

Why the Market Abuse Regulation (MAR) should not kill the business of activist short sellers

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Warning

❖ Warning

- Droit & Croissance / Rules for Growth Institute is an open, independent & non-partisan think tank, which takes part in public debates, assists policymakers and influences legislators
- Ms Vermeille has been the legal counsel of several « anonymous » short sellers and thereafter Muddy Waters LLP in the Casino / Rallye case – a second investigation launched by the AMF is still open
- Ms Vermeille is presently acting as legal counsel of Muddy Waters LLP in the ongoing Solutions 30 case
- **The views presented here are solely those of Ms. Vermeille and may not be shared by her clients**

- Part I **A Short Introduction to Short Selling**
- Part II **An Overview of the Market Abuse Regulation (MAR)**
- Part III **MAR and Activist Short Selling: A Critical Analysis**
- Part IV **Case Analysis: Muddy Waters v. Solutions 30 (France)**

PART I

A SHORT INTRODUCTION TO ACTIVIST SHORT SELLING



Partie I: A Short Introduction to Short Selling

❖ What is short selling?

- **Objective: betting on a fall in share prices**, either (i) to make a profit or (ii) to hedge a position

- **Two main possible techniques:**
 - **Technique 1 (most frequent):** borrow shares, sell them immediately, rebuy them on the market later on, and reimburse them

 - **Technique 2 (less common):** enter into a derivative contract whose underlying are an issuer's bonds (CDS)

- **Consequence:** limited opportunity of gain but unlimited risk of loss (although exposures are usually capped): risky activity - the **last events relating to Tesla and Gamestop** how dramatic short sellers' losses can be

Partie I: A Short Introduction to Short Selling

❖ What is activist short selling?

- **Objective:** making a profit by identifying overvalued companies and betting against them

- **Technique:**
 - In-depth review of available public information (corporate filings) and sometimes (lawful) private investigations = **very time-consuming review**
 - Borrowing & selling the target's shares (or any other equivalent technique)
 - Publication of a **report / letters** explaining why the shares are overvalued (typically because of fraud or aggressive accounting)
 - After the fall in price usually following the publication of the report, waiting some time for the market to digest the information (and not being accused of market manipulation)
 - Shares buyback and reimbursement : short positions are « covered »

Partie I: A Short Introduction to Short Selling

❖ Why is activist short selling a good thing?

- **Activist short sellers** are the **only market actors properly incentivized** to identify fraud:
 - **Statutory auditors** do not get a bonus for identifying fraud / often have conflicts of interests with the issuer which often pays them / simply do not have the skills to identify subtle and/or hidden fraud
 - **Market authorities** often lack financial resources / do not routinely conduct in-depth investigations of issuers / may lack the skills to identify some forms of fraud
 - **Other investors** do not actively seek to identify fraudulent companies

Partie I: A Short Introduction to Short Selling

❖ Why is activist short selling a good thing?

- As a consequence, they contribute substantially to **share price accuracy** as a counterpart to **many opposite driving forces (ETFs, monetary policies)**
- They are **strongly incentivized to be right** (at least when they are not anonymous)
 - Publishing information and profiting *immediately* from it (whether the info is true or false) is very likely to be considered as amounting to market manipulation, which is heavily sanctioned
 - Publishing fake (or false) information, then *waiting* leaves time to other market participants to verify the info and realise that it is false + constitutes market manipulation in case false information is published on purpose

PART II

AN OVERVIEW OF THE MARKET ABUSE REGULATION



Partie II: An Overview of the Market Abuse Regulation

❖ Relevant provisions of Regulation No. 596/2014 (MAR) (1)

- **Market manipulation (art. 12):** notably consists in (i) “entering into a transaction, placing an order to trade or any other behaviour which [...] gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of, a financial instrument [or] which employs a fictitious device or any other form of deception or contrivance” or (ii) “disseminating information through the media, including the internet, or by any other means, which gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of, a financial instrument”
- **Insider trading (art. 7 & 8):** “a person possesses inside information and uses that information by acquiring or disposing of [...] financial instruments to which that information relates,” inside information being defined as “information of a precise nature, which has not been made public, relating, directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments”
- **Investment recommendation (art. 20):** “persons who produce or disseminate investment recommendations or other information recommending or suggesting an investment strategy shall take reasonable care to ensure that such information is objectively presented, and to disclose their interests or indicate conflicts of interest”

Partie II: An Overview of the Market Abuse Regulation

❖ Relevant provisions of Regulation No. 596/2014 (MAR) (2)

- **Market manipulation (art. 12):** short selling activists can be sanctioned if they intentionally disclose misleading information and draw a benefit from it
- **Insider trading (art. 7 & 8):** Contrary to US law, any inside information (whatever its source) can be sanctioned on this basis; activist short sellers can therefore be subject to insider trading regulation (varies from country to country)
- **Investment recommendation (art. 20):** although this provision was initially intended to concern sell-side analysts and the likes (ie people who are paid by their clients to produce research), some countries consider that reports published by hedge funds (including activist short sellers) can be considered as investment recommendations

Partie II: An Overview of the Market Abuse Regulation

❖ Other applicable rules

- **There exist several other rules** whose aim is to allow issuers to know how much of their capital is shorted and/or to protect the well-functioning of financial markets
- **Examples:**
 - Short sellers must **disclose** their position when they short more than a certain fraction of an issuer's capital (Europe has stringent rules)
 - **Uptick and circuit breaker rules:** national authorities can impose temporary bans on short selling for a specific issuer when its stock is heavily shorted (cf Wirecard case)
- The merits of these rules are **debatable**; uptick and circuit breaker rules are almost unanimously considered as bad by the academic literature (except for SIFIs)

PART III

MAR & ACTIVIST SHORT SELLING: A CRITICAL ANALYSIS



Part III: MAR and Activist Short Selling: A Critical Analysis

❖ What should we expect from MAR?

