The Development and Problems of the Chinese Market Short Selling System

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Abstract. This paper focuses on the short-selling mechanism in the Chinese capital market, which is not fully mature at this stage, and firstly explores the current development of its shorting behavior and related activities to show its impact on the market operation. Secondly, it analyzes important development issues such as low shorting activity, lagging shorting development process, and information disclosure. Research finds that the lag of shorting activities in the Chinese market is mainly due to the limited availability of underlying assets and the degree of information disclosure directly affects the activity of shorting. Overall, this paper has implications for the development of short selling in China's capital market and suggests constructive ways to improve the short selling mechanism in China's market and even in emerging markets.

Keywords: Short Selling, Information Disclosure, Insider Trading, Margin Trading.

1. Introduction

1.1 Background

Short selling behavior can indicate to some extent whether a capital market is mature or flexible enough. Due to the short history of the Chinese capital market, little experience, and small risks that can be taken, the short selling mechanism is not yet well developed in the Chinese market. Opponents of short selling argue that China's capital markets are not large enough to bear the risks associated with the large development of this behavior. However, this not only reduces the benefits of the rational use of the short-selling mechanism in maintaining market liquidity and performing price discovery functions, but the restrictions on short-selling behavior may also breed developmental problems arising from the imbalance between long and short behavior in the capital market. Therefore, it is particularly important to identify the problems in the development of the short-selling system and explore solutions to the current state of the market.

1.2 Related Research

Zhou analyzed the basic situation of China's stock market, including the development process and problems of margin trading and short selling in China. After investigation and analysis, he concluded that the short-selling system has not been fully developed in China, despite the rapid growth in the scale of financing and securities financing transactions. This is mainly due to the traditional trading system in China, the limited number of underlying securities, and the conflict of interest between investors and securities firms [1].

In terms of the impact of short selling on the market, by comparing data in the context of the 2008–2009 financial crisis, Beber and Pagano investigate the effects of short selling restrictions on the market, focusing primarily on market liquidity, the speed of price discovery, and stock prices. The research indicates that restrictions or outright prohibitions on short selling would severely harm market liquidity, impede the rate of price discovery, and at most have no impact on stock prices [2]. In contrast, Tang et al. take as their starting point the agency problem and information opacity in emerging economies and explore whether the removal of short selling restrictions can mitigate these problems by improving corporate governance efforts and enhancing corporate protection for minority shareholders. The findings demonstrate that removing limitations on short sales will dramatically raise companies' dividend payment ratios. When it comes to protecting investors and disclosing
information, short selling plays a significant governance role [3]. Zhang, on his part, explored the impact of the SEC short selling reform in the US from 2005 to 2007 on the Chinese stock market short selling regime by analyzing its economic impact. It was found that a modest reduction in the constraints of the short selling regime can facilitate the positive influence of the short selling regime and improve market efficiency [4].

Regarding the actual effects of short selling activities in the new market, Ni and Yin, through long-term observations and data collection from pilot companies, concluded that short selling may lead to the abandonment of risky projects by companies, resulting in loss of value, deterioration in industry performance, and reduction in capital expenditures and stock issuance [5]. Massa et al. then focused on the relationship between short selling potential and corporate earnings management in the market, by using worldwide stock short selling data from 2002 to 2009 were validated. The results show that there is a strong negative relationship between SSP and earnings management and that short selling reduces firms' incentives to engage in earnings management [6]. Also with a developing country context, Lin discusses the functions or limitations of short selling in emerging markets, finding that with the rapid growth of foreign investment in developing countries, the information quality effects of short selling are critical for foreign investors as well as local regulators and that emerging markets need to improve their governance mechanisms while lifting the ban on short selling [7].

The impact of short selling is a double-edged sword, and the risk of short selling is not borne by only one party. Peng and Yang examine the effect of different market trading rules and short selling attacks on both sides of the short selling case by reviewing the Luckin financial fraud and Muddy Waters short selling cases. It turns out that the short-selling attacks also led to losses for Luckin's related companies, car Inc. and UCAR Inc. Short sellers are not risk-free but must bear the risk of a run [8]. Moreover, short sellers are a supervisory role. Deng and Gao propose a correlation between short-selling behavior and enforcement actions of regulators based on the characteristics of the Chinese market at this stage. Data are obtained through the China Securities Regulatory Commission's lifting of the short-selling ban on a group of qualified investors in 2018. It was found that short-selling behavior was positively associated with the probability of a firm being inspected or punished by the CSRC [9]. Fan et al. referred to short selling behavior in their study of the relationship between investor sentiment and the risk of stock price collapse for a given firm and concluded that short selling behavior moderates some investor sentiment, but short selling behavior itself is positively associated with the risk of stock price collapse [10].

