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Can a China investment firm legally sell short?

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600518 -1.06% ▾ USDCNY -0.08% ▾

BEIJING (Caixin Online) — Is it legal in China to short a company's shares and then publicly question its financials with prepared research reports? This is the question a domestic investment company formally asked China Securities Regulatory Commission (CSRC) in a letter in March.

The matter drew attention because of the significant weight it carries in the country's nascent short-selling industry.

The method in question is practically the same as that used by American short seller Muddy Waters Research, which has made a name for itself by attacking U.S.-listed Chinese companies in recent years and making big money out of the ensuing share collapses.

Similar actions have apparently been tried by many Chinese investment companies with varying degrees of transparency, but rarely has one sought the media coverage that Muddy Waters did.

The firm that wrote the letter, Beijing Zhongneng Xingye Investment Consulting Co., rose to fame in the financial community mostly because of its high-profile attack on a pharmaceutical company last year.

In December, it published a report accusing Kangmei Pharmaceutical Co. **600518, -1.06%**, a Shanghai-listed medical firm, of lying about its assets based on its own investigation. Kangmei's shares plunged by the daily trading limit of 10% on the next trading day.

Yet Zhongneng claimed to have neither held a short position in the company, nor shared its findings with a third party before the report was released.

Zhao Bing, general manager of Zhongneng, said he was concerned about the legal ambiguity surrounding operations he wanted to employ.

"If I were to prepare a report in private and short the shares in secret, it would not raise any legal problem, but it will not be of any use to me either," he said.

Publicity is important. For a short selling strategy to work, "the report needs to be amplified by the media," but that is where the legal line might be crossed, he said.

His hope that the CSRC would provide a definitive answer to whether he can short and advertise seems to have gone nowhere because the regulator didn't directly address his questions. In its reply published in May, the CSRC simply stated that all actions must fall in line with existing laws and regulations regarding securities investment.

A handful of experts said that amounts to acquiescence. One said: "Now that the question has been asked and the regulator has not explicitly said 'No,' it is as good as tacit permission."

A source close to the CSRC said about the regulator's attitude on the issue: "Short sellers will not be banned when the demand is here for more muckrakers."

But other analysts are concerned that the intentional vagueness in the reply left open legal traps for short sellers.

The Securities Act, which the CSRC cited in its reply to Zhongneng, stipulates that violations include "disturbing the order of securities and futures markets" and "engaging in activities that attempt to manipulate the market."

That means it is up to the discretion of the regulator when determining the legality of a targeted short-selling attack, said Zhang Yuanzhong, a lawyer at Beijing Wen Tian Law Office.

The Securities Law didn't prohibit the practice of short selling the stocks of a company and then attacking it with scathing investigation reports, he said, but the action could be viewed as "manipulative" under the broad description of violations. "In China, there is still a legal risk of following Muddy Waters' model, and the judging criteria are in the hands of the regulator."

Even if the short seller limited the knowledge of its investigation findings to a small group of investors, it still ran the risk of violating the law depending on the size of the crowd, said Liu Gang, a regional general manager for Shenzhen Capital Group Co. Ltd., an equity investment company.

Independent inquiries

Zhongneng owes much of its fame to the attack on Kangmei. The report it coauthored with Capital Week, a financial media outlet that also published it, accused Kangmei of inflating its assets by at least 1.8 billion yuan ($293 million) **USDCNY, -0.08%**, which was almost equal to the company's combined net profits from 2002 to 2010.

When trading resumed, the shares of Kangmei fell by 10%.

The firm's parent company, Puning Kangmei Industry Co. Ltd., rushed to boost investor confidence by promising to acquire 1 million shares.

The share price climbed to new highs in March, despite another report from Zhongneng, which claimed that 760 million yuan worth of Kangmei's intangible assets were in fact a 140 meter high barren hill.

Zhongneng has also targeted leading liquor producers. In December, it published the examination results of samples that showed excessive amounts of plasticizer, an industrial chemical additive that causes disorders in the human reproductive system.

Earlier, it questioned the financials of Letv.com, a video streaming website. The firm suffered a 15% share price decline in two days as a result.

Zhongneng has denied using those attacks to make money, though skeptics think otherwise.

Also in question is the way it gathered information. Unlike most other investment companies that buy or sell stocks based on openly available information, such as industrial policies and corporate announcements, Zhongneng conducts its own investigation.

However, "in my understanding, the CSRC doesn't permit financial institutions to short stocks based on information gained through independent research," said an executive of an investment company.

Nevertheless, many short sellers still ferret out target companies' weaknesses by performing their own investigations, and not of all them play by the rules, a source from a private equity fund said.

Some short sellers send workers to infiltrate the target company, he said. "One year is long enough (for the imposters) to find a problem, especially a financial one" with the company. He said he also knew of short sellers bribing target companies' accountants for information.

A pilot regulation limits investors to shorting firms on a list of 500 companies on the Shenzhen and Shanghai bourses. If the target company isn't on the list, short sellers often attack it and then buy its shares when the price falls, the source from a private equity fund said.

Then they wait until the initial shock of bad news wears off and the stock recovers, he said. That way they can sell the stocks and earn the price difference.

Looking back on the Kangmei episode, "was it not the case?" the source asked.

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