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Legal Protection in Short Selling Transactions in The Capital Market

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ABSTRACT
This study aims to: (1) examine and analyze the implementation of short selling transactions, and (2) explore and analyze the legal protection available to customers/investors involved in short selling within the Indonesian capital market. The data used in this research is obtained from library research or secondary sources, including articles, books, legal norms contained in laws and regulations, and other legal materials. The analysis is conducted using a descriptive research method, employing normative juridical approaches and comparative document analysis. The results of this study indicate that short selling is a high-risk transaction, necessitating adequate protection for investors and securities to foster a sense of security and confidence when transacting in the capital market. This protection can be provided by authoritative bodies in the capital market such as the Financial Services Authority (OJK), the Stock Exchange, KSEI/KPEI, as well as through agreements between the involved parties.

Keywords: *Legal Protection, Short Selling Transactions, Capital Market*

1. Introduction

The capital market serves as a vital source of funding for business actors who need additional capital and also acts as an investment alternative for the public. Andrew M. Chisholm defines capital markets as "places where those who require additional funds seek out others who wish to invest their excess" (Chisholm, as cited in Anoraga & Pakarti). Capital markets encompass the trade of securities such as stocks, stock certificates, and bonds. Investors rely heavily on accurate and complete company information to make informed buy or sell decisions. Transparency is therefore a fundamental principle in capital markets, enhancing efficiency and allowing investors to properly analyze risks and opportunities.

In Indonesia, the capital market has been increasingly recognized by the government as an essential driver of economic growth and national development. Companies are encouraged to raise funds by going public, and the capital market is seen as a reliable mechanism to channel investment into productive economic sectors. However, the market's rapid development has also introduced new challenges and irregularities, one of which is the controversial practice of short selling—a mechanism that often escapes close regulatory oversight (Garbaravicius & Dierick, 2019).

Short selling is a financial strategy that allows investors to profit from the decline in the price of a security. In this transaction, investors borrow securities to sell at current prices, with the intention of buying them back later at a lower price. In Indonesia, short selling has been permitted under specific regulatory frameworks such as Bapepam-LK Rule No. V.D.6

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(revised in 2008) and BEI Rules II-H and III-I. These regulations aim to manage the risks associated with margin and short selling transactions while supporting market liquidity and efficiency (Jain & Jain, 2020; Ma & Tang, 2022).

Despite its potential benefits, short selling also brings significant risks to market stability. The risk of settlement failure is higher in short selling compared to traditional buy-sell transactions (Fahlenbrach & Stulz, 2020). Moreover, when large volumes of shorted stocks are sold, they can create an artificial increase in supply, driving stock prices down beyond their fundamental value. This may lead to overall market downturns, particularly when coupled with panic selling, and has the potential to distort the performance of the composite stock index (Sharma & Kumar, 2021).

From a regulatory standpoint, there have been varied responses globally to address the risks and legal implications of short selling. Some jurisdictions enforce strict disclosure requirements, while others impose temporary bans during periods of market stress (Chen & Zhang, 2020; Singh & Singh, 2020). In Indonesia, the Financial Services Authority (OJK), Indonesia Stock Exchange (IDX), KSEI, and KPEI are responsible for monitoring and managing these practices. However, enforcement challenges remain, particularly in ensuring investor protection and market integrity (Park & Sulaeman, 2021; Harris, Namvar, & Phillips, 2022). Existing literature has extensively discussed the economic rationale, risks, and regulatory variations of short selling across markets (Lin & Lu, 2021; Li & Wang, 2023; Xu & Zhang, 2022). However, limited attention has been paid to the *effectiveness of investor protection mechanisms in Indonesia* specifically, and how regulatory frameworks have adapted post-global financial crises. Few studies provide an in-depth normative analysis of the Indonesian short selling regime in light of global best practices (Iqbal & Usmani, 2021; Nguyen & Pham, 2023).

This study aims to fill the gap by analyzing Indonesia's short selling framework through a normative juridical lens, comparing it to international standards, and highlighting the legal and structural protections for investors. The novelty lies in synthesizing comparative insights with local regulatory realities, addressing both the legal risks (Lee & So, 2020) and investor rights (Zhang & Li, 2023; Wang & Zhao, 2023) in the context of an emerging market. The findings are expected to contribute to policy refinement and enhance investor confidence in Indonesia's capital market.

