

Review of Short-Selling and Private Placement

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Abstract

Chinese securities market introduced the margin financing and securities trading mechanism in 2010, which is considered to be a major step forward in stabilizing the stock market. Recent scholars' research found that the short-selling mechanism can not only stabilize the stock market, but also generate external governance effects on the company. As a high-efficiency and low-cost refinancing method, private placement has been a research hotspot of Chinese scholars since the official launch of China's capital market in 2006, especially the transfer of interests of major shareholders in the process of private placement. Therefore, this article provides a literature review of short selling mechanisms and private placements.

Keywords

Short-Selling Mechanism, Private Placements, Transfer of Interests

1. Introduction

Short-selling is an investment term that is an operational model of financial assets. In contrast to doing more, shorting is to borrow the underlying asset first, then sell it to get cash, and after a while, spend the cash on buying the underlying asset. The short-selling mechanism has been criticized in the capital market. Many investors believe that the short-selling mechanism will cause a sharp fall in the stock price, which is not conducive to the healthy and stable development of the stock market and harms the interests of investors. However, the academic views are contrary to it. Scholars believe that the capital market needs a "transfusion mechanism" and a "blood-letting mechanism". The short-selling mechanism can integrate negative news into the company's stock price, while the rational management prevents the stock from being sold. Empty, and thus improves their behavioral decisions, the short selling mechanism is therefore considered to have external governance effects, which is of great significance for

promoting the sound development of capital markets and a sound capital market trading system. In March 2010, China's stock market officially launched the trial of margin financing and securities lending business. From the initial listing of 90 stocks (According to the announcements from Shanghai Stock Exchange and Shenzhen Stock Exchange on March 30, 2010) in the list of securities lending, after five expansions, it has reached the current 950 stocks, and its scale has gradually expanded. The pilot of margin financing and securities lending in China's capital market not only has great practical significance, but also provides a natural experimental group and a control group for the pricing and governance effects of the short selling mechanism in academic circles, making it possible for Chinese scholars to study the short selling mechanism.

Private placement refers to the non-public issuance of shares by a listed company to a small number of qualified investors who meet the requirements. The issue price is determined by the bidding of investors who participate in the issuance. As an important equity refinancing method for listed companies, private placement has a series of advantages such as less procedures, high efficiency and low cost. Since China's securities market officially introduced the private placement system in 2006, it has been favored by listed companies and has gradually become the main way for most listed companies in China to refinance. The intention of the private placement system is to help listed companies to inject capital and assets more quickly, introduce new strategic investors to listed companies, and provide advanced management experience and technical support.

However, in the actual implementation process of the private placement, it was found that there were misconducts in which the major shareholders carried out the interests and ultimately infringed the interests of the minority shareholders. "Tunneling" refers to the act of a large shareholder encroaching on the interests of small and medium-sized shareholders and transferring property and profits. "Tunneling" greatly infringed the interests of small and medium-sized shareholders, spurred the enthusiasm of small and medium-sized investors. The issue of the transfer of interests of major shareholders after private placement has been widely concerned by scholars, but it has suffered from no good solutions.

2. Literature Review

2.1. Overview of Short-Selling Mechanism

Nowadays, domestic and foreign scholars' research on short selling mechanism mainly focuses on two directions, one is short selling mechanism and stock pricing, and the other is short selling mechanism and corporate governance. The latter is a hot spot for scholars in recent years.

The academic research on short selling mechanisms can be traced back to Miller's study in 1977 of the impact of short-selling restrictions on stock prices. In this article, Miller puts forward the hypothesis of "overvaluation of stock price". He believes that investors have heterogeneous beliefs about the intrinsic

value of stocks. Short selling restrictions make negative information unable to integrate into stock prices, which will cause stock prices to be overvalued for a certain period of time [1].

