

# Soft shell creep

## Securities lending is feeling the impact when exchanges halt trading for Chinese RTOs, says SunGard's Andrew Shinn

### DATA ANALYSIS

In the February 15th edition of Securities Lending Times, I wrote about the challenges of investing in Chinese reverse-merger companies. In a reverse merger, a Chinese company will acquire a shell company that has a stock listing in the US, merge with the shell company, and thereby secure a listing on Nasdaq or NYSE. The Chinese company benefits by avoiding the more rigorous disclosure of an initial public offering.

When there is less disclosure, however, there is an opportunity for unscrupulous behavior. When I wrote about the situation in March, there were allegations that several Chinese reverse-merger companies had issued fraudulent financial statements. Some companies were alleged to have inflated revenue; other companies supposedly made up clients out of whole cloth. But it was difficult to determine the accuracy of the allegations because they had been issued by hedge funds that had short positions.

Nevertheless, many investors believed they knew enough about the situation and took long and short positions as well as purchased or wrote options contracts. However, while investors were prepared for stock prices to fluctuate, it seems that few were prepared for trading to be halted by Nasdaq and NYSE.

For instance, after it appeared that China Media Express (NASDAQ:CCME) had successfully defended itself against two hedge funds that reported that CCME had inflated its revenue, CCME's auditor and CFO resigned and its shares were halted on Nasdaq on March 11 at \$11.88. Stock exchanges have the power to halt trading in any stock if a company has news that is material to the price of the stock. A halt with code T1

is for pending news, but in the case of CCME, the resignation of the CFO and auditor caused Nasdaq to issue a halt code T12. Code T12 indicates that Nasdaq has asked the company to provide additional information. In the case of CCME, Nasdaq gave the company until the end of the month to provide a 'plan of compliance' regarding the fact CCME hadn't yet produced a 10K for the last fiscal year. However, as it turned out, CCME's shares did not resume trading for two months.

The extraordinary thing about the trading halts was that short sellers could not exit their position. Instead, they had to continue to pay high rates to maintain borrowed positions. If an investor sold CCME short on March 1 for \$12.27, he would have had to pay 10 per cent per month to maintain his position.

For the short seller of CCME, the trade worked out despite the high borrowing costs, because CCME finally started trading again on May 19 at \$2.16, allowing the short seller to close out his position for a gain of 82 per cent. If CCME was able to answer its critics' questions and the shares opened higher than \$11, it could have been much worse.

While short sellers had to continue to pay borrowing costs on a halted stock, holders of put options suffered much more. Because CCME's shares were extremely hard-to-borrow in the securities lending market, many investors were not able to borrow shares in order to deliver them to put option writers. For put options that expired when trading was halted for CCME, investors had to let their put options expire worthless, even if those put options were in-the-money, leaving them with nothing.

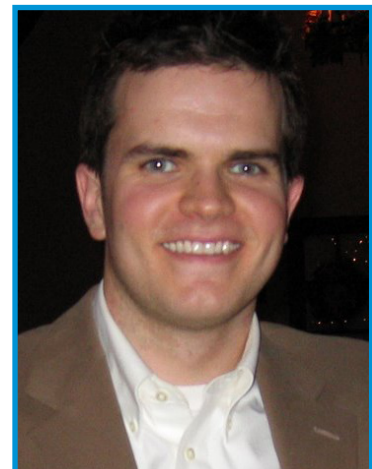
A trading halt is not something that most options investors would have ever imagined. A representative at the OCC said that he was fielding dozens of calls from options investors who were shocked to learn that their options would expire worthless unless they could borrow stock. But going forward, especially when it involves options on Chinese reverse-merger stocks, investors will at least know that there's a chance that trading may be halted.

The SEC and the US House of Representatives have already begun to take a look at the issue of Chinese companies coming to the US capital markets through a reverse merger. The SEC has filed lawsuits against some firms that have helped companies execute reverse mergers. But it remains legal for an auditor to outsource to a local Chinese auditor, so unscrupulous companies can still take advantage of the system.

There are still twenty companies whose shares remain halted on US exchanges. The longest-standing halt is actually on Vitacost.com, a vitamin company based in Boca Raton, Florida. Its shares have been halted since December 7, 2010. More than half of the twenty stocks, however, are Chinese reverse-merger stocks.

Below is a list of the most expensive-to-borrow Chinese stocks that trade on US exchanges. The list includes companies that issued an IPO as well as those that conducted a reverse merger. [SLT](#)

	Ticker	Shares borrowed	Intrinsic rate (%)
CHINA AGRITECH INC	CAGC	1,115,966	88.89
DEER CONSUMER PRODS INC	DEER	929,140	69.87
CHINA MEDIAEXPRESS HLDGS INC	CCME	2,031,594	67.25
CHINA-BIOTICS INC	CHBT	2,369,022	65.42
FEIHE INTL INC	ADY	1,162,995	60.54
CHINA GREEN AGRICULTURE INC	CGA	1,884,269	55.61
YONGYE INTL INC	YONG	3,276,270	48.63
SYNUTRA INTL INC	SYUT	1,278,600	23.47
ORIENT PAPER INC	ONP	650,816	19.81
CHINA MARINE FOOD GROUP LTD	CMFO	1,534,563	16.69



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