2. Literature Review

1. The Concept and Mechanism of Short Selling

Short selling is a financial strategy in which an investor borrows a security and sells it on the open market, planning to buy it back later for less money. This practice allows investors to profit from declining market prices, but it also introduces significant risk, including the possibility of unlimited losses if the asset's price rises instead of falls (Fahlenbrach & Stulz, 2020). According to Garbaravicius and Dierick (2019), short selling can enhance market liquidity and price efficiency if conducted within a robust regulatory framework. However, improper use or lack of oversight can lead to price manipulation and excessive volatility.

2. Risks and Legal Challenges of Short Selling

Short selling is considered a high-risk transaction due to potential price spikes, settlement failures, and its potential to trigger broader market instability (Sharma & Kumar, 2021). During times of financial stress, such as the 2008 global financial crisis, many regulators responded by banning or restricting short selling activities (Jain & Jain, 2020). In emerging markets like China, these restrictions have been linked to improved market stability, although evidence remains mixed (Chen & Zhang, 2020). In Indonesia, the risk of "gagal serah" (failure to deliver) is higher in short selling than in conventional trading, highlighting the need for enhanced regulatory oversight.

3. Legal Frameworks and Regulatory Responses

Regulatory bodies around the world have adopted diverse approaches to short selling. In the European Union, for example, short selling regulations are primarily aimed at balancing investor protection with market efficiency (Garbaravicius & Dierick, 2019). In the U.S., short sellers are subject to stringent disclosure rules and can face litigation in cases of market manipulation (Lee & So, 2020; Wang & Zhao, 2023). Countries like Indonesia have developed specific regulations such as Bapepam-LK No. V.D.6 and IDX rules to manage short selling activities, but their enforcement effectiveness remains underexplored in academic literature (Nguyen & Pham, 2023).

4. Investor Protection and Legal Safeguards

Investor protection is a central issue in short selling discussions, especially in less mature markets. According to Harris, Namvar, and Phillips (2022), post-crisis evaluations reveal that effective legal safeguards can enhance investor trust and market participation. Lin and Lu (2021) demonstrate that regulatory reforms in Asia have had a positive impact on investor protection and market confidence. In Islamic finance contexts, short selling faces additional scrutiny due to compliance with Shariah principles, further complicating its legal acceptability (Iqbal & Usmani, 2021).

5. Short Selling, Market Abuse, and Corporate Governance

Short selling, when improperly regulated, may lead to market abuse, including insider trading and price manipulation (Xu & Zhang, 2022). From a corporate governance perspective, Saffar and Zhang (2022) emphasize that short sellers can act as external monitors, disciplining management and exposing fraud. However, without clear legal boundaries, this role may evolve into predatory behavior that undermines market integrity. Ma and Tang (2022) highlight the existence of legal asymmetries in short selling regulation, where enforcement is often uneven across jurisdictions.

6. Global Best Practices and Regulatory Comparisons

Recent studies have explored the effectiveness of various global short selling laws, revealing a wide gap in disclosure requirements and enforcement mechanisms. Li and Wang (2023) analyze how different jurisdictions tackle short selling and market manipulation, suggesting that harmonized global standards could reduce regulatory arbitrage. Similarly, Zhang and Li (2023) find that transparency and disclosure laws in the U.S. and EU significantly affect the behavior and accountability of short sellers. Singh and Singh (2020) further argue that coordinated international policies are crucial for protecting investor rights in a globalized financial system.

7. Disclosure, Transparency, and Market Trust

Disclosure requirements play a crucial role in ensuring a transparent short selling environment. According to Park and Sulaeman (2021), robust enforcement by regulatory agencies like the SEC in the U.S. significantly deters abusive short selling practices. Marsh and Payne (2020) add that transparency in short selling contributes to overall market quality and efficiency. Furthermore, as Nguyen and Pham (2023) suggest, mandatory disclosure of short positions helps level the playing field and reinforces investor confidence in capital markets.

3. Methodology

The type of research employed in this study is descriptive research, which aims to depict a phenomenon, event, or occurrence as it exists in the present moment (Sujana & Ibrahim, 1989, p. 65). This type of analysis seeks to uncover all variables that contribute to a particular case from multiple influencing aspects. Descriptive research focuses on solving current, real-time problems by collecting and interpreting data through a normative juridical method. The researcher attempts to "photograph" or capture the events and phenomena under investigation as they naturally occur, with findings that are contextually valid at the time of the study and may not necessarily remain relevant in the future.

The normative juridical approach is carried out by examining library materials or secondary data sources, which include books, legal principles, statutory regulations, legal doctrines, judicial decisions, and other legal materials. This study provides a detailed, systematic, and comprehensive overview of all matters related to short selling transactions in the capital market. It does so by analyzing the applicable laws in relation to legal theories and the practical implementation of positive law in addressing legal issues that arise within the context of short selling.

