

## CSA Consultation Paper 25-403

### *Activist Short Selling*

December 3, 2020

#### Introduction

The purpose of this consultation paper (the **Consultation Paper**) is to facilitate discussion of concerns relating to activist short selling and its potential impact on Canadian capital markets.

Since 2019, a committee (**we** or the **Committee**) comprised of staff from the Canadian Securities Administrators (**CSA**) has undertaken research and analysis on activist short selling. The CSA's consideration of this activity arose in the wake of an increased number of campaigns targeting Canadian issuers (**Campaigns**) and concerns raised about the potential impact of activist short selling on our markets.<sup>1</sup> We have also heard concerns from stakeholders about potential regulatory intervention inhibiting beneficial short selling activity and detracting from the price discovery process.<sup>2</sup>

To further inform our analysis of the issues, and to ensure that the CSA has all relevant information before determining whether regulatory intervention is required, the Committee is consulting with the public on issues identified through our research. While this Consultation Paper discusses our understanding of the concerns raised and summarizes the research we have undertaken, we are focussed on soliciting feedback, supported by evidence whenever possible, from stakeholders on specific questions, which are set out in this Consultation Paper.

This Consultation Paper is organized into four parts; Part I provides an introduction and background to the Committee's consideration of activist short selling with the three remaining Parts dedicated to the specific areas of consultation, namely:

- (II) The nature and extent of activist short selling activity in Canada;
- (III) The Canadian and international regulatory framework; and
- (IV) Issues related to enforcement and other potential remedial actions.

Each Part summarizes the Committee's research, our understanding of the issues and concerns raised and sets out questions for consultation.

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<sup>1</sup> See e.g., Barbara Shecter, "Activist short-sellers are increasingly targeting Canadian companies – is Canada ready?", *Financial Post* (6 October 2017) [Shecter]; Orestes Pasparakis, Walied Soliman & Joe Bricker, "It's time for legislators to crack down on abusive short-selling", *Globe and Mail Op-ed* (18 January 2019) [Pasparakis, Soliman & Bricker]; and Pete Evans, "Canada needs to toughen short selling rules to weed out abuse, market watchers say", *CBC News* (11 February 2019) [Evans]; Yves Allaire "Short-seller heists: Why do institutional investors support activist hedge funds only out for a quick profit?", *Financial Post Op-ed* (13 December 13 2019)

<sup>2</sup> See e.g., Larry MacDonald, "Regulations to rein in short-sellers must not undercut activists' positive effects", *The Globe and Mail* (30 January 2020)

## I. BACKGROUND

We use the term “activist short selling” to refer to instances where an individual or entity takes a short position in a security and then makes a public statement, issues a report, or otherwise publicly shares information or analysis that is likely to have a negative effect on the price of the security. If the value of the security declines, the short seller realizes a profit.<sup>3</sup> Activist short sellers are a subset of “directional” short sellers.<sup>4</sup> The key difference between activist and other directional short sellers is that activists will publicly disclose concerns they have identified with an issuer. Material and accurate information about issuers, whether it is positive or negative, assists in ensuring market prices reflect the fundamental value of the issuer’s securities. However, the utility or harm of activist short selling to the market depends on the materiality and accuracy of the information relied upon and whether there is a manipulative intent to spread falsehood or to distort prices.

Activist short selling is not new. However, these types of campaigns have received considerably more attention in recent years. This may be due, in part, to the rise in the use of social media and its impact on markets.<sup>5</sup> Indeed, through social media platforms, prominent activists with a large following can promote and disseminate their short theses about target companies to a broader audience and at a much faster pace.<sup>6</sup>

While traditional long shareholder activism is a well-accepted practice in our markets and viewed by most as an effort to improve shareholder value in public companies, activism by short sellers is often viewed differently. Activist short sellers state that they create real value for public markets by contributing to market efficiency and price discovery. Some take it even further describing their work as a “first line of defence against fraud and subsequent losses.”<sup>7</sup> The approach of activist short sellers is not without controversy. If an activist short seller’s objective is met, it will mean they have convinced the market of their thesis and caused a decline in a target issuer’s share price, leading to a loss of value for its shareholders.<sup>8</sup>

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<sup>3</sup> For further details on the mechanics of short selling, see Part I, Section B below. See also e.g., Wuyang Zhao, “Activist Short-Selling and Corporate Opacity” (January 28, 2020), available at SSRN [Zhao]; and Alexander Ljungqvist & Wenlan Qian, “How Constraining Are Limits to Arbitrage?” (March 5, 2016), Institute of Global Finance Working Paper No. 7, available at SSRN [Ljungqvist & Qian]. Some academics also refer to this type of activity as “negative activism”, see Joshua Mitts, “A Legal Perspective on Technology and the Capital Markets: Social Media, Short Activism and the Algorithmic Revolution” (October 28, 2019), Columbia Law and Economics Working Paper No. 615, available at SSRN.

<sup>4</sup> Directional short sellers anticipate a decline in the market price of a security sold, in contrast to other short sellers who hedge a long position or take advantage of an arbitrage opportunity and who will not benefit from subsequent downward or upward price movements.

<sup>5</sup> See Adam Kornblum “11 Tweets that Turned the Stock Market Upside Down” *Ogilvy Insights* (13 August 2018).

<sup>6</sup> Michael P. Regan, “The Tiny Activist Fund That Reaped 24% Return by Unearthing ‘Cockroaches’”, *Bloomberg Markets* (20 May 2019).

