A Study on the Impact of Short Selling Mechanisms on Investor Protection-A Case Study of CITIC Securities

Xinyi Wang
School of Law, Nanjing Audit University, Nanjing, Jiangsu, China

Abstract: As a core short-selling mechanism in capital markets, securities lending can strengthen oversight of listed companies' information disclosure, improve the quality of such disclosures, and protect investors; however, its effectiveness depends on sound legal and regulatory frameworks.Using the 2012 CITIC Securities "Massive Loss Scandal" as a case study, the analysis reveals that in a weak legal environment, the dissemination of false bearish information can trigger sharp declines in stock prices. The profits from short selling far exceeded the costs of penalties for violations under the Securities Law at that time, causing the short selling mechanism to deviate from its original purpose of price discovery and degenerate into a tool for profit-seeking by certain entities, thereby harming the interests of small and medium-sized investors.The new Securities Law, revised in 2019 and implemented in 2020, specifically addressed these institutional shortcomings [1]. The addition of a dedicated chapter on investor protection, the "opt-in, opt-out" class action mechanism, significantly increased fines for violations, and explicit requirements for fairness in information disclosure have substantially raised the cost of regulatory violations related to short selling and streamlined channels for rights protection.However, as evidenced by the 2021 Shandong "black mouth" syndicate manipulation case, the new law still has shortcomings regarding the determination of collusion among parties and the regulation of online information dissemination.Research indicates that short-selling mechanisms have a dual effect on investor protection; the realization of their value requires a sound legal framework, strict regulatory enforcement, and a robust investor rights protection system. Only by achieving synergistic alignment between short-selling transaction rules and investor protection laws can the short-selling mechanism truly serve the price discovery function of capital markets and the protection of investor interests.

Keywords: Short Selling Mechanisms; Investor Protection; Retail Investors; Legal Regulation

1. Introduction

Since its establishment in the early 1990s, China's capital market has long been in a "one-way market" state, lacking an effective short-selling mechanism. The absence of such external constraints has led to inadequate and low-quality information disclosure by listed companies, which has become a key institutional flaw hindering the market's healthy development.Short selling mechanisms are an integral part of mature markets, and their advantages and significance are particularly prominent for China's market, which is undergoing continuous reform and opening-up. In March 2010, China's securities market officially launched a pilot program for margin trading and short selling, marking the formal introduction of short selling mechanisms into the capital market. The scale of short selling has continued to expand, and it has become an indispensable foundational trading system in the A-share market [2]. The solid theoretical foundation of the short-selling mechanism lies in its construction of a market constraint system. This mechanism not only relies on mandatory disclosure requirements under laws and regulations but also, by introducing the profit-driven incentives of short sellers, encourages market participants to thoroughly investigate and disclose companies' true information, thereby enhancing market transparency. This internal market oversight effectively curbs fraud and excessive speculation, promotes the reasonable adjustment of asset prices, and enhances market efficiency, providing a more robust safeguard for investor

Copyright @ STEMM Institute Press

rights.

In January 2010, the China Securities Regulatory Commission issued the "Guiding Opinions on Launching Pilot Programs for Securities Companies' Margin Trading and Short Selling Business" (CSRC Announcement [2010] No. 3) [3], marking the official launch of China's margin trading and short selling pilot program. The program entered its operational phase on March 31 of the same year.Among these, the securities lending business, as a typical short-selling mechanism, allows investors who anticipate a future decline in the price of a particular security or asset to borrow that asset through a qualified securities firm and sell it immediately at the current market price. Once the price of the underlying asset has fallen, the investor repurchases the same type and quantity of assets from the open market at a lower price and returns them to the lender, thereby profiting from the price difference.From an operational perspective, the short selling business shares a high degree of structural similarity with the short-selling strategies employed by overseas short-selling institutions-such as Muddy Waters Research-against Chinese ADRs, both reflecting the "sell first, buy later" trading logic. Such operations not only help enhance the market's price discovery efficiency and increase market liquidity but also provide investors with risk hedging tools, further optimizing the capital market's resource allocation function.The introduction of margin trading and short selling, particularly the establishment of these mechanisms, represents a significant step in the Chinese securities market's gradual refinement of two-way trading mechanisms and the promotion of financial derivatives innovation. It has also, to a certain extent, brought the A-share market's trading systems into alignment with those of mature international markets.The short selling mechanism is an indispensable component of building a healthy, mature, and resilient capital market. It helps investors uncover issues such as corporate financial fraud and business misconduct, and discloses negative information about companies. At the same time, investors can also derive economic benefits from short selling; a reasonable short selling mechanism can also increase market trading volume and the number of participants, improve market liquidity, and make market operations run more smoothly.Short-selling reports serve as a powerful form of external oversight, acting as a deterrent to listed companies. This external governance mechanism encourages firms to improve financial transparency and operational compliance, thereby protecting the interests of small and medium-sized investors (retail investors) and creating a more fair, transparent, and stable investment ecosystem for them [8].

