Analysis on the Benefits and Reasons Why Short Sale Should Not Be Prohibited

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Abstract. Many enterprises, especially those in China, lack systematic knowledge and understanding of the shorting mechanism. In China's A-share market, due to the long-term lack of short-selling mechanism and the habit of traditional ways of thinking which is largely limited to long-selling, most of these enterprises fail to pay sufficient attention to the possible short-selling risks. Under the inherent cognitive and thinking framework, they fail to form a systematic understanding of the short sale and its possible impact. More importantly, previous studies have investigated the role each company or institution plays in a shorting process, however, very few of them lay emphasis on the value and positive impacts provided by the short sale as well as why it is necessary to exist. Therefore, the purpose of this paper is to demonstrate shorting should not be prohibited. The author studies the case of Muddy Waters shorting Luckin Coffee to analyze the causes of the incident and its impact on the capital market. Then, the author discusses the possible benefits of shorting of the capital market and how the regulatory system regarding this can be improved in the future. This paper concludes that short-selling should not be prohibited because of its benefits in monitoring companies, optimizing resource allocation, improving information timeliness, improving market liquidity and so on.

Keywords: Finance · Short sale · Stock · Prohibit · Market

1 Introduction

Short sale, a common operation in the stock market, refers to a phenomenon that an operator sells the stock in hand when expecting a downward trend and buys the stock back after the decline of it to earn the intermediate price difference. As early as 1609, a businessman named Isaac Le Meir shorted stocks including the Dutch East India Company on the Amsterdam Stock Exchange. This offended the East India Company whose directors began to stop short sellers, blaming them for driving down share prices. Then, at the request of the East India Company, the Dutch government enacted a law banning short selling. However, this law was widely criticized by the community and was repealed in 1689. Similarly, the same thing happened again in 1720 with the South Sea investment bubble. Eager investors pushed the price of South Seas shares from about £120 per share in early 1720 to more than £1,000 in July of that year, but the stock price dropped sharply and once again the short seller became one of the scapegoats. Then Sir

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John Barnard introduced a bill that would ban all short selling, which disappointingly had no effective means of enforcement and was repealed in 1860. Later, with the increasing openness of securities markets, many emerging economies are constantly trying to introduce short-selling mechanism, including Argentina (1999), Chile (1999), Poland (2000), Greece (2001), and Peru (2002).

Based on a case analysis, this paper not only reveals some problems of enterprises themselves behind the events, but also demonstrates a series of benefits of shorting to the capital market, focusing on why this behavior should not be banned. Therefore, this paper offers more important insights into guiding people to hold an open and objective attitude towards short-selling and dialectically treat it rather than holding inherent prejudice, so as to encourage and promote a healthy short-selling environment and guide investors as well as intermediaries to participate in appropriate and legitimate short-selling.

2 Problems of the Companies Attacked by Short Sellers

It is worth noting that most of the companies attacked by short sellers do exist their own problems. The Luckin Coffee scandal and short selling attacks can be taken as an example. On January 31, 2020, Muddy Waters released a short-selling report on Luckin Coffee on its official Twitter account, causing a remarkable decline of the stock price of Luckin Coffee. On February 3, Luckin issued a statement denying the allegations in the report provided by Muddy Waters. On February 4, Luckin's underwriters, China International Capital Corporation and Haitong, responded that the allegations lacked evidence. Since Citron also expressed skepticism about the Muddy Waters report, Luckin shares increased by 15.6% on the day. In March, shorting positions in Luckin Coffee doubled and numerous people were betting against its stocks. Finally, on April 2, Luckin admitted that the total sales related to fake transactions in the second to fourth quarters of 2019 were about 2.2 billion yuan, making its shares falling considerably by 85%. It should be emphasized that this incident of Luckin Coffee was not led by Muddy Waters or Intentional targeting at Chinese concept share, but because there were indeed many internal problems existing in Luckin Coffee.

2.1 The Unrealistic Expectation of the Company's Stock Price

First of all, managers of Luckin Coffee knew exactly that the expectations of the general investors on stock price was rising at an amazing speed. Taking advantage of the information they controlled, these managers knew Luckin's financial numbers would not surprise investors at all but they still took a big risk by manipulating some key financial indicators or non-financial information to define Luckin as a very promising stock in order to boost investors' confidence.

2.2 The Flawed Business Model

At the same time, Luckin Coffee had a flawed business model. Luckin Coffee attracted customers by means of coupons and discounts. Its advantages presented to customers were not its style, service, or culture, but the free coffee and discount coffee. This has made the company have no transaction without coupons and discounts, and fail to cultivate customer loyalty. As a consequence, Luckin's actual sales and effective prices showed that it was losing a lot of money, contrary to management's promise that this business model would increase revenue and profit. It also made the majority of investors have an illusion that the price of coffee could be reduced through discounts, so as to increase sales volume, revenue, and profit.

