

DEMYSTIFYING SHORT SELLING: A STEP-BY-STEP GUIDE TO PROFITING FROM FALLING PRICES

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ABSTRACT

The rapid development of China's capital market in recent years, coupled with the advent of the big data era, has opened up new avenues for enterprise growth. Enterprises, while actively engaging in technology research, development, and innovation, are confronted with pressing financing needs. In response, some companies are exploring listing on overseas capital markets.

However, the year 2022 brought a significant challenge as the U.S. Securities and Exchange Commission (SEC) unveiled its "pre-delisting" list, which encompassed over 150 Chinese concept stocks. These stocks now face the looming threat of delisting and are increasingly targeted for short-selling by foreign institutions, resulting in not only a loss of refinancing opportunities but also substantial financial consequences.

This paper focuses on NIO, using two short-selling incidents as a starting point. It employs a comprehensive analysis of the short-selling transmission chain, examining the roles and impacts of each stakeholder within the short-selling mechanism. The objective is to identify recommendations and strategies to mitigate the challenges faced by Chinese concept stocks in the context of short-selling. The insights provided aim to serve as valuable references for listed companies, accounting firms, investors, and government regulatory bodies.

Keywords: Chinese Concept Stocks, Short-Selling Mechanism, Overseas Capital Markets, Delisting Risk, Financial Regulation

Introduction

In recent years, China's capital market has developed rapidly, and the arrival of the era of big data has also brought more possibilities for enterprise development. Enterprises are also facing severe financing needs while following the trend and actively participating in technology research and development and innovation. Therefore, some companies choose to list in overseas capital markets.

In 2022, the U.S. Securities and Exchange Commission (SEC) announced the "pre-delisting" list, of which more than 150 Chinese concept stocks were included. Chinese concept stocks are facing the risk of delisting, and Chinese concept stocks are frequently shorted by overseas institutions, which not only loses the ability to refinance, but also pays a huge price.

This paper intends to take NIO's two short-selling as the starting point, based on the perspective of the transmission chain of short-selling, through the analysis of the role and influence of each subject in the short-selling mechanism, to seek suggestions and countermeasures for the short-selling of Chinese

concept stocks, in order to provide possible reference for listed companies, accounting firms, investors and government supervision.

1. Case Background

2.1 NIO

2.1.1 Company Profile

NIO is a smart electric vehicle brand, which is committed to creating a pleasant lifestyle for users by providing high-performance smart electric vehicles and ultimate user experience. NIO was registered and established in Shanghai on November 25, 2014, and has maintained a rapid expansion trend. It has received more than USD 7 billion investment from dozens of well-known institutions such as Temasek, Baidu Capital, Sequoia, Magnolia, Lenovo Group, Warburg Pincus, TPG, GIC, IDG and Joy Capital. NIO successfully landed on the New York Stock Exchange in September 2018, landed on the Hong Kong Stock Exchange in March 2022, and successfully landed on the Singapore Stock Exchange in May 2022.

2.1.2 Business Model

NIO's business model is mainly composed of direct mode and battery rental mode, which complement each other. The user model has laid the customer group of the battery rental model. The battery rental model has brought changes in consumption habits to users and broadened the customer base.

NIO adopts the direct sales model like Tesla, bypasses the 4s store, and has no middleman to make a difference. It has established an experience center and an online direct sales model. All the services involved are directly provided by the brand, creating a unified and transparent price system and an exclusive club for NIO car owners. This way of direct docking from the brand has led to the emergence of NIO House and NIO APP. Users are organized into communities through NIO House and mobile APP with cars as tickets. The fundamental purpose is to maximize profits by fully tapping the needs and values of users. NIO has held NIO day and user meetings for many times, so that car owners can become fans, enhance their sense of identity and collective belonging, so as to have a large number of loyal users. The word-of-mouth among users is equivalent to soft radio, which attracts a large number of potential customers for NIO.

The popular battery rental mode " BaaS " (Battery as a Service), through the separation of vehicles and electricity, purchases models without batteries, which greatly reduces the threshold for purchase and is more economical and affordable. The subsequent rental of rechargeable, replaceable and upgradeable batteries will keep the batteries used by users in a healthy state, increase the value of vehicles, and make the car experience more sustainable. This model allows a large number of young groups to become their users. Most of the young groups will change cars in 3 to 6 years, and battery rental will be more cost-effective than buying a vehicle directly. The future consumption ability of the young group is unpredictable, and they may become a member of NIO's exclusive club in the future, so that NIO can maximize profits.

