Current trends in short selling 'activism': boards and management are advised to consider preparing themselves against an attack

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After its controversial role during the GFC, short selling is again the focus of increasing debate both in Australia and overseas. Short selling (or 'covered' short selling) is where someone borrows stock (for a fee) which they then sell, in the hope that the price of the stock will fall and they will be able to buy it back at a lower price, and hence profit on the transaction. However, if the price of the stock rises they will make (a potentially unlimited) loss. There is a widely accepted argument that short selling improves market efficiency (specifically because it provides liquidity and 'facilitates price discovery' by identifying overvalued stock and restoring the price). For this reason it is permitted in Australia and in other jurisdictions (subject to varying degrees of regulation).[1] Short selling can also specifically benefit longer-term shareholders in target companies, although some recent developments suggest it can in some cases be detrimental. In any event, as explained below, from the perspective of management and boards becoming the target of short sellers is something to be avoided. In this context, despite the obvious distinction in their ultimate goals, it can be useful to consider some of the strategies that companies have been advised to implement in order to guard against hedge fund activists. In particular, both short sellers and activists target perceived weaknesses, for example in a company's strategy, operations or governance.

Short sellers can benefit longer-term shareholders

Some academics have argued that short sellers are sophisticated traders, who are more informed than average traders, and can therefore act as an external governance mechanism by actively monitoring and disciplining management.[2] This can have two benefits for shareholders. First, the threat of being targeted by short sellers can help to ensure that management remains focused on maximising shareholder value. Short sellers can be particularly effective in this role because they are thought to be skilled in identifying issues that other investors may not be able to see, therefore acting as a strong deterrent against management misconduct or underperformance. Second, if short sellers do identify overvalued stock and 'short' a company, this can ultimately inform management and force it to resolve identified problems and restore value, for example by making strategic or operational changes. Short sellers can also identify, and therefore help address, financial misconduct or governance failings which can (in the long run) benefit shareholders.

However, they can also have a negative impact on corporate prospects

Despite the potential benefits short selling brings, as one academic says, short sellers are 'often portrayed by the media to be the villains of the financial markets'…'presented as evil traders that drive down the prices

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[1] For the position in Australia see http://download.asic.gov.au/media/1241087/rg196-short-selling-20110429-updated-asx200-to-asx300.pdf

[2] See for example the discussion in Xiaoran Ni 'The Real Effects of Short Selling on Firm Risk-Taking: Evidence from a Quasi-Natural Experiment in China' 15 September 2015, via SSRN and Massimo Massa and Bohui Zhang 'The Invisible Hand of Short Selling: Does Short Selling Discipline Earnings Management?' 9 October 2014, via SSRN

of good companies.[3] One of the key criticisms in this regard is that by targeting a company short sellers can cause market panic, which can result in the price of 'shorted' shares falling dramatically, including to below their true value. This can be the case particularly where a short-selling firm releases research alleging some accounting, operational or governance issue because the market can overreact (especially where the allegations are accompanied by high profile media attention). In this regard it is interesting to note that The WSJ reported earlier this month that 128 research reports critical of companies have been published to date this year in the US. This type of targeting might not be a problem for longer-term shareholders, and in fact could offer a buying opportunity, but it might have a negative impact on those who are unable to hold the stock until the price is restored. In addition, in some cases the share price may take a long time to correct, particularly if the company's reputation is seriously damaged.

A recent paper, *The Real Effects of Short Selling on Firm Risk-Taking: Evidence from a Quasi-Natural Experiment in China*, by Xiaoran Ni (Tsinghua University, School of Economics & Management) asserts that there is another potential downside for shareholders – that firms react to short-sales pressure by undertaking less risk.[4] The author examines the impact of a March 2010 regulatory change in China, which allowed short selling only of securities on an official short sale list of 90 stocks. The list was periodically revised (a total of 17 times between 2010 and December 2014), which created 'time-series and cross-sectional variation in terms of short-sales pressure for firms listed in [the] Chinese stock market'.

The author relies on existing theories relating to short selling to propose two competing hypotheses. The first is that short selling encourages risk-taking, on the basis that: short sellers are active monitors and the threat of short selling mitigates 'value-destroying under investment in risky projects'; and that short sellers provide information to managers about stock price which means those managers can learn about 'prospects of profitable projects and engage in more value-enhancing risky projects'. The second hypothesis is that short selling impedes firm risk-taking, because it imposes short term pressure on management. That is, if managers have incentives to keep the stock price high, they may sacrifice long-run growth and cut investment in risky projects to boost short-term profits. This can be exacerbated if their 'wealth and human capital are closely tied to firm performance' as they will want to limit their own exposure to short-selling.