Subsequently, foreign scholars began to empirically study the impact of short selling mechanism on stock pricing. Based on the sample of stock markets in different countries, they proved Miller's hypothesis: short selling restrictions will lead to overvaluation of stock prices, while in the market where short selling mechanisms exist, stock prices absorb negative information faster, stock price adjustments are faster, and stock pricing efficiency increases [2] [3]. Scholars have further studied the path of short selling mechanism affecting the pricing efficiency of stock prices, and found that short sellers can find and use negative information in time, so that stock prices can be quickly adjusted to their true value [4]. After the introduction of the margin financing and securities lending system in 2010, Chinese scholars also began to verify whether the short selling mechanism plays a role in China's stock market. Li Ke *et al.* (2014) found that in China's stock market, the restriction of short selling leads to an overvaluation of stock prices, while the release of short selling restrictions increases the pricing efficiency of stock prices [5]. Xiao Hao *et al.* (2016) found that short selling the mechanism reduces the volatility of stocks, which is the same as that of foreign scholars [6]. Research on the pricing of stocks by margin financing and securities lending shows that in China's stock market, short selling mechanism mainly affects the pricing efficiency of stocks by reducing the degree of information asymmetry, speeding up information transmission and accelerating stock liquidity [7].

The influence of short selling mechanism on stock pricing will inevitably lead to positive response of corporate management and governance behavior. Therefore, in recent years, domestic and foreign scholars have begun to focus on the corporate governance effect of short selling mechanism, but scholars are outside the short selling mechanism. Research on governance effects is more limited to governance aspects of management behavior.

Domestic and foreign scholars first selected management's earnings management as the research object. The empirical research results show that short selling mechanism can reduce the level of earnings management of enterprises and constrain management's earnings management behavior [8] [9]. Scholars further found that short-sellers can identify problem companies with serious earnings management, thus achieving the effect of constraining management earnings management behavior, and short-selling mechanism has better effect on financing-type earnings management, but threshold-based earnings management Poor governance [10] [11]. Domestic and foreign scholars also studied the impact of short selling mechanism on management investment behavior, and found that short selling mechanism can influence management's investment decisions, forcing management to choose better investment opportunities for investment and restricting management's excessive investment behavior [12] [13], while the short selling mechanism prompted management to be more cautious in mergers

and acquisitions, improving the long-term and short-term performance of companies after mergers and acquisitions [14]. At the same time, domestic and foreign scholars' research on the governance effect of short selling also involves the degree, quality and accuracy of management information disclosure [15] [16], cash value [17], Management's financing options and financing costs [18] [19], corporate innovation output and efficiency [20], management risk behavior [21].

With regard to the effect of short selling on the agency problem between large shareholders and small and medium shareholders, the current research results are few. In China, only Hou Qingchuan and other scholars have proposed that loose short selling control can restrict the majority of shareholders. "Tunneling" can play a role in protecting the interests of small and medium shareholders [22].

2.2. Overview of Corporate Governance and Tunneling

The emergence of corporate governance is to solve the principal-agent problem, except for the agency problem between shareholders and managers due to the separation of the two powers [23]. Scholars have found that the characteristics of equity concentration exist in Asia and thus exist. Serious agency problems between major shareholders and small and medium-sized shareholders and the phenomenon of "short-selling" of such major shareholders [24] [25] [26], the protection of minority shareholders' rights in the external legal system in weak countries, the "short-cut" behavior of major shareholders is more likely to occur. A series of studies by Chinese scholars on the method of "selling out" of the major shareholders of Chinese listed companies found that large shareholders use their power to control the company's resources mainly through capital occupation [27] and related transactions [28], cash dividends [29] and other three ways to "Tunneling" encroach on the interests of small and medium shareholders.

With regard to the research on the corporate governance mechanism of the phenomenon of "shorting" of major shareholders, Chinese scholars mainly study from the perspectives of internal governance and external governance. From the perspective of internal governance, it is found that the second and third largest shareholders and independent directors can play a role in governance to curb the "Tunneling" of the largest shareholder [30]; but some scholars hold the opposite view and believe that due to Chinese investor law The protection system is weak, and the balance of interests is difficult to play a role. It can only protect its own interests by withdrawing from the company [31]. Scholars' research on the external governance of large shareholders' short-selling shows that market competition [32], financial market development [33], and institutional investors [34] are major shareholders' important external factors in the "Tunneling" behavior.

2.3. Overview of Private Placement and Large Shareholders' Interest Transfer

K.W. Wruck (1989) proposed the "supervised effect" and "announcement effect"

of private placement, in which “supervised effect” means that the participation of new shareholders has a supervisory role, which can reduce the conflict between owners and managers [35]. Explain the reasons for the directional issuance discount; the “announcement effect” means that the market value of the company will increase in a short period of private placement. At the same time, he also mentioned that the private placement is likely to result in a “one big share” situation, leading to major shareholders. Infringe the rights and interests of minority shareholders. Johnson *et al.* (2000) suggested that in the process of private placement, major shareholders may set a higher discounted issue price for profit transfer [36].