This research also addresses the juridical consequences related to investor protection in the context of insider trading, highlighting two main legal issues in Indonesia: normative ambiguity (vagueness in legal norms) and normative voids(unregulated aspects). The method of problem approach used is the statutory approach, which involves the study of relevant laws and literature. Legal materials in this study consist of primary legal sources (such as legislation and court rulings) and secondary legal sources (such as journal articles, books, and academic commentary).

The process of analyzing the existing legal materials is carried out through the following stages:

1. Data Collection Stage
   Relevant laws, regulations, academic articles, journals, and other written works directly related to the research issue are collected systematically and used as reference materials.
2. Data Categorization Stage
   All collected data are then organized and categorized according to the context of the study. This step facilitates a more focused and relevant examination of the research problems addressed in this thesis.
3. Analysis and Writing Stage
   This is the final and crucial stage, where the selected data are carefully analyzed through interpretation aligned with legal concepts, principles, and doctrines deemed appropriate and relevant to the study's objectives. The results of the analysis are then compiled in written form to serve as both a research outcome and a reference for future academic work.

Through this systematic analytical process, the study aims to derive a conclusion that explains the relationships between the various legal materials used. The end goal is to provide answers and policy recommendations concerning the central research question: how and to what extent legal protection is afforded to investors in electronic securities transactions within the capital market.

4. Results

A short selling transaction refers to the sale of securities not owned by the seller at the time the transaction is executed. The initial requirement for engaging in stock market transactions is the opening of a securities account. However, investors who wish to utilize short selling financing facilities must first enter into a Securities Transaction Settlement Financing Agreement. Short selling transactions are embodied in contractual agreements, which reflect the principle of freedom of contract between the securities company and the investor/client. These agreements define the rights and obligations of each party and serve as a legal protection mechanism. To access short selling facilities, investors are required to provide a cash collateral.

Short selling transactions are fundamentally similar to typical stock trading, with the key distinction being that in short selling, the seller does not own the shares at the time of sale. To fulfill the delivery obligation, the short seller must source the shares from the market or, if unavailable, borrow the securities using a securities lending facility provided by PT KPEI (Indonesia Clearing and Guarantee Corporation). This facility enables investors to borrow the shares they intend to sell short.

Violations or crimes committed in the capital market can have extensive and far-reaching consequences. Such misconduct affects not only brokers and investors but also the listed companies whose securities are traded. This influence extends to the public and investors' decision-making processes in buying or selling shares. Insider trading, in particular, is often likened to theft. As noted by Nasarudin and Indra (2004), "The difference between conventional theft and insider trading lies in the object; conventional theft involves tangible property belonging to others, while insider trading involves using information that should be publicly accessible, thereby enabling unfair gains." While the victim of conventional theft is the property owner, insider trading harms numerous parties, including counterparties, regulators, and the credibility of the capital market itself. Loss of credibility ultimately erodes public trust in the market.

According to Article 1 point 7 of the Capital Market Law (UUPM), "Material information is any important and relevant information or fact about an event or occurrence that may affect the price of securities on the Stock Exchange and/or the decisions of investors, prospective investors, or other parties with interest in the information or fact."

In Indonesia, short selling is not regulated directly under Law No. 8 of 1995 on the Capital Market. The law primarily governs general trading activities, while specific transactions like short selling and insider trading are regulated through derivative regulations. These include:

- Bapepam-LK Regulation No. V.D.6 on Financing of Securities Transactions by Securities Companies for Clients,
- Jakarta Stock Exchange Regulation No. 19 of 1997 on Margin Transactions, and
- Bapepam-LK Chairman Decree No. Kep-556/BL/2008 on Securities Transaction Financing and Short Selling by Securities Companies.

Short selling agreements are also subject to regulations found in Book III of the Indonesian Civil Code, particularly regarding contract law. Under Article 1313 of the Civil Code, "An agreement is an act whereby one or more persons bind themselves to one or more other persons." This legal basis supports the validity of agreements made in insider trading and short selling arrangements, often involving multiple legal events of borrowing and lending, such as between the investor and a securities company, or between securities companies, custodians, and PT KPEI.

To use the securities lending and borrowing facility, the investor must open a KSEI borrowing account and sign the appropriate agreements. This is governed by KPEI Regulation No. II-10 (November 14, 2007), which outlines securities lending services in scripless form. In this system, lenders can include securities companies, custodian banks, and other parties (e.g., investors), while borrowers are typically clearing members. Investors must also comply with Circular No. SE-16/BL/2012, which elaborates on Bapepam-LK Regulation No. V.D.3 concerning internal controls in securities companies engaged in brokerage activities.