<sup>7</sup> Letter from Fahmi Quadir, Chief Investment Officer, Safkhet Capital Management LLC to Dr. Jean-Pierre Bussalib, Head of Short Selling Section, Bundesanstalt für Finanzdienstleistungsaufsicht dated March 15, 2019. [Safkhet Open Letter]

<sup>8</sup> As noted by Partoy et al., “unlike positive activism, which often carries a powerful and positive normative presumption, negative activism faces an uphill normative battle, the presumption being that it destroys shareholder value.” Barbara A Bliss, Peter Molk & Frank Partnoy, “Negative Activism” (February 25, 2019) 97 *Washington University Law Review*, Forthcoming. University of Florida Levin College of Law Research Paper No. 19-19 at 11. Available at SSRN. [Bliss, Molk & Partnoy]

## A. Concerns Raised

In the last few years, certain Canadian market stakeholders, primarily in the issuer community, have raised concerns about activist short selling and its impact on our markets.<sup>9</sup> These concerns appear to be based on perceptions that:

- There is an increasing number of activist short selling Campaigns in Canada<sup>10</sup>;
- The Canadian regulatory framework addressing short selling is less strict in comparison to other jurisdictions<sup>11</sup>; and
- There is inadequate deterrence to problematic conduct given the limited number of enforcement proceedings involving problematic activist short selling as well as a lack of meaningful remedial actions for misconduct.<sup>12</sup>

In contrast, activist short sellers have said they target Canadian firms because Canada is “fertile ground for corporate malfeasance”<sup>13</sup> and that their research and analysis serve an important function in the price discovery process by bringing to light new information.<sup>14</sup> Shorts sellers and others have expressed concerns that regulatory intervention that restrict activist short selling could inhibit beneficial short selling activity.<sup>15</sup>

As the CSA considered these issues, additional information was necessary to properly analyze the concerns raised. For example, with the exception of activist short sellers that have become well-known in the media or have publicly issued full reports and analysis, there is very limited information and data about other less prominent activist short selling activity (e.g., an anonymous negative commentary or analysis about an issuer posted on social media platforms). Even among more prominent activists, there is little information on the impact such campaigns have on affected issuers and on markets more generally.

As regulators considering the overall impact of activist short selling on our markets, it is important to consult and understand the concerns that have been raised from all stakeholders and understand the evidentiary basis for these concerns.

## B. Short Selling

Short selling, as a trading activity, is subject to a well-developed risk based regulatory regime and is overseen mainly by the Investment Industry Regulatory Organization of Canada (**IIROC**), as will be further discussed below in Part III. IIROC’s Universal Market Integrity Rules (**UMIR**) define a short sale as a sale of a security, other than a derivative instrument, which the seller does

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<sup>9</sup> As discussed in Part III.D, concerns about short selling and activist short selling have also seen a resurgence in other jurisdictions.

<sup>10</sup> See e.g., Shecter, *supra* note 1; Pasparakis, Soliman & Bricker, *supra* note 1; Evans *supra* note 1.

<sup>11</sup> See e.g., Justice Perell’s statement in *Harrington Global Opportunities Fund S.A.R.L. v Investment Industry Regulatory Organization of Canada*, 2018 ONSC 7739 at para. 11: “There is a perception that the regulation of shorting [*sic*] selling is permissive and lax in Canada compared to other capital markets.” [Harrington]

<sup>12</sup> Paul Davis et al, “An Analysis of the Short Selling Landscape in Canada: A New Path Forward is Needed to Improve Market Efficiency and Reduce Systemic Risk” (2019) *McMillan LLP*. [Davis et al.]

<sup>13</sup> See e.g., Shecter, *supra* note 1.

<sup>14</sup> See e.g., Ben Axler “Counterpoint: Short sellers like us create real value for public markets by telling Canadian investors the truth”, *Financial Post* (17 December 2019).

<sup>15</sup> See Saffkhet Open Letter, *supra* note 7, criticizing the short sale ban on Wirecard: “Short selling, writ large, affords positive externalities on the broader market, and more specifically to the investors which regulators have a duty to protect...the data does not support the existence of any material level of short seller manipulation.”

not own either directly or through an agent or trustee.<sup>16</sup> It involves selling the borrowed securities at the current market price with the expectation of being able to cover the short position by purchasing later at a lower price to replace the borrowed securities.

Short selling is a legitimate trading practice which contributes to market liquidity and price efficiency.<sup>17</sup> It also contributes to the price discovery process by providing an opportunity for negative views about the issuer to be reflected in the price of a security thereby limiting overvaluation and biased price increases.<sup>18</sup> Short selling can also be an important part of an investor's hedging and investment risk management strategy.<sup>19</sup> For example, the proceeds from a short sale may be applied to a long position in a different security. Even so, there is also risk inherent in short sales because unless the sale is otherwise "hedged", a short seller can lose a potentially unlimited amount if the price of the security rises unexpectedly.

A short seller can take a short position in a stock either directly (by borrowing shares to sell short)<sup>20</sup> or synthetically (via options or stock futures). There are, however, obstacles to short selling. For example, it can be difficult or expensive to borrow shares to sell short if the securities are thinly traded, in large demand by other short sellers, or not readily made available for loan.<sup>21</sup> Further, many Canadian listed issuers trade infrequently<sup>22</sup> and the available inventory of equities in the Canadian securities lending market, where short sale shares are typically borrowed, tends to be more heavily concentrated in securities of larger, widely held, heavily traded issuers.<sup>23</sup> Similarly, it can also be difficult to take a synthetic short position as the listed derivatives market for

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<sup>16</sup> Universal Market Integrity Rule (UMIR), Part 1 - *Definitions and Interpretation*, Rule 1.1.

<sup>17</sup> Carole Comerton-Forde, Charles M Jones & Talis J Putnins, "Shorting at Close Range: A Tale of Two Types" (March 18, 2015). *Journal of Financial Economics (JFE)*, Forthcoming; AFA 2012 Chicago Meetings Paper; Columbia Business School Research Paper No. 12/22, available at SSRN.

