Financial Media Regulation

The contents of this note were first published in August 2019 after a shorting attack by Muddy Waters on Burford Capital (BUR). The company was attacked over its accounts, corporate governance and other matters. Muddy Waters, led by Carson Black, was shorting the stock. The share price of Burford fell by 60% from where it was at the start of the year. At the same time we had a similar attack on venerable US company General Electric (GE) who were accused by Harry Markopolos of false accounting over liabilities on long-term care insurance policies. This caused the share price of GE to drop by 11% on one day alone. You can see Harry talking about his report on CNN here: https://www.youtube.com/watch?v=MGvsXPY26KI

As in the Burford case, the accuser had not bothered to contact the company they were attacking before publishing their accusations. This is bad journalistic practice because it's easy to make mistakes over simple facts particularly when relying on third party sources who can often be unreliable.

I have expanded the original article with some further thoughts on the subject in this version.

The Problem

These are just two of numerous such examples over the last few years including some in which I had an interest. Sometimes the allegations escalate to the point that a company is severely damaged and never recovers. Or the business is revealed to be a simple fraud – as in the case of Globo. But sometimes the allegations go nowhere and the companies recover. For example, Carson Black attacked a number of Chinese companies listed in the USA or Canada before 2012 including Orient Paper and Sino-Forest. Sino-Forest was clearly a fraudulent business and the company subsequently filed for bankruptcy – you can read the full story here: https://medcraveonline.com/SIJ/SIJ-03-00145.pdf . In the case of Orient Paper, the company hired third parties to investigate the claims and showed they were of little substance and the SEC took no action although the company did settle some civil claims against it over the matter. Not all the allegations made by shorters turn out to be true, in full or in part.

A similar UK case was that of Blinkx – subsequently renamed RhythmOne (RTHM) and recently taken over by Taptica. The allegations here were that video advertising revenue was often fictitious in that and other similar companies and the whole sector came under suspicion although many of the allegations were false or based on innuendo. A lengthy period ensued of claim and counter-claim but no action arose by the regulatory authorities – the FCA or AIM regulators. The share price did recover but only after a long period and after significant changes at the company. Investors in the shares were unable to quickly separate fact from fiction about the allegations and hence many investors sold out – that is similar to events in the Burford case where it might be many months before any conclusions are reached by the relevant regulatory authorities and the share price remains depressed.

These attacks on companies are often publicised by the media – both the traditional paper press and by on-line news sites of which there are many in the financial world (this blog alone might be considered one such of course). As any journalist will tell you, “bad news” stories tend to gain more public attention than “good news” stories. Exaggeration and hyperbole are common because by doing so the web sites attract attention and hence more readers or subscribers – in effect these stories are often “clickbait” in current parlance.

Clearly the motive for many of these attacks, and why the attackers do not contact the companies concerned before promoting their stories, are financial. The attackers hope to make money from shorting the stock, or advising others to do so. In the case of Blinkx, the attack was based on evidence provided by a third party who had a direct financial interest in supplying the required information.

Needless to point out perhaps that the traditional national media such as newspapers have always paid for stories although paying criminals or police officers for stories is viewed with disdain. But newspapers do usually try to corroborate facts before they publish and usually invite comments from those attacked. This gives the defendents time to take action to prevent publication where they claim the allegations are simply untrue.

Which brings us on to how the more traditional media are regulated to avoid the abuses that one sees in the blogosphere. OFCOM regulates television and radio, including “catch-up” services, i.e. “broadcast” media. It now covers the BBC although one sometimes might not realise it. OFCOM requires programme makers to show “due impartiality and due accuracy” without “undue prominence of views and opinions”. See https://tinyurl.com/mazam3q where there is extensive guidance.

OFCOM does not regulate on-line media so video programmes on YouTube are not regulated in any way by an independent third party. YouTube only has its own guidelines which it tries to enforce against harmful content, but it has opposed any suggestions of outside regulation. As OFCOM says in its own report on Addressing Harmful Online Content, “While regulation has evolved, most online content is subject to little or no specific regulation”. In reality such media of all kinds and covering so many subjects have grown at an enormous rate in recent years and have reached the point that regulating it as is done with broadcast media would be very difficult.

The traditional paper press are regulated by either IPSO or IMPRESS which were set up relatively recently (by 2016) after the Leveson Inquiry. IPSO has a Code of Practice for Editors for example that covers such matters as accuracy. It includes these requirements: “(i) The Press must take care not to publish inaccurate, misleading or distorted information or images, including headlines not supported by the text; (ii) A significant inaccuracy, misleading statement or distortion must be corrected, promptly and with due prominence, and — where appropriate — an apology published.

In cases involving IPSO, due prominence should be as required by the regulator; (iii) A fair opportunity to reply to significant inaccuracies should be given, when reasonably called for; and (iv) The Press, while free to editorialise and campaign, must distinguish clearly between comment, conjecture and fact". IMPRESS has a similar "Standards Code".