2.2 Case Review

2.2.1 The First Time be Shorted by the Citron

At the end of 2019, NIO's stock price rose by more than 60 times and its delivery volume exceeded 100,000 vehicles. However, in November 2020, Citron Research, a short-selling agency, issued a

shortselling report, which had three accusations against NIO: First, Tesla's price reduction will suppress NIO 's sales, which will lead to NIO 's stock price falling to the average Wall Street expectation; second, NIO 's valuation is too high; third, there are a large number of speculators.

2.2.2 The Second Time be Shorted by the Grizzly Bear

On June 28, 2022, Grizzly Research LLC, an overseas short-selling institution, issued a short-selling report on NIO, which pointed to NIO 's financial fraud and believed that NIO exaggerated income and net profit margin through accounting means. Due to the battery rental mode " BaaS ", we have set up a related party enterprise with partners. We sell the battery to us, and the owner subscribes for the battery service from us and pays the battery usage fee on a monthly basis. The first three accusations of the report are mainly aimed at NIO 's battery rental model: First, it inflates revenue. NIO sells batteries to Weiyang batteries, and includes the subscription fee within the battery life cycle (about 7 years) into the current financial statements at one time; second, the battery is oversold, NIO sold more than the actual demand of the battery, the battery supply surplus; third, the transfer of depreciation costs, NIO transferred battery assets to WEIDONG NEW ENERGY POWER TECHNOLOGY, saving depreciation costs of CNY 336 million. The fourth is to question Li Bin's interpersonal relationship, saying that Li Bin, chairman of NIO, is closely related to the core related party of Luckin Coffee's performance fraud case, Joy Capital, and its founder Liu Erhai.

3. Case Analysis and Discussion

Short-selling is a common way of operation in the stock futures market. When the stock futures market is expected to have a downward trend, the operator sells his chips at the market price, and buys them after the stock futures fall to earn the middle price difference. In the conduction chain of shortselling, the short-selling mechanism is located at the beginning of the conduction chain, and the shortselling report is issued to obtain benefits ; as the object of short selling, the image of listed companies is damaged, the stock price is low, and the valuation is evaporated ; shareholders own the company's shares, whether major shareholders or retail investors, will suffer economic losses because of the decline in stock prices ; the company is shorted, and the reputation of the accounting affairs as the " gatekeeper " is damaged. If the company has financial fraud, the accounting firm even needs to bear joint and several liability; the company's valuation evaporated, the investment bank's customer volume shrank, and the income decreased significantly; it is still debatable whether the competitors of the shorted enterprises can profit from customers and investors.

3.1 Short-selling Institutions

With the rapid development of China's economy and the rapid growth of emerging industries, many mainland Chinese companies are facing severe financing needs while expanding rapidly. Deng Lu (2017) pointed out that the company has a higher threshold for listing in the domestic market, the approval process is complex and the time is longer, and the overseas listing has a wider source of funds, and has a higher valuation in the foreign market^[1], so some companies eventually choose overseas capital market listing, known as " China concept stock company ".

Due to the large number of overvalued stocks in the financial market, short-selling institutions have emerged, such as the well-known Muddy Waters, Citron Research Company, Soros Team and so on.

Through on-the-spot investigation, interviews and looking for all kinds of information, they generally issue short reports around the company's data fraud, financial fraud and other suspicious places. At the same time, they borrow a large number of stocks at intermediary brokerages and sell them. Then they hype the short report, gradually control the market sentiment, and wait until the stock price falls to buy the stock back to make a profit.

The operating entities of the Chinese concept stocks are far away from the listed market. Generally speaking, investors have language barriers and relatively do not understand the market environment. This information bias leads to short-selling reports that are very likely to affect investors' judgment. In addition, the development of Chinese companies is changing with each passing day, and the accounting information opacity index of enterprises is high. Therefore, in the case of limited short-selling objects, the Chinese concept stocks are undoubtedly an excellent choice for short-selling institutions, facing greater short-selling pressure.

In many cases, the short-selling institutions lack substantive evidence for the allegations of Chinese stocks, and only point out the high possibility of fraud. However, due to the lack of understanding of the market and enterprises by investors, the information disclosed by enterprises is less, and the authenticity of the data of enterprises is easily questioned, which will lead to a series of chain reactions. Therefore, many times on the day the short report is issued, the stock price will decline sharply.

