Emerging Issues In Evaluating Market Efficiency: Part 2


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Law360, New York (July 30, 2013, 1:30 PM ET) -- On June 28, 2010, an unknown and untested research firm called Muddy Waters published an online report on Orient Paper Inc., a Chinese company that became publicly traded on the New York Stock Exchange through a reverse merger, accusing the company of chronic financial fraud. The Internet became ablaze with both commentary deriding Orient Paper and questions about Muddy Waters' legitimacy.

The market, however, responded swiftly and unambiguously. Orient Paper stock dropped almost 40 percent in the three days following the publication of the Muddy Waters report, erasing tens of millions of dollars worth of equity. How could an unknown research firm have such a profound effect on the company's stock price? And how has the rise of online reports, financial blogs, social media and the Internet, more broadly, changed the landscape of market efficiency for publicly traded securities?

We use Orient Paper as a case study to illustrate the importance of online financial research, especially as related to stocks with less coverage by traditional equity analysts. Further, we argue that these new avenues of information dissemination should be considered along with traditional equity analyst coverage in a discussion of market efficiency for a security.

Class certification in securities litigation cases hinges on the evaluation of market efficiency, that is, whether the price of the security at issue rapidly incorporates publicly available news and information. Market efficiency in these cases is conventionally evaluated with an analysis of the five Cammer factors, including analyst coverage: "[I]t would be persuasive to allege a significant number of securities analysts followed and reported on a company's stock during the class period."[1] The concept of "analyst coverage," however, as the Cammer court understood it, has evolved over time.

The Cammer decision dates back to 1989, now 24 years ago. The availability of information, including pertaining to investment research and analysis, is very different than it was in the late '80s. Rather than obtaining traditional equity analyst reports, the average investor is much more likely to seek out financial blogs and Internet-only financial research, which are among the top hits on Google searches.

For example, Seeking Alpha, Zero Hedge, Business Insider, Street Sweep and many other financial blogs have become the "first stop" for many investors. This information is easily accessible, and in most cases, freely available. Thus, these information-age models of communication are, in fact, new channels of information dissemination that contribute to market efficiency for publicly traded securities.

Financial academics have recognized the importance of financial social media to the stock market. As far back as the early 2000s, researchers analyzed the relationship between online posting activity and abnormal stock returns.[2]

In a recent research study, Chen et al. (2013) describe the influence of information from Seeking Alpha on stock prices, showing that a high frequency of negative language in an article correlates in a statistically significant manner with negative contemporaneous stock returns; even future returns may be predicted by negative articles on Seeking Alpha.[3] These researchers conclude:

> The Internet has become increasingly popular both as a venue to place trades and as a source of information. Da et al. (2011),[4] for instance, provide evidence of a strong link between aggregate search frequency of stock tickers in Google and trading by retail investors. This study examines how views expressed on a popular social media site [Seeking Alpha] for investors pertain to security prices. We find that the opinions revealed on this site strongly predict future stock returns and earnings surprises, even after controlling for the effect of traditional advice sources, such as financial analysts and newspaper articles. Together, our findings point to the usefulness of peer-based advice in financial markets and the value-relevance of peer opinions in general. ("Customers as Advisors: The Role of Social Media in Financial Markets," by Hailiang Chen, Prabuddha De, Yu Jeffrey Hu and Byoung-Hyoun Hwang, Jan. 17, 2013, p. 20.)

Moreover, financial blogs have been on the forefront of investment research, frequently breaking stories of potential fraud or malfeasance at publicly traded companies. Muddy Waters Research, for example, is a financial blog headed by Carson Block, a former lawyer in Shanghai, that, among other things, has been an industry leader in exposing fraudulent behavior of Chinese companies traded on U.S. exchanges.[5]

The Case of Orient Paper Inc.

Orient Paper Inc. (ONP) was the subject of Muddy Waters' first-ever report and Block's first casualty as a vigilante researcher. Muddy Waters exposed Orient Paper as engaging in potentially fraudulent behavior in a report dated June 28, 2010. Orient Paper serves as the holding company for a brick-and-mortar paper producer in China called Hebei Baoding Orient Paper Milling Co. Ltd. The company specializes in the production and distribution of paper products, including "corrugating medium paper, offset printing paper, writing paper, and other paper and packaging-related products."[6]

The Muddy Waters report contained a number of serious allegations. The first sentence of the report, highlighted in bold, states in no uncertain terms, "We are confident that ONP is a fraud. Its purpose is to raise and misappropriate tens of millions of dollars."[7]

Muddy Waters specifically alleged that Orient Paper greatly overstated the value of its assets and revenue for fiscal years 2008 and 2009, including misstatements of inventory value and improper recording of purchase prices for assets. Indeed, the Muddy Waters report alleged fraudulent behavior by Orient Paper that would raise concerns among its investors. Importantly, though, Muddy Waters is not a traditional equity analyst.