According to the paper, the research found that firms reacted to the increase in short-sales pressure by undertaking less risk. Specifically, after the inclusion of the short-sales list, firms' cash-flow volatilities decreased significantly, and those firms held more cash, took less debt, invested less in R&D and were involved in fewer mergers as acquirers compared to other firms in the same industry. The study also found that following inclusion in the short-sales list, holdings by dedicated institutional investors 'significantly' dropped which appeared to further impede firm risk-taking (on the basis that dedicated institutional ownership was found to be positively correlated with firm risk-taking). In conclusion, the paper asserts that '[o]n the whole, short selling could exaggerate managerial myopia and frustrate dedicated institutional investors and induce firms to undertake less risk, which is harmful to economic growth' (on the basis that prior studies have found that 'taking risk is almost always a prerequisite for creating shareholder value and a fundamental underpinning of long-term economic growth').

However, another interesting finding of the study was that firms with stronger internal governance were 'immune' from this effect of increased short selling pressure. Specifically, the author found that the negative impact of short selling was mitigated in subsamples with a smaller board, high proportion of independent directors and low ownership concentration. In addition, managerial ownership significantly increased following inclusion in the short-sales list in subsamples with strong internal governance, but not at those with weak internal governance.

The potential impact on boards and management

For boards and management, becoming the target of short sellers can raise a number of issues. Although some commentators might perceive any negative impact as 'just desserts' for a poorly performing board or management team, to the extent that short sellers drive the price down unreasonably, there may be unjustified damage to the reputation of the company, and to its board and management, (that is potentially difficult to remedy), as well as negative impacts on executive remuneration to the extent it is tied to share

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[3] Carole Comerton-Forde The Conversation 25/10/12

[4] Xiaoran Ni 'The Real Effects of Short Selling on Firm Risk-Taking: Evidence from a Quasi-Natural Experiment in China' 15 September 2015, via SSRN

price. Being targeted by a short seller can also be extremely distracting for boards and management, as well as a drain on corporate resources, especially if short sellers have made allegations that need to be addressed.

The recent example of US pharmaceutical company Valeant shows just how damaging being the target of a short seller can be. In that case, short-selling firm Citron Research released a research note alleging that the company's ties to speciality pharmacies helped it create invoices that artificially inflated revenue. Valeant 'categorically' denied the allegations. According to media reports, Valeant said that 'Citron's false and misleading statements…appear to be an attempt to manipulate the market in an effort to drive down Valeant's stock price'. One commentator asserted that Citron's proof for its 'explosive charge that Valeant is another accounting fraud like the onetime energy highflier Enron was more circumstantial than conclusive'. In a note to clients, Nomura analyst Shibani Malhotra reportedly said the firm believes the concern raised by Citron is likely 'misinformation' and the fall in Valeant's stock price offers a buying opportunity. However, Valeant's stock reportedly fell by as much as 40% following the note's publication, before regaining some ground. Shares of some Valeant competitors also reportedly 'fell sharply'. In addition, for Valeant's board and executives the situation has been a huge distraction as they have been forced to devote a great deal of time and effort in soothing investors' nerves. For example, they were faced with a long conference call to about 3,800 people in an attempt to restore investor confidence.

Meanwhile, it was reported that the fall in Valeant's stock price represented about a US$550 million loss for activist Bill Ackman's hedge fund Pershing Square Capital Management (although he reportedly added to his holding following the price fall), while activist fund ValueAct apparently suffered a US$422 million 'paper loss' on its investment in Valeant. Activist Insight's editor Josh Black said '[i]ronically, given the regular accusations of short-termism levelled at them, it was the activist investors who really suffered', and that '[o]ne of the salutary lessons from this extraordinary day is the influence of activist short sellers and investigative research bodies'.[5]

The Valeant case also highlighted another potential issue for executives that can arise where short-selling activity results in dramatic falls in share price, when a financier reportedly sold 1.3 million Valeant shares that had been pledged by the company's CEO in respect of loans totalling US$100 million. As a result, both the CEO and the board attracted criticism, partly because (according to The WSJ) the trade 'contributed to a selloff that sent the company's shares down 14%' therefore extending the rout in its share price. However, the shares subsequently rallied, The WSJ reported, 'with some investors expressing relief that the previous day's selloff was at least in part a forced sale, rather than a large holder deciding to bail out'.[6]