<sup>18</sup> Ekkehart Boehmer and J Julie Wu, "Short Selling and the Price Discovery Process" (July 16, 2012). *Review of Financial Studies*, Forthcoming, available at SSRN.

<sup>19</sup> See: Canadian Securities Administrators/Investment Industry Regulatory Organization of Canada, CSA/IIROC Joint Notice 23-312 *Request for Comment – Transparency of Short Selling and Failed Trades*, (2 March 2012). [Joint Notice 23-312].

<sup>20</sup> Short sales made without prior arrangements to borrow or reasonable expectation to borrow the security first are considered "naked short sales" and not permitted under securities legislation and UMIR except for short sales by market makers that provide liquidity in the stock (See *Rules Notice – Notice of Approval – Provisions Respecting Regulation of Short Sales and Failed Trades*, IIROC Notice 12-0078 (2 March 2012) [IIROC Notice 12-0078]). Naked short sales can lead to failed trades when the seller is not able to deliver the shares within the two-day settlement period. Discussed further in section III.B.

<sup>21</sup> See Owen A. Lamont, "Go Down Fighting: Short Sellers vs. Firms" (July 24, 2009). Yale ICF Working Paper No. 04-20, available at SSRN [Lamont].

<sup>22</sup> For example, in the years 2017-2019, between 50% to 57% of listed issuers in Canada's two largest marketplaces (based on number of issuers) had fewer than 2,500 trades per year or an average of less than 10 trades per day. Also, more than two-thirds of listed issuers had an annual traded volume of less than 25 million shares or an average daily traded volume of under 100,000 shares. (Based on aggregated annual trade counts and volume traded of TSX and TSXV issuers obtained from TMX listings data.)

<sup>23</sup> Short sellers represent only one of many borrowers in the securities lending market. Since securities lending is a scale business, the lenders are typically large buy-side firms (pension funds, insurance firms, mutual fund/ETF providers etc.) that offer for loan their holdings of securities of mostly large and frequently traded issuers. Additionally, IIROC's fully-paid securities lending (FPL) program will only include certain equity securities that meet at least one of three minimum requirements: volume-weighted average price (\$2.00), average trading volume (100,000 share) or average free float market capitalization (\$2 million) over a six-month period. For more information on securities lending, see Bank of Canada, Staff Discussion Paper 2019-5, *Canadian Securities Lending Market Ecology* (2019). For more information on IIROC's FPL program see IIROC Notice 19-0109 *Fully-paid Securities Lending* (June 17, 2019).

derivatives with an underlying equity is relatively small in Canada, representing only a small proportion of listed equity securities.<sup>24</sup>

### C. Activist Short Selling

In most CSA jurisdictions, activist short sellers are not currently subject to specific regulatory requirements,<sup>25</sup> nor are they defined or easily identifiable. However, as with other market activity conducted by non-regulated or unregistered entities or individuals, short selling activism is subject to the existing prohibitions under securities law, for instance prohibitions against market manipulation, making misleading statements or fraud.<sup>26</sup>

Activist short selling campaigns can be understood as occurring on a spectrum and their utility to the market ultimately depends on whether the information being disseminated is material and neither false nor misleading.<sup>27</sup> At one end of the spectrum, there are beneficial campaigns that can contribute to price discovery by producing research and analysis about issuers based on facts. At the other end of the spectrum, there are campaigns that may involve either intentionally producing false information about the issuer or making misleading or untrue statements for which there is no factual foundation. These are often referred to as “short and distort” campaigns.<sup>28</sup>

The types of conduct that give rise to concerns in the context of activist short selling campaigns include:

- disseminating unbalanced information that does not provide a complete picture, does not include other material contrary information or is inconsistent with information disclosed in a broader report;
- disseminating exaggerated reports or commentary;
- making conclusions without an evidentiary basis; or
- making potentially misleading statements through links to other documents.

Exacerbating these concerns is the speed at which information spreads through social media and the constraints on the target of a campaign to respond or disprove allegations before the price of their stock is impacted. However, issues arising from the use of social media or similar online

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<sup>24</sup> For example, as of March 11, 2020, Canada’s primary options exchange, the Montreal Exchange, listed fewer than 300 companies (under 10% of all TSX and TSXV issuers) on their equity options list and only 223 of those had available options contracts on the market.

<sup>25</sup> For example, activist short sellers would not be required to obtain registration under securities law requirements unless they otherwise meet a registration requirement, such as fund manager. See also in British Columbia where recent amendments to the *Securities Act* introduced rule making authority over those engaged in “promotional activities.” “Promotional activities” is defined to include any activity / communication that encourages a person to buy, not buy, sell or hold a security or derivative. Note there is rulemaking authority to prescribe that certain activities are not promotional activities. See *Securities Act* (British Columbia), RSBC 1996, c 418, s. 1 and 183(12.2).

<sup>26</sup> See e.g., *Securities Act* (Ontario), RSO 1990, c S.5, ss 126.1 and 126.2; *Securities Act* (Québec), V-1.1, ss 199.1 and 196; *Securities Act* (Alberta), RSA 2000, c S-4, ss 93 and 221.1; *Securities Act* (British Columbia), RSBC 1996, c 418, ss 57 and 168.1; *Securities Act* (Manitoba), CCSM, c S50, ss 76 and 136(1); and *The Securities Act* (Saskatchewan), 1988-98 c S-42.2, ss 55.1, 55.11, 55.13(1).

<sup>27</sup> Bliss, Molk & Partnoy describes this as “informational negative activism” – behaviour that seeks to uncover and then communicate the truth about companies whose shares the activists believe are overvalued. It can be focussed on past disclosures by companies which the activist argues contain misrepresentations or omissions or on future expectations about a company’s prospects. See: Bliss, Molk & Partnoy, *supra* note 8 at 12.