Traditional equity analysts from leading investment banks failed to scrutinize potential wrongdoings by Orient Paper, and only a handful of analysts had followed the company. A search of the Thomson Reuters database shows that, in the period leading up to the Muddy Waters report, four equity analysts were following the company: Roth Capital Partners LLC, Religare Capital Markets, SKP Securities Ltd. and Sharekhan Ltd.

Despite the fact that Muddy Waters is not a traditional equity analyst, the firm's online research report sent shock waves through the market for Orient Paper stock. Though Orient Paper released a statement shortly after the Muddy Waters report denying the allegations, its stock price fell from $8.33 at the close of trading on June 28, 2010, the day the Muddy

Waters report was published online, to $5.09 on July 1, 2010 — a loss of more than $59 million in the company's equity, or 39 percent of its total market capitalization.[8]

Since the publication of the Muddy Waters report and subsequent fallout, Orient Paper stock has been beaten down. As we write this article, Orient Paper stock was trading at $1.69 per share as of market close on July 18, 2013.

Market reaction to the Muddy Waters report was dramatic. New, Internet-based channels were perhaps the most important information disseminators in the case of Orient Paper.

Breakout Performance, a financial blog covering different markets, featured an article about the author's own due diligence trip to Orient Paper. The author disagreed with Muddy Waters' analysis of Orient Paper's business practices and future opportunities.[9]

Another example, published a few weeks after the Muddy Waters report, is an article on Seeking Alpha that noted a number of suspicious behaviors by Orient Paper, and the author's belief that Orient Paper had falsified its financial statements. Further, commentators on the article gave their 2 cents, debating the merits of the company and the allegations of potential fraudulent activities.[10]

It is clear that in the case of Orient Paper, the Internet vastly expanded the ability of analysts, and both professional and individual investors, to discuss the company and its stock, facilitating information dissemination, and thereby contributing to the efficiency of the market for Orient Paper stock.

Conclusion

The case of Orient Paper is representative of a broader shift in how capital markets research, examine and evaluate companies since the advent of the Internet. This shift is especially important for stocks with less coverage by traditional equity analysts. While the 1989 Cammer decision focuses on traditional analysts, it is important to incorporate an understanding of how value-relevant information is disseminated in the Internet age into the evaluation of market efficiency for a security.

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[1] Cammer v. Bloom, D.N.J.,1989, 711 F. Supp. p. 1286.

[2] "Internet Message Board Activity and Market Efficiency: A Case Study of the Internet Service Sector using RagingBull.com," by Robert Tumarkin, Financial Markets, Institutions & Instruments, volume 11, issue 4, November 2002.

[3] "Customers as Advisors: The Role of Social Media in Financial Markets," by Hailiang Chen, Prabuddha De, Yu Jeffrey Hu, and Byoung-Hyoun Hwang, January 17, 2013, available at http://ssrn.com/abstract=1807265.

[4] “In Search of Attention,” by Zhi Da, Joseph Engelberg, and Pengjie Gao, Journal of Finance, 66(5), 2011, 1461-1499.

[5] “Meet The Guy Who May Have Just Cost John Paulson $500 Million In 24 Hours,” by Katya Wachtel, Business Insider, June 3, 2011.

[6] Orient Paper, Inc., form 10-K for the Fiscal Year Ended December 31, 2011, dated March 15, 2012.

[7] Orient Paper Inc., Report, by Carson C. Block, Esq., and Sean Regan, Muddy Waters Research, LLC, dated June 28, 2010.

[8] “Orient Paper Responds to Allegations Made by Muddy Waters, LLC,” PR Newswire, June 30, 2010.

[9] “Orient Paper Visit Satisfies Investor,” by Eric Jackson, TheStreet through Breakout Performance, July 2, 2010.

[10] “Orient Paper: Key Pieces of Evidence for Fraud,” by “Chinese Company Analyst,” Seeking Alpha, July 15, 2010.