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A case study of the short-selling regime as a disincentive to financial fraud: Taking Muddy Waters' shorting of Listed Company Huishan Dairy Co. as an example

Gemei Zhao

Nanchang No. 2 Middle School, Nanchang Jiangxi 330006, P. R. China

ABSTRACT
Since China's reform and opening up for forty years, countless Chinese enterprises have been listed on various exchanges, but due to the lack of experience, the financial fraud of enterprises has become more and more intense. The short-selling mechanism, as an emerging financial counterfeiting mechanism different from internal self-investigation and external auditing, has high enthusiasm in investigating financial counterfeiting due to its strong conflict of interest with enterprises, and has a superb effect on suppressing corporate finance. This paper introduces the background of both sides in the case of Muddy Waters' shorting of Huishan Dairy and the game in the release of the two shorting reports, as well as the final results of the case. At the same time, it analyzes the advantages and disadvantages of the short-selling system in suppressing financial fraud and gives the corresponding counterbalance to the short-selling system, so as to maximize the effect of its suppression of financial fraud. Finally, it is concluded that the short-selling mechanism can make up for the deficiencies of the existing system and help stabilize the social equilibrium as a more aggressive and effective fraud-suppression mechanism.

KEYWORDS
Short selling Financial fraud Audit Internal self-inspection

1 Introduction to the Huishan Dairy Incident

Headquartered in Liaoning, China, Huishan Dairy Group Co., Ltd. is one of the first large-scale dairy enterprises in China to practice the whole industry chain model of the dairy industry. (The construction of the whole industry chain includes: pasture planting, concentrate feed processing, breeding of good-breed cows, processing of all kinds of dairy products, research and development of dairy products, quality control and brand operation.) Established in 1951 as a result of aid from the former Soviet Union, its main business is the production of raw milk, liquid milk and milk powder and other dairy products, and it is one of the leading dairy enterprises in Northeast China.

After Chairman Kai Yang took over the company, Huishan Dairy took the creation of a whole industry chain of dairy processing and production as the root of the enterprise. While this move enabled the company to become self-sufficient, it also led to a slower pace of development. However, because no other dairy company in the market had its own farms to produce milk after the melamine scandal of Sanlu milk powder in 2008, Huishan Dairy sold more than twice the share of

* **Corresponding Author:** Email: zhaogemei@gmail.com

the previous year during the three-month period from December 2008 to February 2009 by virtue of its whole industry chain management strategy, and seized 85% of the Shenyang dairy market in one fell swoop [1].

In September 2013, Huishan Dairy was officially listed on the Hong Kong Stock Exchange, with Chairman Kai Yang and his concert party Kun Ge (Vice President) holding a total of 49.73% of the shares, making them the controlling shareholders of Huishan Dairy.The IPO raised $1.3 billion, with a market capitalization of nearly $40 billion on the first day of the IPO, making it one of the top three listed companies in China's dairy industry in terms of market capitalization. On the surface, it looks like a very good Chinese private company.

2 Review of the financial fraud incident of Huishan Dairy

Carson Block, Muddy Waters' founder, has previously said in an interview that the entry point for finding financial counterfeiters is listed companies' balance sheets. “If a listed company inflates its profits, then there is a 'false cash' problem.” released two investigative reports on shorting Huishan Dairy in succession, in which it accused Huishan Dairy of being a fraudulent company whose company value was close to zero.

2.1 First shorting report

In its first report, Muddy Waters said it had investigated 35 dairy farms, five production facilities, and discussions with three dairy experts, employing specialists and drones, and found that not only did Huishan Dairy falsify the source of its alfalfa grass supply, but that the company's chairman, Kai Yang, had personally misappropriated at least 150 million yuan of company assets. Since 2014, Huishan Dairy has been claiming self-sufficiency in alfalfa grass supply to inflate profit margins. At a time when most other companies in China were buying alfalfa grass for nearly $400 a ton, Huishan Dairy claimed that they had been able to produce and harvest their own alfalfa grass for as little as $70 a ton. As a result, Huishan's official gross profit margins are on average 30 percent higher than those of Mengniu, Yili, and Modern Dairy, China's leading dairy companies. Huishan Dairy's actual gross profit margins are actually lower than those of these companies, and do not even come close to the figures they publish.