<sup>28</sup> Although out-of-scope, we also recognize that within the context of social media, the converse is also true – the potential for investors or related parties to spread false or misleading positive information about the issuer in order to profit from a rise in the issuer’s share price (otherwise known as a “pump and dump”).

platforms to spread information to the market are not limited to activist short selling. The CSA has acknowledged that social media can present challenges when used for sharing information with the market.<sup>29</sup> While we acknowledge that the new market reality is that any individual (e.g., influencers, customers, clients, vendors) can easily share unverified information on social media about an issuer that could potentially impact its stock price,<sup>30</sup> the integrity of the capital markets is undermined if those participating in our markets engage in activity that may mislead investors or otherwise artificially distorts an issuer's share price.

In order to be successful, an activist short seller must, at the very least, have some credibility and their thesis should raise sufficient doubt about an issuer that it convinces existing shareholders to sell their shares, and potentially other investors to short the stock or not buy it. Unlike long-only investors, activist short sellers generally incur direct costs to maintain their positions. Once a campaign is launched, activist short sellers are also exposed to the additional risk that the target's share price does not decline because of responses from issuers, opposing views from long traders, large institutional shareholders and analysts. If the share price rises significantly this can make the cost to close out the short position very expensive.<sup>31</sup>

As discussed in further detail in Part II, our research indicates that the prominent activist short sellers behind the Campaigns are relatively well-established (e.g., close to 80% of the 48 activist short sellers identified have been active for over 5 years) and predominantly based in the U.S. (approximately 60%, compared to 13% that are Canadian-based).<sup>32</sup> Anonymous or pseudonymous short sellers, or those with only a presence on SeekingAlpha.com (SA),<sup>33</sup> account for less than 20% of the 48 activist short sellers that have targeted Canadian issuers since 2010.<sup>34</sup>

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<sup>29</sup> See CSA Staff Notice 51-348 *Staff's Review of Social Media Used by Reporting Issuers* and CSA Staff Notice 51-356 *Problematic Promotional Activities by Issuers*.

<sup>30</sup> Social media's implications on financial markets extends beyond activist short selling and is therefore outside the scope of this consultation paper. For more information see Lin, Tom C. W., *The New Market Manipulation* (July 3, 2017). *Emory Law Journal*, Vol. 66, p. 1253, 2017; Temple University Legal Studies Research Paper No. 2017-20, available at SSRN.

<sup>31</sup> See: Ljungqvist & Qian, *supra* note 3. In that paper, the authors conclude that the main barrier to launching public short campaigns is the cost to produce credible and new information that will convince long investors to sell, rather than a lack of capital or other short-sale constraints (such as cost of borrowing).

<sup>32</sup> Academic studies have noted that a key component for the activist short seller's strategy is dependent on its own track record to convince current long shareholders to sell. See: *Ibid*. Statistics based on AI data of short campaigns targeting issuers with Canadian headquarters as of December 31, 2019.

<sup>33</sup> SA is a crowdsourced research platform and claims to be "the world's largest investing community" with approximately 17 million users per month; over 16,000 contributors; and a dedicated section to short selling for called "Short Ideas" for paid subscribers. The platform requires all contributors to disclose positions in stocks they write about and to obtain editor approval before posting information. SA states that pseudonym contributors are held to the same compliance and biographical standards and their real name and contact information are kept confidential. Additionally, contributors involved in a settlement or SEC action must reveal their real names. For more information see, [About Seeking Alpha](#).

<sup>34</sup> This may be a relevant factor to understanding the potential impact of activist short sellers on Canadian markets as a recent U.S. academic study found evidence that potential short and distort strategies are more likely to be associated with pseudonymous authors than with identifiable individuals. Activist short sellers identified in the study were authors who published a negative article about an issuer and declared that they held a short position on SA. See: Joshua Mitts, "Short and Distort" (February 13, 2020) *Columbia Law and Economics Working Paper No. 592*, available at SSRN.

## II. Research and Empirical Findings

The CSA's research consisted of an empirical analysis of activist short seller Campaigns and an academic literature review related to activist short selling.<sup>35</sup> The empirical analysis was limited to Campaigns identified by Activist Insight (AI), a third-party data provider focused on tracking activist investors on both the long and short side. AI's database only tracks campaigns by prominent activist short sellers, whether they are named or they are anonymous individuals or entities.<sup>36</sup> This data would cover campaigns that have the most market impact but may also potentially overlook campaigns by less prominent actors engaged in similar activities.

The current academic literature on activist short selling activity is sparse and is focused predominantly on U.S. markets where, as explained below, there is a sufficiently greater amount of activist short selling activity and data to conduct a more rigorous analysis.

### A. Activist Short Selling Activity

Between 2010 and September 2020, a total of 73 Canadian issuers have been the target of 116 Campaigns and among them 16 Campaigns (including all 12 Campaigns from 2020)<sup>37</sup> are still active according to AI.<sup>38</sup> While there has been increased activity since 2015, annually there have been no more than 5 Canadian targets for every 1,000 Canadian listed issuers.<sup>39</sup> In comparison, U.S. issuers are more frequently targeted by activist short sellers - an average of 21 U.S. targets annually for every 1,000 U.S. listed issuers.<sup>40</sup>

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<sup>35</sup> This analysis was based on listed issuers with a head office in Canada. Canadian listed issuers without a Canadian head office are not captured. In 2019, there was only one Campaign that targeted a Canadian listed issuer without a Canadian head office.

<sup>36</sup> AI considers prominent activist short sellers to be those with a history of disclosing strong thesis or reports, disclosing a position in the target company and having a considerable impact on the target's stock price.