- Activist short sellers are a good thing for markets; we want them to detect fraudsters and overvalued companies
- However, we don't them to spread false information in order to manipulate the stock price



Part III: MAR and Activist Short Selling: A Critical Analysis

❖ The shortcomings of the definition of Market manipulation (art. 12)

- Essentially the only part of MAR whose application to short sellers really makes sense
- Lesser evil: the concept is very difficult to define and is therefore a source of uncertainty for market actors but **needs to remain sufficiently flexible** to catch all sorts of undesirable behaviors
- Is coordination between hedge funds likely? No, considering the risks of **short squeezes** afterwards (cf. Casino which was a case of financial engineering).

Part III: MAR and Activist Short Selling: A Critical Analysis

❖ The shortcomings of the definition of insider trading (art. 7 & 8)

- Source of substantial uncertainty for short sellers due to its very **vague perimeter** and **unpredictable enforcement** – the definition can apply to situations when the person who relays the information to the market has not breached any fiduciary duty
- Can technically be applied to short sellers in situations where it shouldn't, eg when short sellers are trading in anticipation of the release of an article published in a newspaper – should the “Daily Mail decision” rendered by the French Market Authority (AMF) apply to short sellers?

→ Insider trading prohibition is a source of permanent fear for market actors that isn't justified

Part III: MAR and Activist Short Selling: A Critical Analysis

❖ The shortcomings of the definition of insider trading (art. 7 & 8)

- **Insider trading (art. 7 & 8):** The regulator must take a decision between two conflicting purposes:
 - **Efficiency**, ie prices reflecting the value of underlying assets: informational efficiency implies that information is incorporated into prices
 - **Fairness**, ie giving access to the same information to everyone, and preventing actors from profiting from information asymmetries

→ In a situation of fraud, efficiency must clearly prevail over fairness

→ Rumors about the release of an anonymous report or an article following an investigation conducted by journalists should not restrict activist short sellers

Part III: MAR and Activist Short Selling: A Critical Analysis

❖ The shortcomings of the definition of investment recommendation (art. 20)

- In France, short seller reports are considered as investment recommendations although investment recommendation rules have not been created for this purpose (but rather for sell-side analysts)
- Investment recommendation rules are not adapted to the specific business of short sellers and is often a source of confusion: how can you ask someone who holds a position to remain neutral?

Part III: MAR and Activist Short Selling: A Critical Analysis

❖ The shortcomings of MAR: other issues

- **Very different solutions** from one country to another; lack of consistency
- Possibility in some countries (eg France) to **trigger criminal actions** that are bound to fail but nevertheless frighten foreign investors / investors who are not knowledgeable enough about the French criminal procedure
- Stringent rules in Europe about the disclosure of short positions (threshold of 0.5% that is rapidly crossed) – **too much transparency can encourage short squeezes**

PART IV

CASE ANALYSIS: MUDDY WATERS V. SOLUTIONS 30 (FRANCE)



Part IV: Case Analysis: Muddy Waters v. Solutions 30 (France)

❖ Facts

The rise

- Solutions 30 (S30) is a French tech company founded in 2005 (especially known for electricity meter installations in households) which transferred its registered office in Luxembourg in 2013
- Excellent share price performance up until December 2020 (175% increase over 3 years and 658% over 5 years)
- One of the small cap favourites of many financial analysts convinced by its performance and growth perspectives
- Muddy Waters was short S30 since 2019 but didn't explain why



Part IV: Case Analysis: Muddy Waters v. Solutions 30 (France)

❖ Facts

The fall (1)

- In early December 2020, disclosure of an **anonymous report** pointing numerous accounting malpractices and esp. money laundering and other criminal transactions (links with the Italian mafia, etc.)
- **Several letters sent by Muddy Waters Capital** to the management of S30 asking them to address several questions raised by the anonymous report
- **Denial of all accusations** by the company
- **48h+ trading suspension** of S30 shares at the request of the company

Part IV: Case Analysis: Muddy Waters v. Solutions 30 (France)

❖ The role of the law

- Obviously, the discovery / disclosure of as much information as possible about S30 (whether to confirm or discard accusations) is in the market's best interest
- Short sellers are incentivised to spot and disclose as much negative information as possible / management is incentivised to show how great their company is and how wrong short sellers are
- If there is no rule, both parties will be inclined to lie / manipulate the market to make their point
- **Question:** How to make sure that both parties will be incentivised to disclose as much true information as possible? How to limit the risk that the market be manipulated by the diffusion of false information?

Part IV: Case Analysis: Muddy Waters v. Solutions 30 (France)

❖ The role of the law

- Simple **answer**: sanction investors / managers / issuers for market manipulation in case they disseminate false information (solution retained by MAR)
- But investors shouldn't be discouraged from disclosing the information they acquire and believe to be true
- Pursuing fairness objectives in the short term leads to discouraging short seller activists from whistleblowing misleading and/or fraudulent practices, which poses a problem in terms of efficiency
- In order to build a European Capital Market Union, there is no other choice but to favour efficiency over necessary short-termist perceptions of fairness

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