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Short Selling

A free market alternative for exposing foreign corporate fraud

Mark McGinley

In order to ensure the integrity of the financial markets and the continuance of investor confidence, it is crucial that foreign corporate fraud be rooted out and eliminated. The question then becomes, who is most capable of achieving this objective: the public or private sector?

As the US economy continues to struggle out of the Great Recession, public sentiment is shifting to favour increased government regulation of the financial markets, and a tightening of auditing requirements to prevent corporate fraud (MyBankTracker.com, 2010). While this approach may successfully reduce instances of domestic fraud, US government regulation is less able to address the problem of corporate fraud perpetrated by foreign companies trading on US exchanges. US regulators are constricted in their ability to investigate foreign fraud because they are required to liaise with the foreign company's home regulator—a regulator that may be unresponsive, corrupt, incompetent, or outright hostile (Rahn, 2008). As a result, US regulators can have a difficult time getting the information required to conduct their investigations.

Instead of looking to expand the scope and power of US regulators, perhaps we can look to the private sector for innovative solutions that can help maintain the integrity of our financial system. One such solution can be found by enlarging the role that short sellers play in uncovering and punishing foreign corporate fraud. To understand how short sellers can act to uncover and punish foreign corporate fraud in the marketplace, and how they could be able to do so more effectively than US government regulators, let's look at an example provided by the noted short seller, Muddy Waters LLC.

The mechanics of short selling

Before explaining the role short sellers can play in uncovering and punishing foreign corporate fraud, it is important to understand what short selling is and how it works. Basically, short selling is the counterintuitive act of buying high and selling low; in essence, it is betting against the market. Here is how it works: a short seller (shorter) decides that a particular stock is overvalued, perhaps because they think the company is headed for a bad quarter, or they suspect that the company is engaged in fraudulent activity. To initiate the short, the shorter approaches a lending institution, which agrees to lend the shorter a certain number, let's say 100, shares of that company's stock, typically charging them a lending fee. The shorter agrees to give back the 100 shares at a later date. Immediately after borrowing the shares, the shorter sells them at the current market value, let's say $100 per share, and pockets the proceeds. Following the sale, the shorter waits to see if the share price will fall to reflect what they consider to be the actual value of the shares. Let's say that the share price falls from $100 to $50 two weeks after the sale. In this scenario, after having made $100 per share, or $10,000, in the initial sale, the shorter is able to buy back the 100 shares owed to the lender for $50 per share, or $5,000. The shorter's net profit from the endeavor is thus $5,000. However, if the share price rises during that time, the shorter is forced to buy back the shares owed to the lender at a price higher than that received in the initial sale, resulting in a net loss.

Now that the basic mechanics of short selling are clear, let's look at Muddy Waters and how they are using short selling to punish foreign corporate fraud in the marketplace.

The Muddy Waters approach

The short selling conducted by Muddy Waters focuses on privately held Chinese companies that purchase publicly traded American companies to gain access to highly coveted American stock exchanges, like the New York Stock Exchange. These types of purchases are called reverse takeovers (RTOs). They are called reverse takeovers because in an RTO a private company is taking over a publicly held company, whereas in a typical takeover a publicly held company would be acquiring a private company (Investopedia, 2011). Aware of the potential for fraud in Chinese RTOs, Muddy Waters utilizes an extensive network of investigators and analysts, both in the US

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and China, to examine companies suspected of fraudulent activity. In cases where fraud is uncovered and confirmed, Muddy Waters responds by shorting the company's stock. As described above, this means borrowing the company's stock from a lender and then immediately selling it at market value. After shorting the stock, Muddy Waters releases a comprehensive report detailing their allegations against the company, as well as the evidence that it has accumulated in support of the charges. In response, the company's stock price begins to decline. Once it reaches the price level anticipated by Muddy Waters, they then repurchase the stock at the new lower market price and deliver the borrowed shares back to the lender, effectively "closing" the short sell and making a tidy profit in the process.

Now that the mechanics of short selling and the Muddy Waters approach have been explained, let's discuss why short sellers using the Muddy Waters approach can be more effective at uncovering foreign corporate fraud than US regulators, and how short sellers themselves can be prevented from committing the very type of fraud they are supposed to be punishing.