Law No. 8 of 1995 categorizes capital market offenses such as fraud, market manipulation, and insider trading as criminal acts. It also prescribes penalties, ranging from 1-year imprisonment and IDR 1 billion fines to 10-year imprisonment and IDR 15 billion fines, depending on the severity of the offense.

The Indonesia Stock Exchange (IDX), as a capital market facilitator, plays a vital role in ensuring secure and efficient trading. On May 22, 1995, in preparation for scripless trading, the IDX introduced the Jakarta Automated Trading System (JATS), which enabled computerized trading. This was later upgraded to JATS-NextG on March 2, 2009, a more advanced system capable of handling 1 million orders and 500,000 transactions per day, far exceeding the capacity of the original system.

JATS-NextG facilitates real-time access to trading information such as:

1. Price data, foreign shareholding portions, and buy/sell orders.
2. Executed trade details and market data.

This technological enhancement supports IDX's vision of becoming a competitive and globally credible exchange. All trading members are required to comply with JATS operational guidelines (as outlined in IDX Director Decision No. Kep-00012/BEI/02-2009).

Investor protection is further supported by two essential capital market institutions:

1. KSEI (PT Kustodian Sentral Efek Indonesia) – the Central Securities Depository, established on December 23, 1997, and licensed on November 11, 1998. KSEI handles electronic securities custody, account administration, clearing, and post-trade processing, including C-BEST, its high-tech electronic system for scripless securities settlements.
2. KPEI (PT Kliring Penjaminan Efek Indonesia) – the Clearing and Guarantee Institution, founded under the mandate of UUPM on August 5, 1996, and licensed on June 1, 1998, to provide orderly, fair, and efficient clearing and settlement services. KPEI ensures that margin and short selling transactions are conducted securely.

These institutions are crucial to maintaining an effective and efficient capital market, particularly in managing margin trading and short selling. KSEI, functioning as the custodian bank, assures the safety of investor assets, while KPEI ensures transaction settlements are reliable and guaranteed.

Capital market crimes are unique in nature. The primary object is often non-material, such as information. Moreover, perpetrators rely not on physical strength, as in theft or robbery, but on the ability to analyze and exploit market information for personal gain. This makes evidence collection and prosecution more complex, and violations often carry widespread and severe consequences.

Despite the principle in Article 1338 of the Civil Code that all legally formed agreements are binding as law between the parties, failure to meet formal requirements (e.g., execution before an authorized official) does not render a Securities Settlement Financing Agreement null. However, it may lack preferential rights and executorial power, placing the creditor (e.g., the securities company) in a less secure legal position.

5. Discussion

This research highlights the complex legal and regulatory framework surrounding short selling transactions in the Indonesian capital market. Although short selling is operationally permitted through mechanisms involving securities lending and borrowing (such as through PT KPEI), it remains under-regulated in primary legislation such as Law No. 8 of 1995 concerning the Capital Market. This legal ambiguity is consistent with the observations of Ma and Tang

(2022), who argue that legal asymmetries across jurisdictions pose significant challenges for effective enforcement and investor protection.

Compared to more developed markets, Indonesia still relies heavily on secondary legislation—like OJK (formerly Bapepam-LK) regulations and BEI policies—to govern short selling. Garbaravicius and Dierick (2019) emphasize that while flexible regulatory frameworks allow market efficiency, inadequate statutory integration may leave gaps in legal protection, particularly during periods of volatility.

The risk of insider trading and market manipulation in the context of short selling has serious legal and ethical implications. As described by Lee and So (2020), short selling poses significant litigation risks, especially when traders exploit non-public material information. This aligns with Indonesian legal doctrine, which classifies insider trading as a criminal offense, yet often struggles with enforcement due to vague norms and evidentiary challenges. Xu and Zhang (2022) highlight that emerging markets like Indonesia often face significant difficulties in detecting and prosecuting market abuse due to institutional weaknesses.

In response to these risks, jurisdictions have implemented disclosure requirements and temporary bans to stabilize markets during crises. For example, Fahlenbrach and Stulz (2020) found that blanket bans during crises can be double-edged swords: while they may prevent panic selling, they can also reduce liquidity and delay price discovery. This resonates with Indonesia's cautious regulatory approach, particularly post-2008, which was also analyzed by Jain and Jain (2020) in their study on global lessons from short selling bans during the financial crisis.