Table 1 Company gross margin comparison chart

Firms	2013	2014	2015	2016
Modern animal husbandry	30.02%	37.11%	34.34%	30.81%
Erie shares	29.73%	28.67%	32.54%	35.89%
Mengniu Dairy	26.98%	30.84%	31.36%	32.79%
Pfizer Dairy (fake)	54.00%	62.40%	57.60%	56.00%
Pfizer Dairy (real)	17.33%	20.08%	22.69%	20.77%

Source: wind database

Second, Fraser's board chairman, Kai Yang, diverted at least $150 million in assets to a subsidiary that owns at least four cattle ranches, and Muddy Waters believes Kai Yang likely has control of this subsidiary and the related livestock ranches.

This sudden short report led to a 3.91% drop in Huishan Dairy's share price in the morning session of the same day. At 11: 12 a. m., Huishan Dairy suspended trading in an emergency, and Chairman Kai Yang urgently bought 24,766,000 Huishan Dairy shares on the secondary market at a cost of about HK$66.86 million through his holding company, Guanfeng, in an effort to stabilize the declining share price, but it also led to a high percentage of his shareholding of 73.06%. Meanwhile, Huishan Dairy released a clarification report that night, denying each and every one of the QCs in Muddy Waters' short-selling report and announcing that it reserved the right to take legal measures.

2.2 Second short-selling report

In response to the clarification report released by Huishan Dairy, Muddy Waters soon released a second short-selling report, alleging that Huishan Dairy was suspected of exaggerating financial expenditures and fictionalizing the source of operating income for financial fraud. Muddy Waters questioned Huishan's capital expenditures on cattle farms. According to Muddy Waters' internal investigation team, the drone forensics found that many of Huishan Dairy's so-called "ranches" are just empty shells, with imperfect facilities, which are unable to achieve the cow yields higher than 9 tons announced in Huishan's 2014 financial data. Second, according to Muddy Waters' estimates, Huishan's maximum online sales were only about 1 million yuan, and its sales volume on Tmall and Suning was only 1,500th of Yili's and Mengniu's. The company's sales volume on Tmall and Suning was only 1,500th of that of Yili and Mengniu. On this basis, Huishan would need to discount 5% or even 10% more to compete with leading dairy producers such as Yili and Mengniu.

After the release of the second short-selling report, Fraser's chairman Kai Yang once again bought Fraser's shares in the secondary market under the name of Guan Feng to stabilize the stock price. After investing at least HK$58.9 million, Kai Yang's shareholding rose to 73.21 percent, very close to the maximum 75 percent required by the Hong Kong Securities and Futures Commission for individuals. At 12:10 and 23:00 that day, Yang Kai issued two clarification reports to refute Muddy Waters' accusations one by one.

3 Analysis of the short-selling mechanism

3.1 Analysis of the effectiveness of the short-selling mechanism in curbing financial fraud

3.1.1 Corporate share price plummets

This is actually one of the most direct effects and the ultimate goal of the short-selling organizations. After Muddy Waters issued two consecutive short-selling reports exposing Huishan Dairy's financial fraud, Huishan Dairy temporarily controlled the decline in its share price through the chairman's emergency suspension of trading, the acquisition of shares and the publication of a clarification report. And surprisingly, after the resumption of trading, Huishan Dairy's share price did not fall but rose, in the resumption of the day plate maximum increase of more than 2%, the end of the day rose 1.82%. And after two days Hui Shan Dairy's share price still continue to rise.

But just when people thought the situation had subsided in three months, on March 21, 2017 Huishan Dairy rumored that the capital chain broke, and the stock price immediately plummeted more than 90% after the opening of the market, creating the largest single-day drop in the history of Hong Kong stocks, and the market value evaporated by more than 32 billion Hong Kong dollars. The company's consolidated net debt as of March 31, 2017 was likely to reach $10.5 billion, and the company went into provisional liquidation. On December 5 of the same year, two subsidiaries of Huishan Dairy received huge economic losses and formally initiated bankruptcy and reorganization proceedings, thus the notorious Huishan Dairy officially collapsed[2].