3.2 Company

Short-selling reports may damage the company's image, causing investors and users to worry, bringing panic to the capital market, especially retail investors. Investors sell stocks, stock prices plummet, and company valuations evaporate.

In 2020, NIO encountered the first short selling of citron. At the same time, the strategic game between China and the United States continued to deepen. The ' Foreign Company Accountability Law ' was passed, and the Chinese concept stocks had the risk of delisting from the United States and faced great challenges. At the same time, with the reform and development of China's capital market, the mainland and Hong Kong gradually relax the listing requirements, and the return of Chinese concept stocks has become the general trend.

In March 2022, NIO chose to land on the Hong Kong Stock Exchange by introducing the listing. The secondary listing has more exemption clauses than the dual listing, and the listing cost is lower. The secondary listing not only copes with the uncertainty of audit supervision in the United States, but also expands the investor base and reshapes its value. It is no longer affected by short-selling market sentiment. The opening price on the first day was HK \$ 160, and the Hong Kong stock market value reached HK \$ 267.041 billion (about RMB 215.769 billion).

On May 4, 2022, the SEC of the United States announced that there were 105 stocks in the list of "to be delisted ", including NIO. On May 20, 2022, NIO was officially listed on the main board of the Singapore Exchange, and successfully listed in the United States, Hong Kong and Singapore. On the day of its listing on the New Exchange, the third largest exchange in Asia, U.S. after-market prices rose by more than 5 %, improving its ability to withstand risks.

On June 28, 2022, grizzly bear issued a short report. On June 29, 2022, NIO issued a voluntary announcement saying that the report was full of a large amount of false information and misreading of NIO's disclosure of information. On July 11, NIO set up an independent committee and hired independent professional consultants to assist in the investigation, including an international law firm and a wellknown forensic accounting firm. Two months later, NIO issued a notice that its independent internal investigation was substantially completed.

3.3 Shareholders

Major shareholders own a large number of shares of the company. Once the stock falls sharply, the shareholder's wealth will shrink. And retail investors face short selling, if timely stop loss, sell stocks, to minimize losses; once you can't or can't sell your shares, you will suffer economic losses because of the decline in stock prices.

NIO was shorted by citron for the first time, and the share price of NIO automobile fell by 7.74 %. After the release of the second short-selling report, it caused a negative reaction in the market, and the share price of NIO Automobile fell for several consecutive days. In terms of the stock market, as of June 29, 2002, NIO shares closed down 2.57 %, the market value evaporated \$ 998 million; NIO Hong Kong's shares fell by more than 11.3 %, and its market value evaporated by more than HK \$ 37 billion. Singapore 's shares also fell more than 11.4 %, with a market value of more than \$ 4 billion.

3.4 Accounting Firms

Accounting firms are mainly responsible for auditing corporate accounting statements and issuing audit reports. If companies face short-selling, accounting firms will face questions from all sectors of society. Is it insufficient capacity or favoritism? Otherwise, in the face of their own work, after the audit process, why the firm did not identify the fraud of the enterprise in advance, but by the non-professional short-selling institutions found the company's fraud. In this case, the firm is equivalent to joint fraud and is likely to become jointly and severally liable.

3.5 Investment Bank

Investment bank is a non-bank financial institution and a major financial intermediary in the capital market. The main business of investment banks are listed business, mergers and acquisitions business and leveraged financing business, etc., according to the volume of the transaction from the commission profit. The company is shorted, its stock price falls, the market value evaporates, and the volume of cooperation with investment banks will be greatly reduced in the future; what's more, if the short-selling of enterprises leads to delisting, the investment bank will lose an important customer, lose a large number of opportunities for future cooperation and trading, and damage the interests of the investment bank. Therefore, the investment bank is generally reluctant to see the short-selling of enterprises.

NIO was shorted by grizzly bears for the second time. Many international investment banks, such as Morgan Stanley, JP Morgan, Daiwa Capital Markets, refuted the details of the short-selling report and did not support the grizzly bear's report, which stabilized market sentiment to a certain extent, and NIO 's market performance recovered.

