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Short selling and activism don't go together

Contrary to the rationale of short selling, third-party investigative reports from activist short sellers violate Sebi regulations

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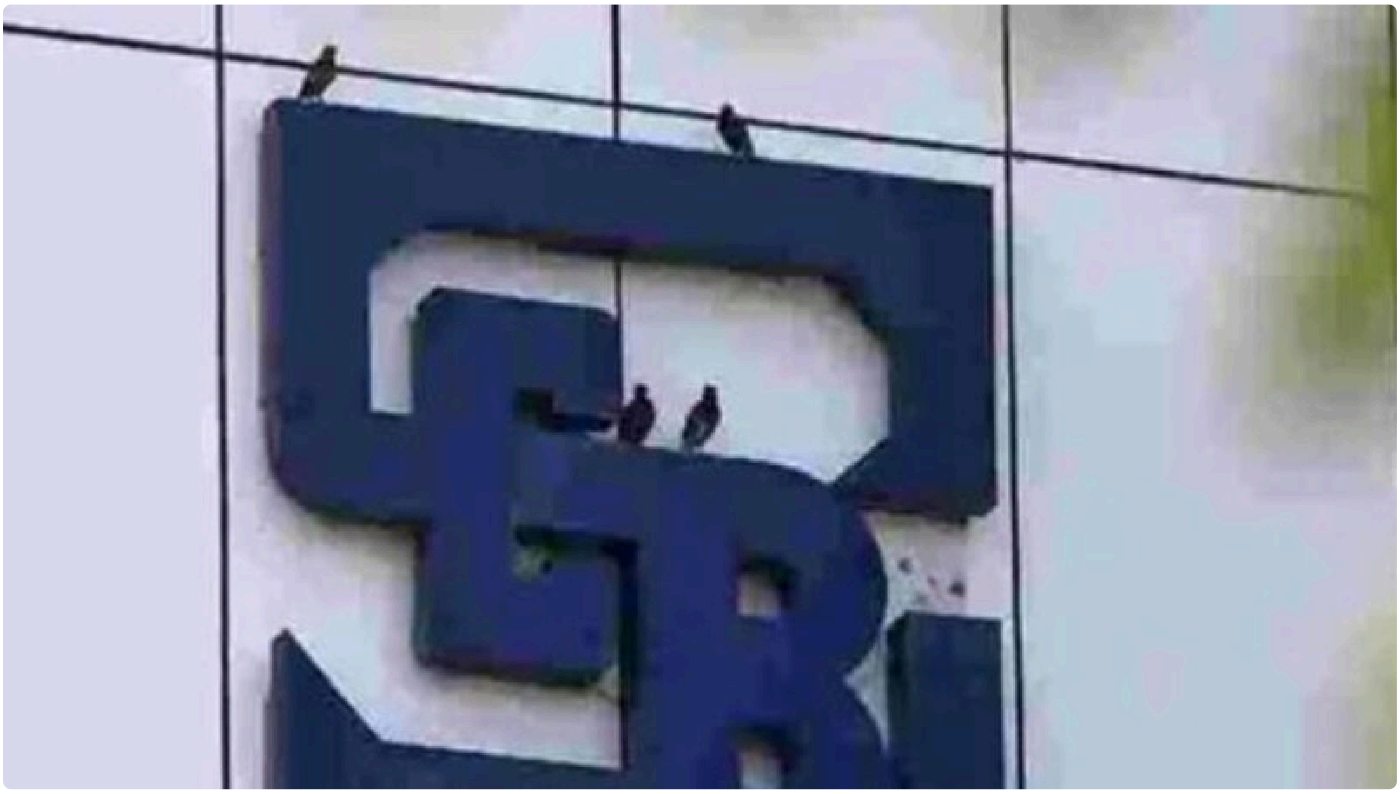

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The Adani-Hindenburg saga has created volatility and waves of uncertainty in the markets. While the media has been proactively covering the story, this article explores the propriety of investigative disclosures by a short seller, leaving the jurisdictional question aside. The commentary is not on the merits of the "investigation findings" covered in the Hindenburg report.