1.3 Objective

The article focuses on the development of the short-selling system in China. It begins by briefly reviewing and outlining the history of short selling in China. It then goes on to show how short-selling behavior has both positive and negative effects on the Chinese capital market. The article goes on to discuss the issues with information disclosure, insider trading, and the Chinese capital market's outdated short-selling procedure and rigid short-selling forms. The study concludes by offering solutions, primarily in terms of broadening the use of short selling and enhancing the system for information control.

2. The impact of short-selling on China's capital market

2.1 Development Status

China's capital markets have a very recent history of development when compared to capital markets in the West. China has less experience in short selling and the short selling mechanism is not ideal, despite being the largest emerging market and the second-largest economy in the world. The Chinese market was slow to implement the short selling system. Since 2010, three short selling techniques—security margin trading, stock index futures, and ETF options—have become popular in China.
In margin trading, investors are responsible for providing certain guarantees and paying certain fees, and for returning the borrowed funds or securities within an agreed period of time. In contrast, investors' financing and selling to securities companies is a form of short selling in the Chinese market. As of June 18, 2015, the balance of financing and financing securities reached RMB 2,272.8 billion. Stock index futures have developed relatively quickly since their opening in China, and turnover is relatively active compared to ETF options. However, even though China's capital market has seen a positive trend after the introduction of the short selling system, with the margin trading of securities and stock index futures, in particular, growing rapidly, short selling accounts for a very small share of it.

2.2 Positive Impact

An obvious benefit of short selling is its impact on market liquidity and price control. Since the short selling system allows short sellers to be bearish on stock prices, this means that there is increased liquidity by selling stocks in the market, and short selling itself can pull back stock prices when they become overheated or inflated, which is the price discovery function of short selling, while he can improve the efficiency of asset pricing by incorporating more information into the pricing.

As an emerging economy, the agency problem and information opacity in the Chinese capital market will be mitigated by the introduction of short selling, as evidenced by the increase in corporate dividends [3]. In emerging markets, short selling can serve as a disciplinary mechanism for companies to monitor their governance and reduce the occurrence of errors. It will also reduce the incentive for management misconduct.

2.3 Negative Impact

Malicious shorting can lead to market turmoil, especially in China's emerging markets. Since the essence of shorting is to try to profit from the stock price on the downside. When a stock's decline is significant enough, further shorting can exacerbate the decline in the stock price.

At the same time, the existence of short selling itself has some potential effects, it is like a warning bell in every economic entity in the market. Short selling is likely to lead to the non-selection of risky projects by companies, which in turn will result in loss of value, deterioration of industry performance, reduction in capital expenditure, and equity issuance [4]. This has a potential negative impact on promoting capital market development and activating the economy.

3. Development Issues of Short selling in China

3.1 Lagging Development

In March 2022, Qingshan Holdings faced a foreign short squeeze. This is a huge event related to the dilemma faced by domestic private companies doing hedging in overseas futures markets. At the same time, it revealed the shortcomings of China's development in the futures market and short-selling mechanism. Qingshan Holdings holds a 200,000nickel short position on the LME for hedging purposes. When the Russian-Ukrainian war broke out, Russian nickel could not be delivered on the LME spot, and foreign capital forces made the price of nickel soar in the futures market. At the worst, the book losses caused by the trading margin were as high as several billion. Although the threat of huge losses was again somewhat mitigated by the LME stepping in to carry out a suspension of nickel futures trading, resulting in time for Qingshan Holdings to prepare nickel spot. This incident led to the suspension of its partner's share price, which also significantly negatively impacted the A-share market.

This incident can bring the following reflections to the Chinese market: First, the risk and uncertainty of domestic companies participating in hedging outside of China are high, but the reason why numerous companies choose to hedge outside of China is that the domestic futures market does not support the companies' behavior very well. In 2021, 7.514 billion lots were traded in the Chinese futures market and 62.584 billion lots were traded in the global futures market. The balance of
Shanghai and Shenzhen financing securities at the end of 2019 was 13.78 billion Yuan, accounting for less than 0.03% of the market value of A shares in circulation. Domestic shorting is not active enough and the regulatory constraints are great, resulting in a market that cannot consume the massive shorting by industry giants like Qingshan Holdings.

Figure 1. The outstanding balance of short selling in China market from 2012 to 2020 [11]

Second, the conservative thinking on the futures market and short-selling mechanism have led to China's lack of a say in the discovery of international commodity trading prices. Especially now that the new energy industry is developing rapidly, China, as a major country in the development of new energy, cannot have the right to decide the international price in the futures market of some metals, which leads to risks to the domestic new energy industry when operating abroad.