Meanwhile, the regulatory frameworks established by the Indonesia Stock Exchange (IDX) and PT KPEI have provided operational safeguards for short selling through the introduction of systems like JATS-NextG and the C-BEST systemmanaged by KSEI. These systems, while technologically advanced, require legal robustness to support investor trust. Nguyen and Pham (2023) emphasize that disclosure requirements play a pivotal role in protecting investors in short selling transactions, especially when combined with strong internal controls and clear legal remedies.

Additionally, Harris et al. (2022) suggest that legal safeguards are only effective when backed by enforcement mechanisms and market surveillance—an area where Indonesia can still improve. Similarly, Park and Sulaeman (2021)underscore the importance of legal enforcement by regulatory bodies, showing that even in developed markets, short selling abuses are only curtailed through rigorous SEC investigations and sanctions.

Al-Abdullah and Al-Khater (2021) conduct a comparative analysis demonstrating that jurisdictions with strong investor protection mechanisms, including mandatory disclosure and legal recourse, foster healthier short selling environments. In contrast, weak regulatory enforcement can lead to systemic abuse and erosion of market integrity—risks that are particularly relevant to Indonesia's evolving legal infrastructure.

Shariah compliance also presents a unique challenge in jurisdictions like Indonesia, which has a significant Islamic finance sector. Iqbal and Usmani (2021) explore the incompatibility of conventional short selling with Shariah principles due to issues of speculation (gharar) and the sale of non-owned assets. This adds another layer of complexity to short selling regulation in Indonesia, where dual legal and financial systems coexist.

In terms of market quality, Marsh and Payne (2020) argue that well-regulated short selling contributes positively by correcting overpriced securities and enhancing liquidity. However, Sharma and Kumar (2021) warn that insufficient legal oversight can amplify market crashes, especially in speculative environments—a scenario that is plausible in Indonesia, considering the relatively low level of public financial literacy and the prevalence of retail investors.

Furthermore, Zhang and Li (2023) find that disclosure laws in both the U.S. and EU significantly improve transparency and reduce manipulation, suggesting a path for Indonesian regulators to enhance current frameworks. Similarly, Singh and Singh (2020) note that protecting investor rights requires not just legal provisions, but also transparency, accountability, and education—a multidimensional approach still in progress in Indonesia.

Finally, Lin and Lu (2021) offer evidence from across Asia that short-selling reforms—when integrated into broader legal systems—can significantly improve investor protection. These findings validate the direction of Indonesia's regulatory evolution, especially with the support of institutions like OJK, BEI, KPEI, and KSEI, but also highlight the urgency for more cohesive, enforceable, and transparent legal frameworks.

6. Conclusion

Short selling transactions refer to the sale of securities that are not owned by the seller at the time the transaction is executed. Opening a securities account is the initial requirement for conducting transactions on the stock exchange. In the case of short selling, investors are also required to sign an Agreement on the Use of Financing Facilities for Securities Transaction Settlement. Additionally, investors must open an account at a designated bank specified by the securities company. Since margin trading and short selling operate through a book-entry transfer system, investors are not required to physically handle cash to buy or sell securities.

However, if an investor wishes to utilize financing facilities for short selling as described above, they must enter into a financing agreement for securities transaction settlement. Short selling transactions are formalized in a contract that reflects the principle of freedom of contract between the securities company and the investor, outlining the rights and obligations of each party as a form of mutual agreement and legal protection. To access short selling facilities, investors must also provide collateral in the form of cash deposits.

Short selling carries high financial risk, which necessitates protection for both investors and securities companies to ensure a sense of security and confidence in capital market transactions. This protection can be offered by regulatory authorities such as the Financial Services Authority (OJK), the Indonesia Stock Exchange (IDX), and the Indonesian Central Securities Depository/Clearing and Guarantee Institution (KSEI/KPEI), as well as through contracts between the involved parties.

Law No. 8 of 1995 concerning the Capital Market (UUPM) defines various criminal offenses in the capital market, and it also stipulates penalties for such offenses, including fines and imprisonment, ranging from one year in prison and a fine of IDR 1,000,000,000 (one billion rupiah) to ten years in prison and a fine of IDR 15,000,000,000 (fifteen billion rupiah).

When engaging in margin trading or short selling, investors must carefully understand the contents of the agreementsthey are required to sign as a prerequisite for using financing facilities. These types of transactions can be very attractivesince investors are provided with substantial funds or shares on loan to allow for larger purchases or sales of stocks. Before investing in stocks, investors should understand the mechanisms of stock transactions in the capital market or seek advice from experienced securities firms with dedicated research departments.

Investors are encouraged to think carefully before engaging in short selling, as the potential consequences can be very harmful. Alternative trading strategies that require greater skill might be more suitable and less risky for many market participants.

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