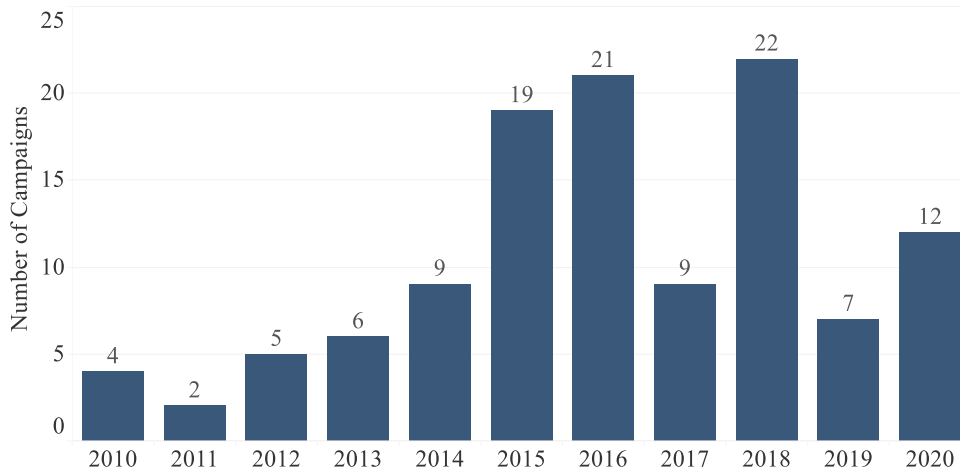
<sup>37</sup> In 2020, there have been twelve Campaigns identified as of September 30, 2020.

<sup>38</sup> Based on AI data from January 1, 2010 to September 30, 2020. Canadian issuers are identified based on the location of their headquarters. Some issuers are targeted by multiple activist short sellers. AI identifies whether a campaign status is ended (as opposed to current) when "the short seller either no longer supports its position according to publicly available information or there has been one year of inactivity from the short seller. As announcements regarding this are rare most campaigns are ended due to inactivity".

<sup>39</sup> OSC calculations based on AI data of annual campaign targets from 2010 to September 2020 and end-of year listed issuer counts from the World Federation of Exchanges from 2010 to June 2020. Includes all domestic NASDAQ and NYSE issuers for the U.S. Market and all domestic TSX and TSXV issuers for the Canadian market, excluding investment funds.

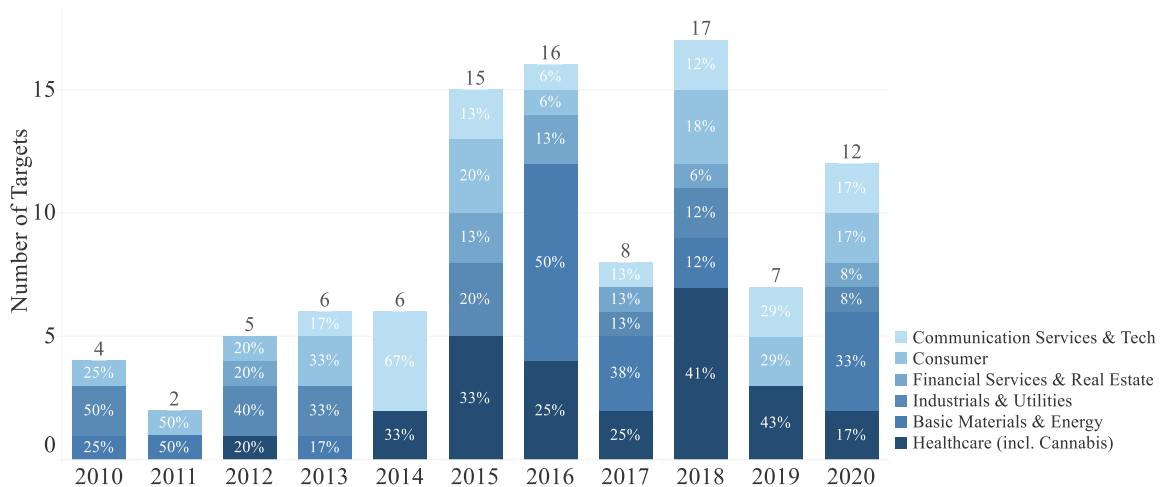
<sup>40</sup> See *Ibid.*

**Figure 1 - Activist Short Seller Campaign Activity in Canada (2010 – Sept. 2020)**



For the small number of Canadian targets identified, annual Campaign activity appears to be highly cyclical as evidenced in Figure 1. In general, short sellers gravitate towards the securities of issuers and sectors where there is a perceived overvaluation (See Figure 2).<sup>41</sup> In peak Campaign years, this is evident as activist short sellers targeted Canadian issuers in specific, potentially overheated, sectors. For instance, in 2018 among a record 17 Canadian targets, approximately 35% (or 6 targets) were operating in the cannabis industry.<sup>42</sup> However, Campaign activity was largely muted in 2017 with 8 Canadian targets and in 2019 with only 7 Canadian targets. In 2020, there have been 12 new campaigns targeting Canadian issuers as of September 2020, however 4 of those Canadian issuers were also the target of activist short sellers in prior years.

**Figure 2 - Activist Short Seller Targets by Sector (2010 – Sept. 2020)<sup>43</sup>**



<sup>41</sup> Ekkehart Boehmer, Charles M Jones & Xiaoyan Zhang, “Which Shorts are Informed?” (February 4, 2007). AFA 2007 Chicago Meetings Paper, available at SSRN.

<sup>42</sup> Cannabis issuers were categorized under the healthcare sector. The 2019 AI report on Activist Investing in Canada reported that the precedent set in 2018 was “largely due to exuberance in the emerging cannabis sector, which invited detractors.” In 2016, increased activist short seller activity was concentrated among materials and mining issuers.

<sup>43</sup> The number of Campaigns and targets are not equivalent for any given year because there may be multiple Campaigns against the same target.



## B. Canadian Campaign Characteristics

The following highlights select Campaign characteristics to provide a better understanding of the types of Canadian issuers targeted; the target size; the stock price impact; the pattern of allegations made by activist short sellers; and the proportion of targets that engaged in a strategic response or were impacted by certain negative outcomes during the Campaign as identified by AI.