IPOS and IMPRESS are effectively voluntary schemes unlike OFCOM which was created by an Act of Parliament. As a result they are often seen as relatively toothless and the printed press have more ability to promote comment and less necessity to be "fair" than the broadcasting organisations. So for example the Daily Telegraph ran the GE story under the headline "Did Jack Welch build his GE house on sand?" with a sub-title of "A financial investigator has accused America's best known industrial giant of accounting jiggery-pokery" with extensive coverage of the allegations although they did cover some of the rebuttals from the company. But asking loaded questions that promote the allegations is simply a rhetorical way around the rules. Such questions are similar to that of the question, "when did you stop beating your wife" which is difficult to answer without acknowledging the allegation.

What other things might inhibit on-line media? Libel law is one although few companies will pursue that avenue because: 1) It is very expensive; 2) It takes many months, if not years, to conclude such legal actions and 3) the associated negative publicity can simply compound the problem. For companies to sue for libel in the UK they also have to show that they have suffered significant financial damage which may not be easy. In addition UK companies would have great difficulty pursuing those based in the USA or in other foreign countries where libel laws are less strict about the burden of proof. As the internet is a global service and content can be published and hosted on servers in numerous countries, that compounds the difficulties faced by the accused.

Financial regulators have some capabilities to stop market abuse. The Financial Conduct Authority (FCA) has powers under the Market Abuse Regulations (MAR) to prevent Market Abuse. To quote from the FCA: "Market abuse is a concept that encompasses unlawful behaviour in the financial markets and, for the purposes of this Regulation, it should be understood to consist of insider dealing, unlawful disclosure of inside information and market manipulation". That covers a wide spread of media and covers the use of bulletin boards to disseminate false information. In reality although the FCA's Handbook would appear to give it powers over market manipulation where false or inaccurate information is being published with the purpose of affecting share prices, the FCA seems remarkably reluctant to use those powers. In addition, there is the question where the story is complex (as most financial ones are), whether the treatment is fair or not. That is often a matter of judgement and can be disputed for a long time before any conclusion is reached. Financial regulators are typically unwilling to get into such minefields. Investigating such matters can take large resources in any regulator when they often have more obvious and urgent frauds to deal with, and very limited resources to pursue them.

You can see from all of the above that there are very limited deterrents to those seeking to profit from alleged failings in companies, and even fewer deterrents to ensure that what they promote to the public is always accurate, fair and reasonable.

Discouragement in advance of publication of articles on the internet is not there and penalties afterwards are non-existent except in very rare circumstances. Internet publishers are simply not regulated in any meaningful sense and you or I could publish pretty well anything on the web so long as it was not criminal (e.g. “hate speech” or “extreme pornography”). Criminal libel was removed from UK law in 2010, when the Coroners and Justice Act 2009 came into effect and abolished the offences of sedition and seditious libel, defamatory libel and obscene libel. Libel can only now be pursued in the UK under civil law by the offended with damages being awarded if the complaint is upheld. Such actions have to take place in the High Court which means they are very expensive even for trivial complaints. Newspapers appear to be willing to afford the risk of large damages they sometimes incur for the sake of a “good story”, and many on-line bloggers have few financial resources that would even cover the legal costs of a successful or unsuccessful case.

Fixing the Problem

What could be done to improve the situation and bring more morality back into this area of the financial markets? I suggest the following should be considered:

1. An offence of criminal libel be introduced where any person or organisation makes false allegations from which they or associates may financially benefit directly or indirectly (e.g. by boosting readership), or when they repeat such allegations made by third parties. Such an offence could be heard in a magistrate’s court as a “summary offence” to avoid excessive costs in most cases although some might justify being classed as an “either-way” offence where it might be referred to a Crown Court.

2. The above offence should impose an obligation on publishers to check their facts with third parties including a company which is the subject of the story before publication while allowing the company reasonable time to respond – perhaps 2 days would be reasonable, i.e. failure to verify the facts with the accused before publication would be considered as evidence of guilt.

3. Where an organisation is the publisher of financial commentary, rather than an individual, then they would be required to be licensed by a body such as OFCOM and be required to adhere to a code of conduct laid down by that body. This would need to cover those who run financial information web sites, bulletin boards and chat-rooms. The code of conduct would need to be similar to that for broadcasting organisations and would require an obligation to quickly remove for review any article that was the subject of a complaint. It would need to be made clear that reference to “publishers” would need to encompass those who not just had editorial responsibility and control over content but also those who simply hosted comments or stories from others, i.e. Facebook and most bulletin boards and blogging sites would be treated as publishers and not be able to use the excuse that they were simply technically hosting a service and not providing content.

Note that a simple submission of a complaint would not mean that the offending item was permanently reviewed – just that it is removed to give time for the complainer to fully plead their case to the publisher and if necessary, get an initial review from the regulatory body. This might impose some delay on the handling of complaints but there are few published articles that are so time-sensitive that a few days would make any difference.

4. There should be a specific obligation imposed on directors of companies, and on their auditors, to investigate allegations of fraud or misconduct when it is brought to their attention whether or not there is an intention to publish the information. The directors should also immediately request suspension of the shares when serious allegations are made until some clarity on the credibility of the allegations is reached (this is so as to avoid sales by directors before publication of the claims, or share trading by those making the claims).