In Australia at least, companies may be protected to some extent from short sellers recklessly or negligently spreading false information in an attempt to drive down share price by the market misconduct provisions in Part 7.10 of the *Corporations Act 2001*, (specifically, s 1041B (which prohibits creating a false or misleading appearance of active trading),s 1041E (which prohibits false or misleading statements which induce trading in financial products or effect the price of financial products) and 1041F (which prohibits inducing a person to deal in financial products by making false, deceptive or misleading statements)). In addition, further constraints on aggressive short selling strategies may arise from the terms of share borrowing arrangements. In particular, they are generally limited to a term of 12 months (to comply with s 26BC of the *Income Tax Assessment Act 1936*), and often give lenders the right to recall stock in order to participate in corporate actions (for example to vote at AGMs).

Short selling trends in Asia

Although short selling has recently been making the headlines in the US, it also has a growing profile in Asia. The WSJ recently reported[7] that short sellers and activist-research firms there are taking on higher-profile targets in preference to the lesser-known firms they have been focussed on in previous years. In the past, says The WSJ, campaigns by short sellers and activist research firms 'pushed low-profile firms into the limelight, and exposed examples of dubious corporate governance in China, which in some cases has resulted in regulatory action'. The WSJ puts the change down to 'a shaky corporate outlook amid spending pullbacks', which 'has given Asian firms less wiggle room to paper over problems like high debt levels and

[5] See Governance News 27/10/15
[6] See Governance News 10/11/15
[7] The Wall Street Journal 6/11/15

inconsistent accounting standards'. The result, it asserts, is 'an opening for short sellers and research firms in the region to lob bruising critiques against some of the region's most-recognized companies'. According to Activist Shorts Research, research firms have published 'highly critical reports' targeting nine Asian companies since January this year, compared with seven last year, and predicts that that number will rise.[8] The article reports that according to data from Markit, the total value of shares on loan in Asia, 'a proxy measure for short selling', has doubled to around US$120 billion over the last five years from around US$60 billion in 2010, 'levels not seen since the financial crisis'.

Some thoughts for boards and management

Even though short-selling pressure might help a company to see (and therefore resolve) its own weaknesses, discovering them through short-selling activity is obviously better avoided, and boards and management should consider preparing themselves against an 'attack', particularly in light of recent global trends. In this context it is worth considering some of the steps that companies are advised to take to ward off activist hedge funds. Although this might appear counter-intuitive – activists identify companies they believe are undervalued and buy stakes in the hope that they can increase the value in the short or long term, whereas in contrast short sellers identify companies they perceive as overvalued, and hope the price will fall – there are some important parallels between the two strategies. In particular, taking steps such as acknowledging and closing any significant weak spots in financial performance, evaluating the board to ensure it is adding maximum value, proactively communicating strategy to the market, engaging frequently and effectively with key shareholders, and focusing on corporate governance and internal controls can all help identify weaknesses before they are targeted by short sellers.

MinterEllison's corporate team advises that short sellers often target companies whose board and management have an 'over-inflated sense of what their company is worth'. They suggest that a useful motto for the effective handling of short sellers is 'under promise and over deliver'. In other words, 'clear, meaningful, accurate and timely disclosure is key so that the market gets a clear understanding of the business'. In this context, the 'over delivery part' of the motto is important because the only way short sellers will learn to leave companies alone is to suffer painful losses when the share price rises on positive news.

US lawyer and commentator Ronald Barusch recently raised another interesting point relating to disclosure. He asserted that drastic falls in share price following analyst or research statements may be linked to the fact that corporate disclosure has become so opaque that even sophisticated investors cannot properly evaluate allegations made.[9] The effect is that 'between the mind-numbing disclosure of voluminous draconian risks and [the] massive amount of information included in reports, even sophisticated investors can miss the plot'. This may provide further incentives for companies to ensure that their corporate disclosures are clear and meaningful.

In terms of 'responding' to an attack by short sellers who have 'invested' in the share price going down, the issues are obviously very different from those that companies need to consider when responding to hedge fund activists who have invested in the share price going up. However, two tips still apply: actively engage with and reassure other large shareholders and the market more broadly, and listen to the issues raised by short sellers and where appropriate resolve or otherwise address them.

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[8] A recent high profile example is Noble Group, see Governance News 11/8/15
[9] The Wall Street Journal 30/10/15