### *i. Target Size*

The Campaigns tended to be focused on relatively larger issuers (with a median market capitalization of \$867 million and average market capitalization of \$4.5 billion<sup>44</sup>) compared to the broader Canadian market.<sup>45</sup> This is in some ways not surprising given AI's focus on prominent activist short sellers but it is also consistent with the findings of U.S. academic studies indicating that target firms are more likely to be larger sized issuers with listed securities that are more heavily traded in both the cash and options markets.<sup>46</sup>

### *ii. Price Impact*

Most Campaigns analyzed (75% of targets) experienced a negative price impact on the day of the first-campaign announcement and up to one month after the first-campaign announcement.<sup>47</sup> However, the extent of the short-term price impact varied across targets and also over time (see Figure 3). Approximately 26% of targets experienced less than a 5% price decline on the day of the first-campaign announcement. The proportion of targets with negative share price returns of 10% or greater increased over time from day of first-campaign announcement (approximately 30% of targets) to 1-month after first-campaign announcement (approximately 45% of targets).<sup>48</sup>

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<sup>44</sup> Market capitalization calculated 1-day prior to the announcement of the first activist short seller campaign for 69 Canadian targets from 2010 to September 30, 2020 for which historical market data was available.

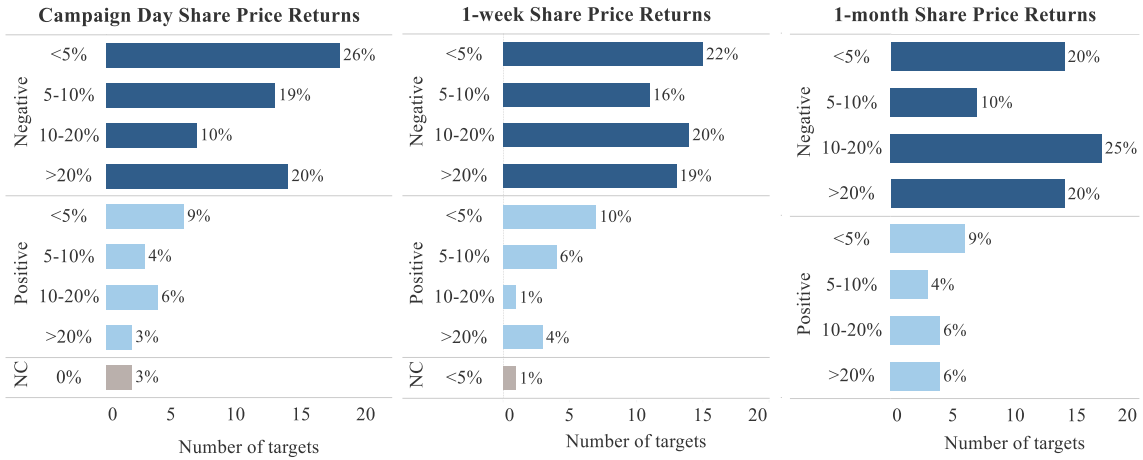
<sup>45</sup> In contrast, the year-end median market capitalization of all TSX issuers from 2014 to 2019 was between \$112 million and \$153 million. As of September 30, 2020, approximately 64% of TSX issuers had a market capitalization of \$300 million or less and 92% of TSXV issuers had a market capitalization of \$100 million or less.

<sup>46</sup> See: Ljungqvist & Qian, *supra* note 3; Ian Appel, Jordan Bulka & Vyacheslav Fos, "Public Short Selling by Activist Hedge Funds" (October 1, 2018); and Zhao, *supra* note 3.

<sup>47</sup> Stock price returns were calculated by OSC from 1-day prior to the first Campaign announcement for 69 Canadian targets between 2010 and September 2020 for which historical market data was available. Stock price returns reflect more than just the disclosure of a short seller's Campaign, it also incorporates other positive or negative information about the target either specifically or more broadly (e.g., market or sector).

<sup>48</sup> *Ibid.*

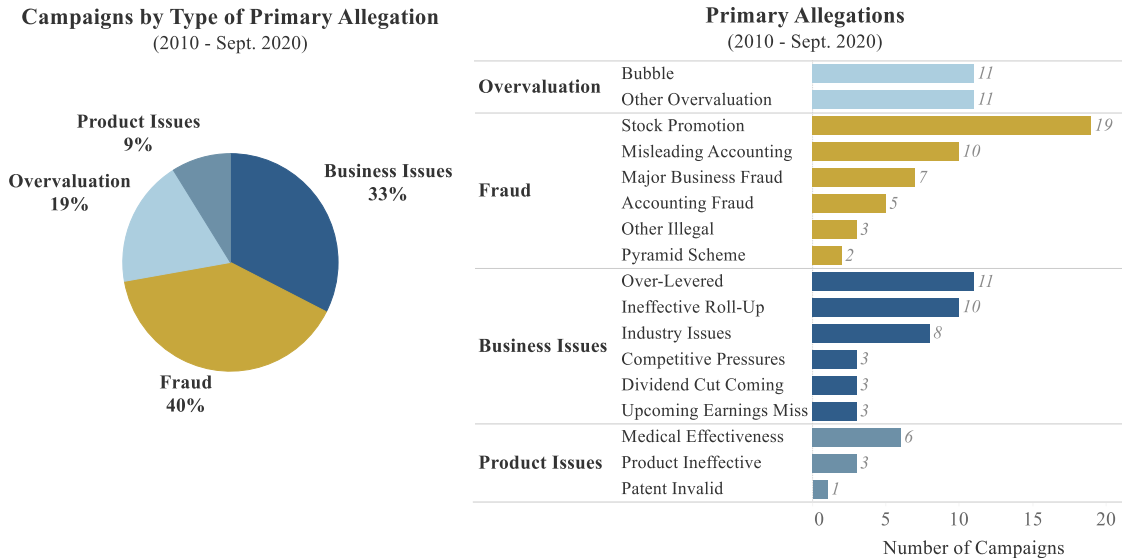
**Figure 3 – Share Price Impact of Canadian Target’s First Campaign (2010 – Sept. 2020)**



