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In this Story, Short Sellers are not the Bad Guys

There's been a deluge of press about the collapse of Adani Group after a report from Hindenburg Research which accuses Adani Group of: stock manipulation, improper use of offshore tax havens to hide the amount of Adani's family stock ownership in the group companies, and excessive valuations. Hindenburg releases this report and acknowledges that it also holds short positions in Adani Group companies. Adani Group denies any wrongdoing and has hired top US law firm Wachtell Lipton Rosen Katz to fight the allegations brought by the Hindenburg Research.

This is not the first time that Hindenburg has toppled a company's share price. Just look at Nikola, WINS Finance, and Genius Brands all subjects of Hindenburg Research resulting in significant market devaluation of each company. And while no one outside of Hindenburg knows how much Hindenburg has made from its short selling, it's clear that it could be significant in that Adani group companies have lost over $100 billion in value. And as a result, the company's founder, Gautham Adani once the 2nd richest man in the world (briefly displacing Jeff Bezos) has seen his wealth plummet from $119 billion prior to the release of the report to $59 billion and falling.

Except for Hindenburg, many have lost millions and it brings into question the regulations around short selling as well as the regulator's ability to thoroughly audit large conglomerates to identify fraud and put confidence in the markets.

Let's look at India's regulations around institutional short selling. Unlike in the EU, India does not have a threshold for reporting short positions. Institutional investors must disclose on a gross basis whether the transaction is a short sale at the time of placement. Brokers are further required to disclose to the relevant stock exchange. So effectively, all short sale transactions are duly disclosed to the exchange and made public.

Considering that the Adani family holds most the shares in the group companies and those shares do not trade outside of India, and the public disclosures of short sales in India, this makes it quizzical about how Hindenburg was able to quietly build its short position. Remaining tight-lipped on how they built their position, Hindenburg offered this, "through U.S.-traded bonds and non-Indian-traded derivatives, along with other non-Indian-traded reference securities". Bankers and analysts are looking at derivatives such as Adani corporate bonds and participatory notes which could be the basis of Hindenburg's short selling success. Cracking this code could lead to more short selling in Indian companies.

While many consider short selling a desirable and essential feature of securities markets, regulators are in the business of protecting investors. Because of the backlash from Indian investors, it is quite likely that SEBI will revisit its short selling regime to either close loopholes or ban short selling altogether.

Regardless of what side of the argument you are on, one thing is clear, short selling does have the potential for identifying fraud that otherwise may have gone undetected. But should we have to rely on a short seller's report to be able to identify widespread company fraud?

What about Adani's auditors? Without question, this should have been a red flag to SEBI and large institutional investors. Adani's listed auditing firm, Shah Dhandharia & Co. is, according to the Hindenburg Research report, an auditing firm of only four partners and 11 employees. Looking at LinkedIn, this looks somewhat accurate and is the only information now available as there is no valid website for Shah Dhandharia. So, the question is, how can a conglomerate of Adani's size faithfully employ an auditing firm of less than two dozen accountants to be its auditors?

While India issued 17 fines for shareholding infractions in 2022, none of them were for short selling. This suggests that the short selling regime in India is working and therefore short selling is not the "bad guy" in this story. But to claim that, would mean India and specifically SEBI would be the center of attention for not adequately examining issuers trading on its markets and no regulator wants to be in the spotlight when investors have lost millions. ■