5. Most civil libel actions should be heard not in the High Court but in a court similar to the “Small Claims” court so as to minimise costs and expedite resolution. Most libel claims are actually fairly straightforward with the evidence not complex and frequently undisputed. But because of the very large costs that can be awarded and the fact they must be heard in the High Court, the current costs of such cases are out of proportion to the nature of the offence that is alleged.

Note that such laws and regulations would not necessarily totally prevent those based overseas from publishing false allegations but it would certainly inhibit the circulation of the allegations within the UK and hence reduce the impact on financial markets in this country.

Would it allow frauds to remain undiscovered, and shareholders to remain in the dark about misleading accounts? If the allegations were true then clearly not as truth would be a good defence, and investigations by company directors and their auditors would reveal truths that could not be concealed.

Could it inhibit individuals from posting their comments or opinions on the web? It would be unlikely to do so but any organisation that published the comments on a financial subject would need to take responsibility for the content, and have systems to ensure very quick review and removal of offending items – most financial web sites already have such systems in place. But they might need to take steps to ensure they know who is publishing the information whereas at present anonymous malicious posts are common. Anyone who repeatedly makes false allegations could then be blacklisted.

Is introducing the criminal law into libel a disproportionate remedy? When the amount of money that can be made by financial market abuse is so large, and the alternative remedies so ineffective, it is surely appropriate to toughen up the regime. The penalties for abuse need to be substantially increased. Would the police or

regulatory authorities have the resources to pursue such matters? Probably not but the solution to that might be to permit private prosecutions.

Common Abuse

What I have not discussed in the above is the publication of abuse without any factual allegations being involved. Such comments about individuals such as is a “sender of fascist lawyer’s letters” when a victim complains or simple derogatory comments such as “fatty” aimed at ladies can be both extremely annoying to the recipient and damage their reputation but can be difficult to pursue under libel law. Good manners have simply disappeared in the modern world. Readers of such comments might be amused by them but the victims are not.

Many politicians and media personalities now suffer from such abuse without any recourse and so do companies. I have been on the receiving end of such comments personally in the past as is well known. It is a fact of life that standards in public life have gone significantly downhill in the last few years. This is partly due to the ease of distribution of such comments at trivial cost using the internet, the lack of practical and effective remedies and the fact that it is easy for the abusers to hide behind anonymity.

Even such reports as that on Burford by Muddy Waters are riddled with abuse. They don’t just present facts from which the readers can draw their own conclusions. They mix comment with the facts in derogatory form so as to strengthen their arguments.

If OFCOM licensed and regulated financial news/commentary web sites, it would be easy for them to put a stop to such behaviour by suitable regulations and prevent the “monetisation of abuse” that currently happens. By stimulating debate and response, web sites can generate traffic and hence gain financial benefit. It’s the equivalent of “trolling” on social media where perpetrators gain notoriety and personal satisfaction from upsetting others and starting arguments.

It would not be my intention to outlaw the making of derogatory comments about companies in the financial world. Most companies would not be damaged by such comments and not suffer any financial losses even if the shareholders might. But individuals might suffer for no good reason. Restoring good manners to modern society is an impossible task for the law, but regulation and licensing of publishers could prevent the worse abuses in financial markets where publishers of articles which are a mixture of fact, fiction and derogatory comment can profit financially.

It is of benefit to maintain an orderly market in company shares that companies can still come under criticism from investors. This helps to prevent the various “manias” that can sweep the market for company shares in hot sectors such as internet companies in the dotcom era. But it is surely the case that the pendulum has swung too far in favour of laissez-faire regulation of such matters.

Company directors may be expected to be thick-skinned but we now have a situation where company investors can suffer very substantial financial losses from the activities of professional doomsayers. That includes not just individual investors but institutional investors including pension schemes.

It is market abuse however you look at it.

Shorting

No doubt this article will stimulate some active debate from readers. It is important to state that I am not opposed to people shorting stock as such although I would like to see tougher regulation of stock-lending which often supports it. In particular the institutional holders who lend stock without the knowledge or consent of the beneficial holders who gain little benefit need to be restrained I suggest. But shorting stock might contribute to better market liquidity and price stability. Any market only works if there are people with contrary opinions on whether a stock is a fair price – for every buyer there needs to be a seller. What is surely wrong is that shorters can magnify their gains by making public allegations that are poorly grounded in sound evidence and on which the target companies have had no opportunity to comment before publication.

This is surely an area of the financial markets where more regulation is required.

Conclusion

When the original article on this subject was published there was criticism from some financial web sites and bloggers that the costs of a licensing system would put them out of business. As a result many of the frauds that shorters have revealed might remain undiscovered. That would certainly not be my intention although some might need to change their editorial approach and take more care over what is published. That would surely be to the good.

It would be important that any licensing system was simple and low cost in operation. Similarly my proposals on libel law, whether civil or criminal, would minimise the costs of such claims, both for the accusers and the accused. The costs imposed by improving on media regulation in financial markets so as to avoid the worse market abuses is surely justified.

Roger Lawson (Twitter: https://twitter.com/RogerWLawson)

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