*iii. Campaign Allegations*

Across all 116 Canadian Campaigns, 40% involved allegations of some type of fraud at the issuer. The most common type of fraud allegation was that of there being a stock promotion scheme (or an alleged “pump and dump” scheme), where the company was being promoted by a connected third party (e.g., an outside firm) (see Figure 4).<sup>49</sup> In peak Campaign years (2015, 2016 and 2018) fraud-related allegations accounted for under one-third of the Campaigns. Allegations related to business or industry issues (e.g., drop in commodity prices) and more general market overvaluation concerns have been more common in recent years.

**Figure 4 – Activist Short Sellers' Primary Allegations**



<sup>49</sup> Based on AI’s assessment of the Campaigns.

iv. *Target Responses and Outcomes*

Across the 73 Canadian targets in the 116 Campaigns identified, approximately 73% of targets pursued certain responses during the Campaign (Figure 5). These responses included either changing or replacing the CEO or CFO, hiring a new auditor or independent investigator, halting the issuer’s stock from trading, pursuing a lawsuit against the activist short seller or announcing a capital market transaction (e.g., divestiture, acquisition, private placement) during the Campaign.<sup>50</sup>

**Figure 5 – Campaign Target Responses and Outcomes (2010 – Sept. 2020)**

Target HQ	Targets	Target pursued response (%)	Target had negative outcome (%)	Target either responded or had negative outcome
Canada	73	73%	29%	78%
US	783	60%	26%	67%
Other foreign issuers	344	65%	28%	69%

Separately, the AI data also identified certain outcomes which occur following a Campaign and would generally be viewed as negative by the market (e.g., a delisting, auditor resignation or class-action lawsuit). Among the Canadian targets, approximately 29% of them experienced at least one of these outcomes.<sup>51</sup> Class action lawsuits against issuers were the most common among the three types of outcomes considered. In about 23% of the Canadian targets, class action proceedings were commenced following a Campaign (as compared to U.S. (23%) and other foreign (21%) targets).<sup>52</sup> We cannot know with any certainty that the issuer’s responses or the outcomes experienced were the direct result of the Campaign, however, academics have considered such responses (or similar ones) to be indicative that a campaign brought to light problems with the issuer.<sup>53</sup>

**C. Analysis and Consultation Questions**

There appears to be a perception that activist short selling is on the rise in Canada<sup>54</sup> and that this form of activism plays a negative role in our markets. As previously noted, taking into consideration the size of our market and the number of public companies, it does not appear that Canada’s experience with activist short selling is disproportionately high compared to the U.S.

<sup>50</sup> Issuer responses identified from AI data.

<sup>51</sup> This is consistent with campaign outcomes for foreign issuers in foreign markets as well (see Figure 5).

<sup>52</sup> Our review confirmed that almost all class proceedings commenced following a Campaign made the same or similar allegations as those made in the Campaign. We acknowledge that the commencement of a class proceeding, even with similar allegations, does not establish the veracity of the underlying allegations in a Campaign.

<sup>53</sup> A U.S. study reviewed 124 campaigns in an effort to determine whether activist short sellers were engaged in short and distort campaigns based on a study of subsequent events. The study indicated that separate investigations by the Securities and Exchange Commission and the Department of Justice reached similar conclusions as the activist short sellers in 90% of those campaigns and eventually, 50% of the targets were delisted, 47% replaced auditors, and 23% restated earnings. See: Ljungqvist & Qian, *supra* note 3.

<sup>54</sup> For example, see: Schechter, *supra* note 1. We note that activism in general has increased (both long and short). See e.g., “Shareholder Activism: 2019 Trends and Major Developments”, *Davies Corporate Governance Insights 2019* (3 October 2019); Eric Woerth and Benjamin Dirx, *Report to the National Assembly (France) on Shareholder Activism* (October 2, 2019) [Woerth Report].

With that said, we recognize that comparisons of this nature, or simply comparing the absolute number of campaigns, does not provide the necessary context to understand the issues. Market factors unique to each jurisdiction must be considered.

The available empirical evidence indicates that recent increases in Campaigns may be indicative of a cyclical trend, i.e., activist short sellers targeting issuers in specific potentially overheated sectors. This suggests that our market will see increases in activism of this nature where there is a sense that an industry sector or issuer is overvalued, but does not necessarily address whether, in this context, there is misconduct by activist short sellers.

Activism by short selling is premised on effecting a loss of shareholder value for the target issuer, which makes it controversial. Most academic studies of U.S. markets support the notion that activist short sellers are more likely to improve the market's informational/price efficiency by identifying actual problems with an issuer's business and operations, than they are to engage in "short and distort" strategies. The analysis of post-Campaign outcomes and responses by issuers suggests the allegations have been a force for change although it is not obvious that such changes were intended to address the concerns raised by the Campaign.

Activist short sellers are also criticized for being driven by short-term trading profits rather than promoting long-run price accuracy. However, they can also serve as a countervailing check on the potential for excessive market optimism.

Lastly, we recognize that targeted issuers may be reluctant to complain to the securities regulator about what they view as problematic conduct in the context of a campaign as this may be seen as inviting a review of the allegations by the regulator. An issuer's response following a campaign may be seen as giving credibility or in some way substantiating the legitimacy of the issues raised, however, it also may be that issuers are choosing to respond for other strategic reasons.