3.2 Information Disclosure Problem

Information quality effects are critical in short-selling activities for both investors and regulators. Emerging markets need to improve their governance mechanisms while lifting the ban on short selling [6]. Not only in the Chinese market, but the entire capital market is still exploring the regulation of short-selling and the development of related rules. The principles of short selling regulation in different countries after the financial crisis reflect convergence: emphasizing the institutional value of short selling transactions and highlighting the importance of information disclosure.

According to a new plan by the Securities and Exchange Commission (SEC), hedge funds and other large investors will have to disclose more information about their shorting of stocks to make the public more aware of the market. The disclosure model for short-selling transactions in China is basically through securities companies to their clients for margin trading, and the relevant information is reported by the securities companies to the exchange, which collates and releases the information. In addition, there are clear restrictions on leverage ratios and short-selling limits. Disclosure of information about the market as a whole diminishes the value of an individual shorting the market, as it can reflect to some extent an individual's judgment of market performance. Overly strict disclosure of information makes the market information less open and transparent, and the market lacks incentives to short, which negatively affects market activity.

Lack of clarity in information disclosure requirements can also lead to incidents of insider trading. In China, insider trading has been repeatedly prohibited. Although the China Securities Regulatory Commission (CSRC) has strengthened its supervision of companies and conducted relevant policies, the crackdown on insider trading is clearly inadequate. Since 2020 alone, 90 cases of market manipulation and 160 cases of insider trading in the domestic market have been legally investigated and punished, together accounting for 52% of new cases in the same period. Insider trading has seriously disrupted the order of market transactions, interfered with the market operation, and infringed upon the legitimate rights and interests of investors. The Xinmao Technology-related restructuring insider trading case took five years before it was finally punished [13]. Insider trading
involves more subjects, the difficulty of forensics and supervision is difficult, and the supervision of insider trading is not meticulous and rigorous enough will cause more professionals to exploit the loopholes of the system.

4. Solution strategies

4.1 Broadening the scope of short selling

Compared to mature Western capital markets, China has had a limited number of underlying securities available for short selling since the official start of the short selling pilot in 2010. Contrary to the traditional view that short selling transactions are risky and unethical, a large number of reports show that short selling has a corrective effect on capital market development such as price discovery and improving market efficiency. For the domestic capital market, on the basis of the existing short selling risk control and regulatory strategy, continue to use the centralized credit rather than decentralized credit model, but can appropriately broaden the types of short selling assets.

Increase the types of securities available for securities lending in China and open up the scope of securities that can be short-sold. Providing high net worth, large investors with more options for securities lending. In June 2019, The Science and Technology Innovation Board will be officially opened as a new board separate from the Main Board. The board then carried out a board-wide practice of allowing short-selling transactions. On July 21, the balance of the two financings of the board totaled 82.163 billion yuan, up 367 million yuan from the previous trading day and increased for five consecutive trading days [12]. Therefore, continuing to stabilize the market by retaining the centralized form of credit while appropriately broadening the channels of securities financing or developing new segments will inject new vitality into the Chinese capital market.

4.2 Improving information disclosure mechanism

Improving market disclosure is one way to increase market transparency and help the short-selling mechanism work more consistently in China. The SEC said they are considering requiring some large eligible short sellers to publish their short positions on a monthly basis. Based on these reported data, the SEC would make aggregate data on large short positions in each security available to the public. Mandatory disclosure of significant short positions may be used in the Chinese capital markets. Upward reporting and public disclosure would be required when an investor's short position in security reaches a minimum threshold. Prevent some investors from taking advantage of market information asymmetries and promote fairness in the domestic capital market.

On insider trading, regulators should define more clearly the scope of information disclosure and what must be included in listed companies on the basis of existing regulations. Insider knowledge of different trading activities needs to be reported without concealment in accordance with the law.

5. Conclusion

This study introduces the operation of the shorting mechanism in the Chinese capital market and briefly analyzes the impact of shorting. The problems of the shorting mechanism are illustrated by examples. The main finding of the article is that the Chinese capital market is currently not active enough for short selling, which can be solved by increasing the number of underlying securities available for short selling. Another identified problem is the prevalence of information disclosure, and it is particularly important to increase the requirement of mandatory disclosure of material short positions and the related regulatory precision control. In addition, it is essential for investors in the capital markets to engage in prudent investment or shorting behavior with adequate access to information. As for the stock exchanges, strict self-examination of information disclosure issues and strengthening the quality and timeliness of information disclosure can contribute to the stable development of the shorting mechanism in the Chinese market.
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