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Bridging the information gap

U.S. regulators should protect Chinese public company investors from attacks by short sellers

BY MITCHELL NUSSBAUM

In recent weeks we have seen a handful of Chinese companies listed on U.S. exchanges involved in significant controversy. Many of these incidents have been triggered by the inability to file timely annual reports, causing our exchanges to halt the trading of these companies or to delist them. However, what is troubling about these events is the common cause behind many of them—so-called research reports alleging fraud and overstated financial results as reported by these companies in their Securities and Exchange Commission filings.

What is little-known is that some of the authors of these damaging research reports hold, or have been commissioned by an investor who holds, a short position in the subject company's stock. The potential for abuse is greater when writing about Chinese companies because there are gaps in information between what the U.S. investor typically knows about issues such as the subject industry in China, the identity of customers, suppliers and Chinese business practices, for example. These facts are difficult to verify, and it is easy for unscrupulous individuals to utilize incorrect or misleading information, which can cause substantial damage to long-term investors.

These research reports have also initiated an unprecedented amount of class-action litigation and SEC investigations against the accused Chinese companies. Most recently, large accounting firms have refused to sign off on the audits of these companies out of fear that they may face litigation or SEC investigation. Absent timely financial information, our exchanges have been forced to halt trading, allowing short sellers to cover their positions at unbelievably low levels while wiping out investors. This of course has had the expected effect—a conclusion by the public markets that there is systematic fraud in China or an inability to create transparent companies. The overall effect has been a loss of market value of tens of billions to investors and an unprecedented lack of confidence in investing in Chinese companies—and huge gains for the short sellers.

While some Chinese companies may have significant issues, it is unfair to tar them all with the same brush. Many Chinese companies have vehemently defended themselves against the allegations, but others have volunteered to go private or leave the U.S. public markets for Hong Kong or other exchanges where they feel they are valued fairly. In the past two years the Hong Kong Stock Exchange has become the No. 1 worldwide exchange when ranking the number of initial public offerings and their dollar value conducted across all global exchanges for all companies. The Nasdaq Stock Market is no longer even in the top five globally.

Currently there is been no enforcement by U.S. regulators to ensure the information in these research reports is accurate. What is needed are more modern regulatory practices to deal with these issues rather than scare these companies away.

Our regulators should police the veracity of the information disseminated to investors from each side. The authors of these reports and their underlying short sellers should be held accountable for information they disseminate as management of these public companies.

Disseminating false information that causes an investor to sell should be treated the same as causing an investor to buy on false information. To date, there has been no legal consequence or enforcement actions brought against any short sellers for disseminating false information on Chinese companies, while the reward has been substantial. There are many who believe that these short sellers will follow these companies to other markets. However, this is not the case. For example, the Hong Kong Stock Exchange does not allow short selling unless a company has exceeded a substantial size, and it only allows short selling when there is an uptick in the stock price. We have no such equivalent in the United States.

Also Chinese management teams that disseminate false information or financial results need to feel the pain of the consequences of these actions to defer fraud from being perpetuated on U.S. markets—this is the challenge for our government regulators. Confidence needs to be restored, or the consequences of getting it wrong will be devastating.

A growing portion of the world's future economic growth will come from China and greater Asia, and this growth needs to be sustained by finance obtained from the public markets and private equity. If we can establish confidence, the region's companies may continue to seek and maintain U.S. listings.

If we are unable to meet this challenge, they will not sit idly by. Chinese companies, as well as companies from other parts of the globe concerned about these practices, will undoubtedly find a suitable solution in Hong Kong or other public markets outside the United States and cause a paradigm shift in the center of finance across the Pacific, a shift that would have dramatic consequences for our own economy and the future growth of U.S. financial markets. ■

Mitchell Nussbaum is chairman of Loeb & Loeb LLP's China and emerging-markets practice, as well as chairman of the securities practice group. He has represented more than 75 Asian companies who have listed on U.S. exchanges, and is actively counseling Chinese companies preparing for and responding to investigations and litigation resulting from short-selling attacks.

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