3.1.2 Decline in corporate reputation

For a company that has been shorted before, it is difficult to restore its reputation. After Muddy

Waters became famous, Huishan Dairy was officially put on the "pillar of shame". Three years after it was declared bankrupt and delisted, Huishan Dairy was revitalized by Yuexiu and renamed Yuexiu Huishan Enterprises. Even so, when people think of Huishan Dairy, they associate it with financial fraud. At the same time, domestic and foreign research articles on financial fraud in the case of Huishan Dairy will constantly remind people that this is a company that has been a fraudulent and untrustworthy company.

On the other hand, if Yuexiu Huishan wants to rise again and go public again, the stock exchange will be more stringent in checking it. The auditing department and the judicial department will always remember that this is a company with a "record", and the inspection of Yuexiu Huishan will also come more carefully.

3.1.3 Businesses are put at the opposite end of the social spectrum

As a listed company, Huishan Dairy has many interests at stake. After its share price plummeted, not only Huishan Dairy, but also all Huishan Dairy shareholders suffered. Numerous investment companies and small and medium-sized retail investors were forced to get involved, which inevitably put Huishan Dairy on the wrong side of the community and subjected it to social criticism.

At the same time, this also makes the already credibility crisis of the Chinese stocks once again aggravate the stereotype, so that the state-owned enterprises listed in the outside world a little more obstacles. The Chinese stocks that are already listed will inevitably encounter a series of chain reactions, including discrimination and even damage to their interests. If a class-action lawsuit is filed by a large number of lawyers in conjunction with investors with damaged interests, as was the case with Rexchip when it falsified its finances, Fraser Dairy could be subjected to a huge lawsuit payout, in addition to fines and a loss of market capitalization.

3.2 Comparison of short-selling and other mechanisms

3.2.1 Shorting organizations are highly motivated

Unlike the auditing mechanism, which is conservative in style and has a fixed procedure, the short-selling mechanism is strongly active and independent. Shorting organization and the company being shorted have a strong conflict of interest, can be said to be "you die, I live and die" rivals, whether the success of shorting is directly related to whether they can get a good return. Therefore, the enthusiasm of the short selling company for investigation will be incomparable to that of the auditing department, which is paid dead wages.

3.2.2 Ineffective system of internal company self-checks

The shareholding structure of Huishan Dairy is very irrational. The largest controlling shareholder of the enterprise is Guan Feng Limited, which is 100% owned by Kai Yang, the chairman of Huishan Dairy, and Kun Ge, the executive director of Huishan Dairy. That is to say, Kai Yang and Kun Ge hold 72% of the equity of Huishan Dairy, is the actual controller of Huishan Dairy, they have the absolute right to speak and decide on the management of the company, the other shareholders can not form an effective check and balance of power on them [3]. In the case that the power of the major shareholders has been solidified but still did not introduce new shareholders in time to check and balance each other, Huishan Dairy's internal self-examination is ineffective.

3.2.3 External audit and company ambiguity

External audit firms may be in cahoots with companies. Unlike Europe and the United States, where the Big Four accounting firms PricewaterhouseCoopers (PwC), Deloitte, KPMG, and Ernst & Young monopolize the audit market, China's audit market is a mixed bag, with the number of accounting firms outstripping demand. With a large number of choices available to companies, the quality of external audit reviews of companies will inevitably decline, and some firms may even take the initiative to help with falsification in order to cater to the company.

3.3 Risk analysis of the short-selling mechanism

3.3.1 For listed companies

Short-selling has a stronger initiative than other mechanisms but also has many drawbacks, malicious short-selling and the phenomenon of misinjury are not uncommon. In both cases, short-selling organizations may slander the company being shorted due to wrong investigation or subjective fabrication, forcibly shorting the enterprise and causing the stock price of innocent enterprises to plummet.

Since the fundamental purpose of short-selling organizations is to gain profit by shorting enterprises, their own righteousness is only an accessory for the sake of profit. If they are unsuccessful after devoting a lot of resources to investigating and obtaining evidence, shorting organizations have the chance to recoup their losses through malicious shorting.

Without the support of accurate official data and their own investigations, short-selling organizations may also make mistakes in evaluating a company's corporate performance and financial condition. In 2012, Muddy Waters hurt New Oriental because it didn't understand China's tax breaks, causing its shares to plummet 60 percent and causing it to suffer significant losses.