Empirical studies abroad have shown that there is a “declaration effect” in private placements, and the company’s operating performance has not improved [37]. This also suggests that the motive for large shareholders’ private placement may not be for business performance, which may impairing the interests of small and medium-sized shareholders; the degree of discount for private placement is related to the issue target, the relative discount rate for institutional investors is relatively low, and relatively high for large shareholders [38] and for the phenomenon of interest transfer in private placements, Asia Scholars have studied a lot, and the unique family business and legal supervision environment in Asia has led to the widespread transfer of interests by major shareholders [39] [40].

Due to China’s relatively concentrated equity system, since the private placement in 2006 was officially implemented in China, the issue of interest transfer in private placement has always been the focus of research by Chinese scholars. In the early days, Chinese scholars analyzed the changes in relevant financial indicators and the discount rate of subscription prices in the process of private placement, and concluded that there is indeed a phenomenon of large shareholders’ interest transfer in private placement [41] [42]. Later, Chinese scholars began to use the discount of private placement as the entry point to carry out the empirical research. The empirical research shows that the major shareholder deliberately lowers the stock price before using the private placement, and uses its control right to adopt the high discounted issue price to achieve the benefit transfer the purpose [43] [44]. Then Chinese scholars began to further study the ways of interest transfer. The study found that there are four main ways to transfer the interests of major shareholders: First, related transactions, Wang Zhiqiang *et al.* (2010) show that the major shareholders have significant interest in related transactions after the private placement [45]. The increase provides evidence that the major shareholders of listed companies will transfer their own interests through related party transactions after the private placement. Second, cash dividends, Zhao Yufang *et al.* (2011) found that compared with non-directed companies, they participate in private placements [46]. The listed company will distribute more cash dividends after the issuance, and the cash dividends distributed by the listed companies will be more when the major shareholders participate, which proves that the major shareholders have the effect of transferring

the benefits through cash dividends during the private placement process; Third, injecting inferior assets, Zhang Weidong *et al.* (2010) found that the major shareholders of listed companies in the process of private placement of shares in the process of injecting inferior assets into the company [47], and will affect the company's long-term benefits; Fourth, reduce arbitrage, Xiong Jian *et al.* (2011) research shows that high-issuance issuance of private placement In order to create conditions for large shareholders to reduce arbitrage in the secondary market, the higher the directional arbitrage discount, the higher the arbitrage of major shareholders [48]. This proves that the major shareholders have used the secondary market to reduce the arbitrage in the process of private placement.

2.4. Summary

The research on the governance effect of short-selling mechanism by scholars at home and abroad is deepening. From the initial price-price pricing efficiency to the external governance effect, the research is based on the table. Especially in recent years, scholars' research on the external governance effect of short selling mechanism has empirically tested the impact of short selling mechanism on manager's earnings management, investment decision and financing choice.

However, most of the valuable research is limited to the governance of management. The governance effect on governance is currently only an article by Hou Qingchuan *et al.* in 2017 on the short selling mechanism and the "shorting" behavior of major shareholders. However, under the special institutional background of China and even Asia, the agency problem between the major shareholders and the minority shareholders has been severe and still to be resolved. The short-selling mechanism still needs empirical testing and theoretical exploration.

3. Conclusions

3.1. Theoretical Contribution

The research in this paper can enrich the research on the impact of short selling mechanism on corporate financing decisions, provide more evidence for the existence of short-selling mechanism "external governance effect", and further demonstrate the indispensable role of short selling mechanism for the benign development of capital market; at the same time, we explore the governance effect of short selling mechanism on governance and major shareholders, and empirically test the external governance effect of short selling mechanism to comprehensive management of management and governance.

3.2. Practical Contribution

At present, China's stock market has not completely relaxed the restrictions on short selling. Although the number of underlying stocks is increasing, most listed companies are still outside the list. The academic research on short selling mechanism can promote the process of China's margin financing and securities

lending pilot, further improve the trading system of China's stock market, and promote the stable and effective development of the capital market. At the same time, the effect of the short-selling mechanism governance effect can also restrain the large-shareholders' interest transfer behavior in the private placement of the company to a certain extent, supervise the major shareholder and management of the company to better manage the company and increase the value of the enterprise.

Conflicts of Interest

The author declares no conflicts of interest regarding the publication of this paper.

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