The underpinning theoretical support for short selling is premised on its ability to correct market distortions such as overvaluation (bubbles) of securities. Therefore, the regulatory and market justification for allowing short selling is founded on the play of the market forces. Some investors may short sell a security based on their assessment of a bubble, over-pricing, or overvaluation. In order to remove information asymmetry and help other market participants to take informed decisions, aggregate short position in a security is disclosed by the exchanges, usually as short ratios (short sales to total sales) daily/periodically. The Securities and Exchange Board of India (Sebi) provides a framework for short sales, though under rather tight conditions, on this market distortion correction assumption.

However, a short seller publishing its own research report is grounded in questionable public interest, given the basic conflict of interests involved. When the short seller goes further and publishes an investigation report, that too, unverified by a regulator or authorised third party, it is entering dangerous territory. What is the credibility of a private, unauthorised report?

Markets panic on negative news, even fake news, fast, and in herds. It is like shouting: “Look, this company is on fire; I have already shorted it; please sell the shares of this company and run away with whatever you can get.” Even with a little smoke (real or imaginary), investors would resort to panic sales. This is not an information symmetry-enhancing action. Rather, it is dangerous for the shorted entity and, at times, for the economy. Because a vested interest’s message is always mixed with intentions and it can lead to a “self-fulfilling prophecy”.

Recall the Satyam debacle of 2009. The chairman of Satyam made a disclosure to the regulator that the company had doctored its accounts for years. After due diligence, the regulator published the disclosure and initiated appropriate regulatory actions. The regulator received similar “disclosures”, for some days, purportedly from chief executives of several companies. It did due diligence and closed them; without making them public. While the disclosure from Satyam was correct, others were not. Had all such “disclosures” reached the market directly, the stakeholders would have suffered irreparable loss, as they would not have known upfront whether the information was correct.

Such third-party disclosures, often purportedly backed by “investigation” are becoming common. Their disclosure could be right or wrong; and unbiased or motivated. But it has the potential to cause irreparable damage in seconds. To contain damage, the regulator keeps burdening the listed entities to confirm or deny any information reported in the mainstream media. This only adds to the cost of doing business, while billions may evaporate as the market reacts to disclosures made in some remote corner of the internet.

If such reporting is for highlighting misgovernance or/and misdeeds, there are ways of bringing them out: Informing the regulatory authorities, or the media, or using the whistle-blower mechanism. Or as research analysts, investment advisers, proxy advisers, depending on which hat one is legally wearing. Short sale is a market-enabled discipline, not a vested-interest-advertised shock therapy. Giving multiple caveats, like in the Hindenburg report, that the report should not be taken as any financial or trading advice is taking shelter under the words of law, but evading its spirit.

Let us apply the test, combining the spirit of short selling juxtaposed with Sebi regulations. Regulation 4 of Sebi (Research Analysts) Regulations, 2014, states: "Any person located outside India engaged in issuance of research report or research analysis in respect of securities listed or proposed to be listed on a stock exchange shall enter into an agreement with a research analyst or research entity registered under these regulations". Regulations 15 and 16 impose strict conditions for avoiding conflicts of interest through well-documented internal policy and by enforcing limitations on trading by research analysts. Sebi (Investment Advisors) Regulations, 2013, mandate that they shall prevent conflict of interest by separating all their trading/market-related activities and advisory activities.

Short sellers are traders. The implicit principle is that unless mandatory, trading and trading positions of entities are private information. Whether an investor is short, or long, or neutral in securities trading, it does not disclose that position specifically, unless it crosses specified thresholds of equity holding under takeover regulations. Their trade data is available to the public on the exchange trading screen without the identity of the trader. Further, as in India, a consolidated position of short trades is disclosed by the stock exchanges, which does not reveal any identity. Anonymous trading in the securities market has been introduced with a purpose and for good reasons.

Apart from violating the market logic and the spirit behind short sales, short sellers publishing entity-wise investigation findings violate the spirit of Sebi regulations on research analysts and investment advisers. Further, an activist mode of investigation by short sellers would violate either the Prevention of Insider Trading (PIT) or Prohibition of Fraudulent and Unfair Trade Practices (PFUTP) Regulations. If their investigative findings are correct, they become insiders since they have become privy to "unpublished price sensitive information" and "trading on the basis" of such information violates PIT Regulations. If their allegations are false, they are trying to manipulate the market by publishing unfounded charges against an entity and, thereby, falling foul of the PFUTP regulations. Active short selling, along with public disclosure of their investigation findings, is like combining several conflicted roles, which is not good for the health of the financial markets.

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