The short-selling mechanism is a double-edged sword: while it enhances the transparency of market information disclosure and improves market liquidity, the temptation of profit has also given rise to issues of false information. From a legal perspective regarding investor protection, compared to mature markets, China's legal system has historically had many weak links in terms of investor protection awareness in the securities sector,However, the new Securities Law of 2019 significantly increased the costs of non-compliance. For mass disputes arising from illegal activities in the securities market-such as false statements, insider trading, and market manipulation-particularly major violations like fraudulent issuance and financial fraud, the introduction of a class action lawsuit system has greatly reduced the costs of seeking redress. Yet, the transition is not yet complete; the independence and efficiency of the judicial system still need to be continuously improved, and a body of class action case law must still be built up [9]. The profit model for short sellers relies on "falling stock prices." Given the current situation where relevant laws and regulations are not yet fully developed and investor protection remains inadequate, the existence of short-selling mechanisms raises concerns about moral hazard. Specifically, short sellers may exploit this mechanism by disseminating false "bearish" information-such as fabricating claims of corporate financial fraud, product failures, or investigations into senior executives-as the most direct and lowest-cost method to create market panic, drive down stock prices, and thereby profit.An analysis of the 2012 "massive loss scandal" involving CITIC Securities Co., Ltd. (hereinafter referred to as CITIC Securities) reveals that, in the current environment of China's capital markets, there is indeed a phenomenon of exploiting the short-selling mechanism to generate profits. In the absence of supporting regulatory mechanisms, the short-selling mechanism is highly susceptible to abuse; when combined with false information, it can be used to generate profits and even result in malicious attacks on the market. It is evident,

therefore, that to effectively harness the positive role of the short-selling mechanism in protecting investor interests, the key lies in establishing a sound and comprehensive legal framework for investor protection. Only by clearly defining legal requirements for the authenticity, timeliness, and completeness of information disclosure, and by strengthening supervision and penalties for illegal activities such as false statements, insider trading, and market manipulation,can the price discovery and corporate governance functions of the short-selling mechanism truly be realized. Otherwise, in an environment where legal systems are inadequate and enforcement is inefficient, short-selling activities may degenerate into tools for malicious short-selling and market attacks, thereby exacerbating market volatility and harming investor rights. Therefore, promoting the coordinated development of the short-selling mechanism and legal protections for investors is a systemic prerequisite for building an effective financial market and enhancing the confidence of retail investors.

2. The CITIC Securities "Massive Loss Scandal"

CITIC Securities was established in Beijing on October 25, 1995. In 2012, the "Massive Loss Scandal" (involving false information) triggered the short selling mechanism, causing a massive impact on the company's stock price and sparking market turmoil.

On August 13 and 14, 2012, three pieces of negative information regarding CITIC Securities were disclosed by online media and subsequently widely circulated. At the same time, CITIC Securities promptly issued a clarification announcement. However, this ultimately led to abnormal fluctuations in its stock price within a short period.

First, Zhang Moumou, a self-employed individual from Henan Province, grew dissatisfied after suffering continuous losses from personal stock investments (totaling approximately 60,000 to 70,000 yuan). Consequently, he fabricated and posted false information on the East Money stock forum claiming that "CITIC Securities had incurred massive losses of 2.9 billion yuan from overseas investments." This information rapidly spread throughout the market and was further distorted and amplified.Subsequently, Chen Moumou, an employee at a Zhejiang-based equity investment management company (with approximately 50,000 yuan in his securities account), saw related discussions in a QQ group. Without verifying the facts, he edited and repackaged the rumor, posting the false claim on Weibo that "CITIC Securities suffered a 2.9 billion yuan loss from overseas investments, and Chairman Wang Dongming has been taken away," thereby intensifying market panic.At the same time, a reporter named Cao from a financial news website (who had invested approximately 60,000 yuan in stocks since 2011), upon observing a sharp drop in CITIC Securities' A-share price, posted speculative information on his personal Weibo account stating, "CLSA Securities is experiencing a mass exodus of staff," citing so-called "news sensitivity" and failing to follow rigorous verification procedures.Although his motives were not purely malicious, this action objectively further misled public judgment and fueled the market's irrational decline. The cumulative spread of the aforementioned false information had a significant negative impact on CITIC Securities' stock price. On August 13, the company's stock closed with a sharp drop of 9.1%, resulting in a severe loss of market capitalization and a significant blow to market confidence.This case not only exposed weaknesses in information regulation and investor education within the A-share market at the time but also highlighted a typical risk in the new media environment: the rapid spread of false information via online platforms and the substantial threat it poses to financial market stability. The incident has become a landmark case in the history of China's securities market regulation, underscoring the urgency and complexity of regulating information dissemination, preventing malicious short-selling, and strengthening oversight of investor behavior against the backdrop of deepening market-oriented reforms.