3.3.2 For capital markets

Taking Muddy Waters as an example, most of the shorting organizations can only choose to obtain the internal situation of the company through other means without the support of official accurate data. In the process of investigating Huishan Dairy, Muddy Waters has estimated the use of pastures by calling drones to take aerial photographs of the pastures, and special guards at the entrance of the pastures; and in the case of shorting Luckin Coffee it is even more important to hire full-time spies to penetrate into the store to obtain information.

The above ways of obtaining information are on the edge of the law, the means are effective but the moral level is inevitably criticized; what's more, Muddy Waters may also have used undisclosed and illegal means to obtain the internal information of the enterprise, which leads to the difficulty of guaranteeing the security of the enterprise's information, and this kind of investigation method of thieves' means is very likely to disrupt the order of the capital market.

4 Recommendations for preventing financial fraud under the short-selling mechanism

4.1 Establishment of strict incorporation criteria

For national governments, it is necessary to improve the laws and regulations related to the short-selling mechanism. The government needs to take the lead and conduct strict inspections of the short-selling mechanism.

In terms of regulation, a special statutory department can be set up to manage the establishment and registration of professional short-selling organizations, and the introduction of corresponding rules and regulations on the registration and establishment of short-selling organizations to constrain the requirements. In the case of clear and strict legal standards, only individuals, organizations or groups that meet the relevant legal conditions can apply for the registration of short-selling institutions, and at the same time, according to the size of the capital and credibility of the short-selling institutions for the level of classification [4]. Only if the state attaches importance to the supervision of short-selling mechanism and cracks down on violators can short-selling organizations be effectively warned and restrained.

4.2 Regular inspection of shorting organizations

After the Government has defined the criteria for the registration and establishment of short-selling organizations, the corresponding regular review and reexamination should also continue to follow up. First of all, it is necessary to set up or designate a specialized department or agency to supervise short-selling agencies and short-sellers, who will be responsible for appraising the results of the work of the short-selling agencies, and at the same time making the appraised credibility ratings public and setting up a report board to monitor the short-selling agencies together with the general public.

4.3 Establishment of a special investigation team for short selling

In addition, a special investigation team should be set up to participate in the investigation in a timely manner after each enterprise has suffered a short, the second check to ensure the authenticity of the short. If found to be malicious shorting should promptly help the victimized enterprises to clarify, provide appropriate assistance as well as preferential policies, which can also be very good to encourage the emergence of good enterprises. The government should act as a solid backing for good quality companies, actively help support good enterprises and set a good example.

4.4 Fostering a rational investment community

In addition to some large investment companies in the investment market, small and medium-sized retail investors are also an important part of the entire stock market. That is why it is important for the people to develop a sense of rational consumption.

Before you start investing, you can start by learning basic economics to improve your investment literacy and market information screening ability, thus avoiding market losses caused by information mismatch. Today's society has a colorful and diverse means of communication, all kinds of information is readily available on the Internet, and the reduced cost of learning knowledge can be a good way to encourage people to become a more professional and rational investors to invest in the market. At the same time, it is also important to change people's mindset about investing. Investment is not gambling, it is a professional activity that requires professionals; people change the psychology of speculation and delusion of getting rich in one day, and cultivate a rational investment mentality.

5 Conclusions and outlook

After analyzing the case of Muddy Waters' shorting of Pfizer Dairy, this paper can conclude that the shorting mechanism is conducive to suppressing financial fraud of listed companies. The shorting mechanism is different from the internal self-control mechanism which is virtually non-existent, and the external auditing mechanism which is easy to work together with the public, and its positive initiative and thorough conflict of interests with the listed company make the shorting mechanism suppress the effect of financial falsification superbly. But compared with other mechanisms, short-selling mechanism also has risks. The standardization and authenticity of its investigation are doubtful, and its nature is still a profit-oriented mechanism, which requires the government to introduce corresponding policies and set up relevant institutions to work with the people to check and balance.

Through analysis and argumentation, the short-selling system has a unique role in suppressing financial fraud, but the corresponding checks and balances are still not perfect. In the future, how to utilize the short-selling mechanism, so that it can play its due effect in the capital market at the same time suppress its shortcomings still need our joint efforts to improve.

About the author

Gemei Zhao is a student of Nanchang No. 2 Middle School, and her research field is financial accounting.

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