2.3 The Problem of Inventory Quantity Fraud

At the same time, Chen Yongqing (2020) noted that, Luckin Coffee also had the problem of inventory quantity fraud. In the second half of 2019, Luckin Coffee's revenue grew rapidly, but its inventory remained at about 2 million yuan. In normal cases, when revenue increases, the company needs more raw materials, but Luckin's inventories even fell in the third quarter, which was abnormal and suspicious [1].

2.4 The Risk of Capital Disruption

Li Weibin and Zhang Yifan (2020) also pointed out that, as a coffee consumption service brand, stores of Luckin Coffee were generally located in concentrated offices and commercial areas where the rent was high especially in good locations. The corresponding operating expenses were also high, requiring a large amount of financial support [2]. If the store could not make profits as soon as possible or the profits were weak, it was easy to cause capital shortage under the condition of poor asset operation effect. Luckin had invested a large amount of capital in store expansion and user subsidies during its operation, resulting in a cumulative loss of 2.27 billion yuan in 18 months, that was, an average loss of more than 4 million yuan per day. Therefore, Luckin had to solve the problems of loss and capital turnover through continuous financing, so there was a risk of capital disruption behind the business model that seemed to play an important role in promoting the development of the company.

3 The Positive Effects of Short Sale on the Capital Market

3.1 Monitoring the Market

Short sale itself is a market trading mechanism without value bias or emotional color. However, after a series of incidents against Chinese companies, people seem to take a different view of the term "short sale". In the eyes of many individuals, short sale targeted at Chinese companies is a groundless rumor, or even a disguised attack to undermine China's economic development. This understanding is inappropriate because it reverses the cause and effect of this matter. The stock of a shorted company is falling not because someone is shorting it, but because the company already has problems that attract the short-seller's attention. Short sellers act as messengers to bring problems to light, helping to preserve the health of the market and the interests of mass investors. Without short sellers, the market would lack a monitoring force; With short sellers, fraud and wrong decisions of listed companies will be greatly curbed. Therefore, under normal market conditions, short-selling is legal, and making money from it is a just investment. Moreover, in most of the short-listed companies, false disclosure of financial information is widespread. These short-listed companies have defects such as imperfect corporate governance and low quality of financial information, which give short-selling institutions opportunities to take advantage of. Therefore, the general public does not need to have too much fear of short selling. If short sellers do emerge, there will be better supervision over the fraud of listed companies. For investors, it is also conducive to developing a healthier and more positive investment environment. As a consequence, an objective understanding of short selling is not only a summary and review of past experiences, but also a preventive measure against possible market risks in the future.

3.2 Optimizing Resource Allocation and Timeliness of Information Transmission

Short selling has other potential benefits beyond its supervisory role on public companies. According to Liu Liyan, Zhou Ying, Ye Zhou, and Yang Bo (2021), short-selling mechanism corrects the mispricing and misallocation of resources in the market in a timely manner, thus guiding the allocation of market resources to achieve a more efficient allocation. Short-selling institutions generally have no interest relationship with enterprise owners and operators, and their independence is much higher than that of the accounting firms [3]. In addition, due to the limitation of audit time limit, the timeliness of financial fraud information transmission is affected. After Luckin admitted financial fraud, Ernst & Young, the audit institution of Luckin, responded that Luckin's audit reports from 2017 to 2018 were found no major problems, the audit report of 2019 was not completed, and there were serious falsifications of revenues and expenses from the second quarter to the fourth quarter of 2019. The issue was taken to the company's audit committee. Short selling institutions can release short selling reports in a timely manner without time limit after investigation and evidence collection, which is more conducive to the timely discovery of problems in the market. Li Chuntao, Liu Beibei et al. (2017) demonstrated that short sellers, as informed traders, transmit information to other investors through trading volume and price fluctuations, acting as an information intermediary [4].

3.3 Increasing Market Liquidity

Short-selling also helps to increase market liquidity at the same time. Market liquidity is one of the important indicators to measure whether a market function and mechanism are perfect. Woolridge and Dickinson (1994) concluded that short sellers increase short selling volume in rising markets and reduce short selling volume in falling markets, so as to provide liquidity to the whole market [5]. Chinese scholars shi-guang liao and chao-jun Yang (2004) studied the Hong Kong stock market of China and the shorting of the stock market trading volume and stock volume, and discovered that short trading volume and stock volume showed a very similar situation. The existence of short-selling greatly enhanced the liquidity of the stock market and played an important role in the active market [6].