The "overseas investment" mentioned in the negative reports referred to the acquisition of CLSA. CITIC Securities' acquisition of CLSA was a cross-border M&A initiative that attracted significant market attention at the time. As of August 13, 2013, the acquisition had been largely finalized; however, differing views regarding its strategic value and potential risks persisted both at the time and for some time afterward, with no clear consensus emerging.Some market observers adopted a cautious or even negative stance, questioning the

Copyright @ STEMM Institute Press

difficulty of integration, cultural differences, and the feasibility of achieving synergies. Nevertheless, in subsequent announcements, CITIC Securities consistently stated that the acquisition was proceeding steadily according to plan, with no major irregularities.

3. The Economic Consequences of Negative Information

By spreading false bearish information, short sellers can easily manipulate stock prices and profit from them; this manipulation scheme is essentially no different from the practice of releasing false bullish information.The combination of false information with short-selling merely transforms bearish information into a means of profit-driven manipulation; while it amplifies the potential scale of trading, it does not alter the core nature of information-based market manipulation [4]. The negative information regarding CITIC Securities consisted of only a few false statements, yet it led to significant economic consequences. The market performance of CITIC Securities and the broader industry before and after the incident is shown in Table 1 and Figure 1 [5]. The 2012 CITIC Securities "Massive Loss Scandal" was triggered solely by fabricated negative information, such as claims of "massive overseas investment losses of 2.9 billion yuan," causing CITIC Securities' stock price to plummet by 9.1% that day and the brokerage sector index to drop by 7.64%. Over the following month and a half, the index fell by nearly 9%.Fund flow data showed a net outflow of 720 million yuan on that day. The incident also sparked market concerns about CITIC Securities' operational health, undermining investor confidence and damaging its market reputation.Looking at operational data, CITIC Securities reported operating revenue of 11.694 billion yuan in 2012, a year-on-year decline of 53.29%. Net profit attributable to the parent company was 4.237 billion yuan, down 66.31% year-on-year, marking the lowest net profit since 2007. Revenue from core businesses such as brokerage and asset management saw significant declines, and the gross profit margin of the asset management business dropped markedly.Because CITIC Securities issued a timely announcement, the false negative information did not trigger a sustained decline in the stock price. Theoretically, when a stock price falls due to false information, it should return to its previous level once the information is exposed as false; however, the stock price did not fully recover to the level prior to the release of the false information.

Table 1. Stock Price, Price Changes, and Trading Activity During the Incident

Time	CITIC Securities			Sector
	Closing Price (CNY)	Trading Volume (shares)	Price Change	Price Change
August 9	12.24	38,694,047	0.25%	0.20%
August 10	12.09	32180835	-1.23%	-1.62%
August 13	10.99	175,148,588	-9.10%	-7.13%
August 14	10.81	107,696,225	-1.64%	-0.70%
August 15	10.7	42,907,646	-1.02%	-1.29%
August 16	10.73	54,971,194	0.28%	0.06%

Source: Adapted from Zhao Jingyu, Ye Fan, and Liu Feng. "Can Short Selling Protect Investors?-A Case Study of CITIC Securities' 'Massive Loss Scandal'." Finance and Accounting. 11 (2014): 18–20. Original table redrawn

Figure 1. CITIC Securities vs. Industry Price Changes

Source: Same as Table 1

Table 2. Calculation of Short Selling Returns

Average Selling Price (CNY)	Time	Net Repayment Volume (shares)	Profit 1 (CNY)	Profit 2 (CNY)
12.2	August 13	837,364	1,000,813.68	3,475,191.08
	August 14	859,534	1,027,537.61	1,774,731.11
	Total	1,696,898	2,028,351.29	5,249,922.19
11.96	August 13	837,364	803,690.18	3,278,067.58
	August 14	859,534	825,195.08	1,572,388.58
	Total	1,696,898	1,628,885.27	4,850,456.17

