstances suggest that access to the shares being shorted should be assessed, the broker must determine whether the order can be executed.

- *Checking the availability of shares*

If the order concerns a company the broker knows well, the broker will generally be aware of company events and other relevant factors that may affect the availability of shares in the market. Conversely, if the order relates to a company where the broker lacks such knowledge and involves a relatively large number of shares, this may warrant further investigation to identify potential delivery issues with the shares in the company.

- *Inquiries with the settlement department regarding loan availability/missing deliveries of shares*

If specific factors indicate delivery problems, such as a significant increase in trading volume for the share, the broker should consult the settlement department to uncover potential delivery issues related to prior settlements in the same share. Similarly, the settlement department should alert the trading desk, and potentially compliance, if the settlement department identifies indications of delivery problems in a share experiencing unusually high trading volumes.

If the broker has doubts about the adequacy of the confirmation or documentation provided regarding the availability of shares, the broker must consult their immediate supervisor and/or the compliance department within the firm. If the firm determines that the investment firm cannot ensure timely delivery, the firm must refrain from executing the order until sufficient documentation of the client's access to the shares is provided.

### **Conclusion:**

**If the investment firm, after conducting adequate client due diligence, cannot substantiate that the conditions for (1) the client's access and (2) timely delivery are met, the investment firm must refrain from executing the trade.**

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<sup>3</sup> The investment firm may have an agreement with a lender who will normally lend specified shares, i.e. the investment firm has a borrowing right. It follows from the preparatory works that such a loan right may be sufficient to ensure coverage, but in that case it will depend on the specific agreement between the client and the investment firm whether the client is guaranteed timely delivery, cf. Ot.prp. no. 15 (1995-96) page 53.

<sup>4</sup> Under standardised loan agreements, investment firms (acting as intermediaries for share loans) issue such confirmations on the same day the loan is arranged