3.4 Acting as a Significant Part of the Market

In a longer time dimension, the occurrence of shorting events is not accidental. Many institutions, including investment banks, may be involved in the initial listing of the company, and subsequent accountants and lawyers will also have an impact on the final shorting results. In other words, short selling based on information disclosure is not a simple trading link, but closely related to the legal system and market structure. The market can be seen an organism as a whole, and short sellers are also a part of it that make the whole market system more advanced and perfect, for the reason that no institution or strategy can achieve success all at once. All kinds of investment institutions and strategies will compete with each other in the market, survive and evolve. Only by constantly updating their knowledge and skills in social competition can they avoid being eliminated by social progress.

4 Vicious Short-Selling Incidents

It is undeniable that in the research reports of some short selling institutions, there is no reasonable evidence for the questioning of listed companies, but the intention is to cause panic among investors and cause stock prices to fall in order to gain profits. Listed companies and investors may also suffer losses and have to take corresponding measures to refute. For example, when shorting Spreadtrum Communications in 2011, Muddy Waters' evidence chain was only that the company's operating revenue nearly doubled in 2010 after the CEO and CFO's resigning in 2009, so Muddy Waters claimed that the company's financial data must have been falsely disclosed and falsified. However, all the questions raised were not based on facts. After a swift counterattack, Muddy Waters founder Michael Carlson publicly admitted to misreading Spreadtrum's financial report on July 1, 2011, four days after the short position. However, compared with the serious problems that do exist in enterprises, vicious short selling incidents such as the case mentioned above are very few. Besides, the founder of the Muddy Water has sufficient experiences regarding dealing with China's companies and successfully shorted many Chinese companies in the past. Therefore, after noticing some changes in the financial statements of Spreadtrum Communications, he hastily publicised the problems of Spreadtrum Communications and attempted to short it. To his disappointment, after causing the share prices of Spreadtrum Communications to tumble, Muddy Waters was caught off balance by Spreadtrum's subsequent response and the market's support, and had to admit only two days after publishing the query that the interpretation was "wrong". As a result, short sellers will be more cautious in their future shorting choices because of the high costs and risks of shorting failures.

Moreover, even if there are very few intentional and malignant short-selling behaviors, it is not the fault of short-selling itself, but the fault of people who use it improperly, and this can be solved by improving the system. Investment banks and other service intermediaries are expected to perform adequate due diligence and on-the-spot investigation shall be conducted on the specific business, profit model, and business model of the proposed listed company. Moreover, the governance mechanism, financial system, and historical data should be focused on control. Zhang Binghong (2017) revealed that in addition to the information that the China Securities Regulatory Commission (CSRC) considers necessary to disclose, some companies with good performance often voluntarily disclose more information, so as to convey positive signals to the majority of investors and reduce information asymmetry [7]. In terms of external governance, Wu Peng, Lu Shan et al. (2019) took Chinese A-share listed companies as samples and confirmed that media attention could play an effective role in supervising financial fraud. Compared with positive media attention, negative media attention could restrain financial fraud better [8]. Huang Shizhong (2019) suggested that the sentencing standards should be revised and strict laws should be adhered to. Economic penalties and eliminate regulatory arbitrage should be increased. Corporate governance should be improved. The mechanism of checks and balances should be strengthened as well [9]. Moreover, the survey of Han Hongling, Liu Siyi, Lu Weichao, and Chen Hanwen (2020) indicated that for regulators, the capital market reform with information disclosure as the core should be steadily promoted [10]. It is not difficult to see from the whole shorting event that in addition to the constantly improvement and optimization of information disclosure issues, the connotation of high-quality information disclosure should also be further studied.

5 Conclusion

To sum up, the shorting mechanism has more advantages than disadvantages for the capital market as a whole. Its advantages mainly include the supervision of listed companies, the correction of mispricing and resource allocation in the market, the improvement of the timeliness of financial fraud information transmission, and the enhancement of market liquidity. From the global perspective, the deficiency of this paper lies in that the content may not be comprehensive due to the rapid change of the market. In future studies, more research is needed to not only respond to a single event and make analyses or interpretation from the perspective of a single shorting behavior, but also focus on the long-term system construction according to the lesson provided by each short events as well as what might happen in the future, in order to reflect on the overall system, improve the shorting mechanism, and build a benign shorting environment. At the same time, the mass investors should be guided appropriately and intermediaries are supposed to participate in legitimate short selling, so as to promote the price discovery mechanism of the market and play the governance effect on numerous companies.

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