Source: Same as Table 1

 Copyright @ STEMM Institute Press

4. Short Selling Mechanisms Under Weak Legal Risks

The short-selling mechanism generates profits through counter-cyclical gains, with the expectation that overvalued stock prices will revert to their reasonable levels. However, in the case study, the consequences of false negative information actually cause stock prices to fall below their reasonable levels. Based on short selling data, this paper provides a conservative estimate of short selling profits (as shown in Table 2).By analyzing short selling profits and default costs, we examine how short sellers influence prices by spreading false information or manipulating stock prices. Given that such actions clearly invite legal penalties and retaliation from the target companies, why does the phenomenon of using false information to drive down a company's stock price still occur in short selling? Regarding the short selling mechanism, first, the maximum term for short selling transactions is capped at six months. Data shows that the average holding period for short positions in 2011 was only 2.37 days.Based on this, assuming short selling transactions follow the first-in, first-out (FIFO) principle-where the portion sold earlier is repaid first-the outstanding short positions primarily consist of recently sold shares. Since CITIC Securities' stock price was generally trending downward prior to the event, under this method, the selling prices corresponding to the outstanding short positions are lower and the price spreads are smaller, resulting in relatively conservative estimates.Additionally, the lowest price of 11.96 yuan during the period from August 1 to 10, 2012, was selected as the average selling price, with a holding period of 3 days. The average annual short selling interest rate across securities firms during the event period was 10.19%. Furthermore, since short selling is subject to price restrictions, it is assumed that all short sales were executed at the closing price.Finally, on the 13th and 14th, the short selling balance declined; however, this change was not solely due to repayments but also included new short selling transactions. Since it is impossible to determine whether the specific timing of short sales on those days occurred before or after the news of the stock price decline, two scenarios are assumed: "Scenario 1" assumes the selling price on the day equals the repayment price on the same day; "Scenario 2" assumes the selling price on the day equals the previous day's closing price.Given that the sharp decline in the stock price occurred on the 13th, the short position balance rebounded after the 15th, and CITIC Securities had already issued a clarification announcement, we consider only the short selling profits from the 13th and 14th. The calculation results show that even under the most conservative scenario, the profits reached approximately 1.6 million yuan.Based on an analysis of the costs of non-compliance, the primary cost in this case stems from violating the provisions of the Securities Law regarding the prohibition of disseminating false information. The China Securities Regulatory Commission (CSRC) noted that the relevant conduct in this incident is suspected of violating Article 78 of the Securities Law, which prohibits "state officials, media personnel, and other relevant individuals from fabricating or disseminating false information to disrupt the securities market," and stated that it would handle the matter in accordance with the law pursuant to Article 206 of the Securities Law.Pursuant to this provision, specific penalties include orders to rectify the violations, confiscation of illegal gains, and the imposition of a fine ranging from one to five times the amount of the illegal gains; if there are no illegal gains or the illegal gains are less than 30,000 yuan, a corresponding fine shall be imposed [6].

5. Conclusion

In classical financial theory, the short-selling mechanism is considered to have multiple positive effects: it not only enhances the market's price discovery efficiency and accelerates the incorporation of negative information into stock prices, but also encourages listed companies to improve the quality of their information disclosure and curbs opportunistic behavior by management, thereby improving corporate governance standards.However, an analysis of the relevant information environment, trading behavior, and cost-benefit structure in the CITIC Securities case reveals that, in this incident, the dissemination of false or misleading negative information significantly exacerbated downward pressure on stock prices. Given that China's short selling business was still in its infancy in 2012, the regulatory framework was not yet fully developed, and mechanisms for identifying, holding accountable, and penalizing false information were notably lagging and