Why short sellers are better able to investigate foreign corporate fraud than US regulators

When it comes to investigating foreign corporate fraud, short sellers using the Muddy Waters approach have a number of advantages over US government regulators. By virtue of their status as private organizations, short sellers are able to bypass a substantial amount of bureaucratic red tape when making information requests of foreign regulators, thus enjoying quicker access to information than US regulators (Rahn, 2008). Further, private companies are able to visit and covertly investigate the asset holdings of foreign companies with greater ease than US regulators. Indeed, Muddy Waters researchers were able to enter China easily and directly investigate asset holdings without political interference. Contrast such direct access with the official avenues of inquiry the US Securities Exchange Commission (SEC) must follow, which require liaising with foreign regulators that may be uncooperative, corrupt, or outright hostile (Rahn, 2008). Further, private short sellers are able to reap immense profits from successful fraud allegations, allowing them to offer lucrative compensation to their researchers and analysts, which can far exceed the salaries offered by government regulators. This competitive edge helps enable them to recruit and retain top talent. Moreover, a short seller's private sector status allows them extensive discretion and flexibility in designing their own incentivizing compensation plans to encourage a high level of performance amongst researchers and analysts. Imagine the performance gains that could be realized if the SEC were allowed to compensate investigators with a percentage of the total dollar amount of fraud that they uncovered; presumably, investigators would be more motivated to work to expose fraudulent activity just as commissioned salespeople are more motivated to make a sale.

With all of these advantages over US government regulators, short sellers using the Muddy Waters approach have the potential to be very effective at uncovering and punishing foreign corporate fraud.

Private fraud investigators can enter China without political interference

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However, this approach also carries with it the potential for abuse. Let's look at how short sellers can operate to defraud the market and the safeguards that could be put in place to ensure that short sellers do not negligently or fraudulently accuse companies of wrongdoing for their own gain.

Deterring and punishing fraudulent short selling

Under the US Sarbanes-Oxley (SOX) legislation, the SEC is required to publicly disclose any

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formal investigations conducted regarding corporate fraud, making a decline in stock price inevitable for the company under investigation (Pollock, 2006). Short sellers are aware of this requirement for disclosure and, as a result, there exists a serious concern that a short seller could target a company, short their stock, release a report containing unfounded allegations of fraud, and make a substantial profit upon the launch of a formal SEC investigation. By using such "short and distort" practices, the shorter is seeking to purposely manipulate the market using false information (Pollock, 2006). In this scenario the targeted company could be completely innocent and yet the short-seller would still make money off the deleterious effect the investigations would have on the company's stock price.

There are, however, a few safeguards in place to deter this type of fraud. The legal system should act as a significant deterrent to unscrupulous short sellers by providing falsely accused companies with opportunities for redress. If a short seller were to release a report containing allegations of fraud that turned out to be unfounded, the people responsible for preparing and issuing the report could be charged, both criminally and civilly, with committing fraud (Frenkel, 2011). The wrongfully accused company could also seek redress by suing the short seller for securities fraud, defamation, slander, and tortuous interference with contracts (Frenkel, 2011). US courts have already demonstrated a willingness to punish fraudulent short sellers. In 2004, short seller Anthony Elgindy was sentenced to 11 years in prison for generating fraudulent information about a company which he then released to lower the stock price for his own gain (Dash, 2004).

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While the legal system may prove effective in providing recourse for the wronged company, it is certainly preferable to prevent the company from being wronged in the first place. Alex J. Pollock, former president and CEO of the Federal Home Loan Bank of Chicago, offers a solution to this dilemma. He recommends that SOX be amended to "[r]equire that any party bringing claims of accounting or financial irregularities to the SEC publicly disclose all the short or long financial interests it has or represents in the company it is accusing" (Pollock, 2006). Should this requirement be implemented, the market would be able to weigh the allegation of fraud against the profit the party making the allegation would stand to make if the claims were true. This approach would introduce substantially more transparency into the market, allow the market to weigh the credibility of the accused company and the accusing short seller respectively, and decrease the potential for market manipulation.

Conclusion

US regulators are not well equipped to investigate foreign companies trading on US markets. By virtue of having to deal with foreign regulators who may be hostile, uncooperative, or incompetent, US regulators will often have a difficult time getting the information they require to investigate foreign companies suspected of fraud— if they can get it at all. Instead of working to create large, bureaucratic, international regulators, or expanding the power and scope of US regulators, we should be encouraging short sellers to take an active role in uncovering and punishing foreign corporate fraud.

As private sector entities, short sellers following the Muddy Waters approach are free from the bureaucratic and regulatory restrictions that constrain domestic government regulators. As a result, short sellers may be more effective at discovering fraud perpetrated by foreign companies. Moreover, their workforces can be compensated and incentivized to a much greater extent than government regulators, which may result in a higher level of employee performance.

While the government will continue to regulate the markets within its jurisdiction, it is clear that government regulators have some limitations when attempting to regulate companies that trade on its stock exchanges but conduct their operations in foreign countries. To address fraud perpetrated by foreign companies, we should call upon the private sector, and specifically short sellers, to fill the regulatory void that domestic regulators are unable to fill themselves. Short sellers can complement the work being done by government regulators by illuminating the darkest corners of the market, the corners that government spotlights are unable to efficiently reach. We should be encouraging short sellers to act in concert with domestic government regulators, each making the other stronger, and both making our markets safer and more trustworthy.

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