3.6 Competitors

Generally speaking, the short-selling of enterprises will lead to the damage of corporate image, consumers and investors will turn into competitors, competitors will have more customers and investors, and the stock price of enterprises will increase. However, Fang Yi (2020) points out that the short-selling of Chinese stocks will not only affect their own credibility, but also have a risk spillover effect on other Chinese stocks, which will increase the overall systemic risk of Chinese stocks^[2]. Especially in the same industry, the stock price usually fluctuates in the same direction as the shorted enterprise. NIO was shorted by Citron for the first time, resulting in the same trend of the stock prices of several major new energy vehicles. NIO Motors fell 7.74 %, XPENG MOTORS fell 6.13 %, and Ideal Motors fell 1.83 %.

Both increase and decrease are hedged, and whether rival companies are really profitable is still debatable.

4. Thinking and Enlightenment

4.1 A Listed Company May Choose Dual Listing

Since 2015, the wave of the return of Chinese concept stocks has accelerated. In 2020, the US Senate passed the Foreign Company Accountability Act, and there is uncertainty in US audit supervision. Not only that, Liu Yuan (2016) proposed that Chinese companies frequently encounter short selling by overseas institutions, and most of the Chinese companies have little power to fight. The result is that the stock price plummets or even suspends, not only losing the refinancing ability, but also paying a huge price^[3]. In this way, the return of Chinese concept stocks is the general trend.

Among the Chinese concept stocks returning to A-shares or Hong Kong stocks, NIO chose to return to Hong Kong stocks to introduce secondary listing in Hong Kong, and then chose to list on the Singapore Stock Exchange. Compared with secondary listing, dual listing can enable Chinese concept stocks to issue new shares to achieve higher fundraising, and dual listing can introduce A-share investors, which is more conducive to the return of A-shares. NIO can learn from the experience of Bilibili's transformation from second listing to dual listing on the Hong Kong Stock Exchange. If it succeeds in achieving dual listing in Hong Kong, it is expected to be included in the Hong Kong Stock Connect, which can attract more potential investors and improve stock liquidity.

4.2 New Upgrading of Audit Means of Accounting Firms

Accounting firms are responsible for the audit reports they publish. However, due to the rapid development of capital markets and the rapid rise of emerging industries, accounting firms' cognition and research on new industries are still not perfect. It is difficult to find financial fraud in emerging industries in a short period of time, and the audit methods of accounting firms are more single than shortselling institutions. Li Ruoshan (2021) proposed that auditors can update their audit methods, learn from the short-selling experience of short-selling institutions, and introduce and upgrade data analysis techniques more^[4]. Accounting firms need to adapt to the development of the new economy and new industries, keep pace with the times, keep up with the pace of the development of the times, enhance the public's trust in themselves, and live up to the public's trust.

4.3 Investors Need to Improve Their Professionalism

The short-selling report will cause strong market sentiment, often because the investor's own lack of understanding, over-reliance on the conclusions of the short-selling report, easy to follow suit, triggering a chain reaction, leading to a sharp drop in stock prices. However, the investment report is not completely correct and completely objective, and often only discloses the possibility of fraud in the enterprise. For investors, to improve their professionalism, they should not over-believe and rely on the analysis of shortselling reports. They should have their own independent thinking and judgment, not be influenced by short-selling reports, and carefully distinguish their authenticity and reliability.

4.4 Government Regulation Makes Information Disclosure More Transparent

The big reason for short-selling institutions to do air stocks is that the information disclosure of Chinese stocks is not transparent enough, investors do not know enough about Chinese stocks, and it is easy to listen to the conclusions of short-selling reports, triggering market sentiment. The government should improve the supervision system according to the risk-oriented supervision model, including presupervision, in-process supervision and post-supervision. First, prior supervision, to implement the supervision of information disclosure, so that listed companies, market intermediaries and regulatory agencies perform their duties, cooperate with each other, take preventive measures, and kill the problem at the source. The second is in-process supervision, including administrative supervision and market environment supervision. We should increase the intensity of administrative supervision, make it more active, continuous and daily, find problems in time and correct deviations. Jiang Qingzhong pointed out that the activities of the short-selling mechanism accounting information regulatory body are spontaneous, making the securities market supervision more scientific and more flexible [5]. In the future, China's market can introduce a short-selling mechanism to make market supervision more scientific. The third is post-supervision, which refers to legal supervision. Article 161 of the Criminal Law of the People's Republic of China stipulates that the violation of information disclosure shall be sentenced to fixed-term imprisonment or criminal detention and fined. We should increase the intensity of punishment, increase the cost of illegality, and let enterprises have a sense of awe. Pre-supervision, in-process supervision and post-supervision promote each other and play a role together, which can make information more transparent and make short-selling institutions inorganic.

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