inadequate.Empirical calculations indicate that, in this case, the potential gains from short selling far exceeded the potential costs of penalties for disseminating false information. In the absence of effective institutional constraints, this imbalance between costs and benefits effectively created an improper incentive, potentially inducing market participants to intentionally fabricate or disseminate false information and exploit the short-selling mechanism for personal gain.Therefore, this study argues that whether short selling can fulfill its theoretical positive functions depends to a large extent on the sophistication of supporting institutional frameworks-including strict disclosure regulations, an efficient legal enforcement system, and effective measures to curb malicious short selling. Without these institutional safeguards, the short selling mechanism not only fails to achieve its original purpose of optimizing resource allocation but may instead degenerate into a tool for market manipulation, undermining investor confidence and market stability.The securities market is a vital external environment for the survival and development of listed companies. If the market is sluggish and neglected, listed companies will struggle to obtain effective capital support. Only when retail investors continuously channel their savings into the securities market can market vitality be enhanced. Therefore, protecting the rights and interests of retail investors and maintaining their confidence in the capital market is of paramount importance.The new Securities Law of 2019 has significantly increased penalties, involving substantial changes in the interpretation of numerous legal provisions, and is more in line with modern legal principles of protecting the vulnerable [7]. For example, the new law raises the maximum fine to ten times the original amount,established a minimum penalty threshold of 1 million yuan and a minimum fine cap of 10 million yuan, significantly raising the cost of non-compliance, and established China's "class action" system, providing investors with a powerful tool for seeking compensation. These measures aim to thoroughly purify the market environment, protect investors' legitimate rights and interests, and serve as a deterrent against unreasonable short-selling practices, thereby elevating investor protection to new heights.However, following the implementation of the new Securities Law, the China Securities Regulatory Commission (CSRC) has investigated multiple cases of market manipulation using false information. A typical example is the 2021 market manipulation case involving a "black-mouth" syndicate in Shandong. This syndicate used hundreds of WeChat groups to distribute "after-hours stock picks" (i.e., post-market recommendations claiming a stock would surge the next day) to over 300,000 investors, inducing them to buy shares and driving up stock prices,and the manipulation ring would then take the opportunity to sell in the opposite direction to profit. As the legal and regulatory framework related to short-selling mechanisms continues to mature and improve, the behavioral strategies of short sellers are becoming increasingly complex and covert. They often circumvent the constraints of the current regulatory framework through structured product design, cross-border and cross-market operations, and more specialized information processing methods.This dynamic interplay between "regulation" and "circumvention" poses an ongoing challenge to the integrity and adaptability of the existing regulatory system. Therefore, to effectively guard against potential systemic risks and curb the abuse of short-selling tools for market manipulation, there is an urgent need to establish more forward-looking and systematic supporting mechanisms at the legal level.This includes, but is not limited to, strengthening supervision, improving inter-departmental coordination mechanisms, enhancing the ability to identify complex trading patterns, and strengthening the pursuit of legal liability for the dissemination of false information and malicious short selling. In this way, while leveraging the price discovery function of the short-selling mechanism, we can effectively safeguard the healthy development of China's capital markets and the legitimate rights and interests of small and medium-sized investors.

References

[1] China Securities Regulatory Commission. Guidelines on Launching Pilot Programs for Securities Companies' Margin Trading and Short Selling Business: CSRC Announcement [2010] No. 3 [Z/OL]. 2010-01-22 [2026-03-25]. http://www.csrc.gov.cn/csrc/c101838/c1022047/content.shtml

[2] Standing Committee of the National People's Congress. Securities Law of the People's

 Copyright @ STEMM Institute Press

Republic of China (2019 Amendment) [Z/OL]. 2019-12-28 [2026-03-25]. http://www.csrc.gov.cn/jiangxi/c105769/c7463999/7463999/files/
[3] Zhao Jingyu, Ye Fan, Liu Feng. Can Short Selling Protect Investors? - A Case Study of CITIC Securities' "Massive Loss Scandal" [J]. Finance and Accounting, 2014, (11): 18–20.
[4] Chen Qi, Liang Haoran, Li Li. Can Short Selling Mechanisms Curb the "All Talk, No Action" Phenomenon in Corporate Digital Transformation? [J].Modern Finance (Journal of Tianjin University of Finance and Economics), 2025, 45(08): 112-129.
[5] Xue Qihang, Wang Huimin, Liu Hongyang, et al. How Does Legal Protection for Investors Affect Corporate Innovation? New Evidence from the Revision of the Securities Law [J]. Nankai Economic Research, 2025, (11): 107-126.
[6] China Securities Regulatory Commission. CSRC Strictly Investigates and Punishes Illegal Acts Such as Fabricating and Disseminating False Information in Accordance with the Law [EB/OL]. (2012-09-03) [2025-04-16]. http://www.csrc.gov.cn/csrc/c100200/c1000550/content.shtml.
[7] Miao Yinzhi. A Study on the Regulation of Naked Short Selling, Short-Selling Manipulation, and Short Selling in Stock Index Futures [J]. Financial and Economic Law, 2015, (06): 25-42.
[8] Mu Linjuan, Gao Wenting. The Problem of False Information Dissemination and Prevention under the Margin Short Selling Mechanism: The Case of CITIC Securities' Plunge [J]. Business Accounting, 2017, (02): 44-45.
[9] Zhao Jingmei, He Xin, Wu Fengyun. A Study on Rumors in the Chinese Stock Market: Rumor Spreading, Debunking, and Their Impact on Stock Prices [J]. Management World, 2010, (11): 38-51.