### **Consultation Questions**

1. What is your perception about activist short sellers? Please describe the basis of that perception.
2. Can you give examples of conduct in activist short selling Campaigns that you view as problematic?
3. Given the focus of the available data is on prominent activist short sellers, what is your view regarding less prominent activist short sellers or pseudonymous activist short sellers targeting Canadian issuers? How can they be identified? Is there any evidence that they are engaging in short and distort Campaigns?
4. What empirical data sources related to Campaigns should we consider?
5. In 2019, there was a large drop in the number of Canadian issuers targeted by prominent activist short sellers compared to the year before. Are there market conditions or other circumstances that in your view could lead to an increase? Please explain.
6. Is there any specific evidence that would suggest that Canadian markets are more vulnerable to activist short selling, including potentially problematic activist short selling (e.g., size and type of issuers, industries/sectors represented or other market conditions)? Please provide specific examples of these vulnerabilities, and how they differ from other jurisdictions.

7. Do issuers have practical limitations in terms of their ability to respond to allegations made in a Campaign? If so, what are these limitations, and do you have any recommendations on how to alleviate them?
8. Are issuers reluctant to approach securities regulators when they believe that they are being unfairly targeted by an activist short seller? If so, why? If not, why not?

### III. Regulatory Framework

#### A. Canada – Monitoring, Reporting and Restrictions on Short Selling Activity

Activist short sellers are not subject to formal securities regulatory requirements (for example, Canadian securities legislation does not regulate the content of an activist short seller's statements). Short selling as a trading activity however is subject to a well-developed framework that is largely administered by IIROC involving a detailed reporting regime that provides timely information to IIROC enabling it to monitor and supervise any potentially inappropriate short selling practices. It includes:

- a requirement to mark all orders representing a short sale as either “short” or “short-marking exempt”;<sup>55</sup>
- a requirement to disclose “Extended Failed Trades” to IIROC;<sup>56</sup>
- a requirement that, if an Extended Failed Trade report is filed with IIROC, further short sales generally cannot be made by that Participant<sup>57</sup>(acting as a principal or as an agent) or by an access person without prior arrangements to borrow the securities necessary for settlement (that is, IIROC may require pre-borrowing in certain circumstances);<sup>58</sup> and
- the ability for IIROC to designate a security as a “Short Sale Ineligible Security.”<sup>59</sup>

Canadian securities legislation also requires a person who places an order for the sale of a security with a registered dealer to declare to the dealer at the time of placing the order if they do not own the security.<sup>60</sup> This statutory requirement is supported by UMIR which requires Participants to calculate and report to IIROC the aggregate short position of each individual account twice a month,<sup>61</sup> which IIROC then publishes on its website.<sup>62</sup> IIROC also aggregates trades marked “short sale” from all of the marketplaces it monitors, consolidates that information, and publishes

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<sup>55</sup> See UMIR, *Part 3 - Short Selling, Prohibition on the Entry of Orders*, Rule 3.2 [Rule 3.2]. A short-marking exempt order includes an order for a security from an arbitrage account, an account of a market maker for that account, or other specified accounts that buy and sell securities and that has at the end of any trading day no more than a nominal long or short position in any security. UMIR, *Part 1 – Definitions and Interpretation*, Rule 1.1.

<sup>56</sup> A trade that did not settle and was not rectified within 10 trading days from the original settlement must be reported to IIROC. See: UMIR, *Part 7 Trading in a Marketplace - Extended Failed Trades*, Rule 7.10.

<sup>57</sup> Participants include dealers that are members of an exchange, users of a quotation and trade reporting system or subscribers to an alternative trading system.

<sup>58</sup> “Pre-Borrow Security” means a security that has been designated by a Market Regulator to be a security in respect of which an order, that on execution would be a short sale, may not be entered on a marketplace unless the Participant or Access Person has made arrangements to borrow the securities that would be necessary to settle the trade prior to the entry of the order. UMIR, *Part 1 – Definitions and Interpretation*, Rule 1.1. See also, UMIR, Policy 1.1, *Definitions of Pre-Borrow Security*, 1.1; UMIR, *Part 6 – Order Entry and Exposure – Entry of Orders on Marketplace*, Rules 6.1(4) and 6.1(6).

<sup>59</sup> “Short Sale Ineligible Security” is defined as a security or a class of securities that has been designated by a market regulatory to be a security in respect of which an order on execution would be a short sale may not be entered on a marketplace for a particular trading day or trading days. UMIR, *Part 1 – Definitions and Interpretation*, Rule 1.1; See also, Rule 3.2, *supra* note 55 at (1)(b).

<sup>60</sup> Note for instance section 194 of the *Securities Act* (Québec), which provides that no person may sell a security short without previously notifying the dealer responsible for carrying out the transaction. See also, *Securities Act* (Ontario), section 48.

<sup>61</sup> UMIR, *Part 10 – Compliance, Report of Short Positions*, Rule 10.10.

<sup>62</sup> The Consolidated Short Position Report (CSPR) shows the aggregate short positions on all listed securities as of the current reporting date and the net change in short positions from the previous reporting date, on a per security basis, pursuant to UMIR 10.10. The report is published twice monthly and based on the short position information submitted to IIROC by Participant Dealer Members and applicable Access Persons.

a semi-monthly report showing the total industry short sales for each security over the reporting period.<sup>63</sup> In contrast to other jurisdictions discussed below (EU, Australia), there are no reporting requirements or obligations to disclose information on the short position of an individual account to IROC or to the public. Even so, it is not uncommon for an activist short seller to voluntarily disclose that they are short a particular issuer when they commence a campaign.

## **B. Prohibition on Deceptive or Manipulative Activity**

Securities legislation, National Instrument 23-101 *Trading Rules* and UMIR prohibit activities that are manipulative and/or deceptive. In the context of short selling activity this would include the entering of an order for the sale of a security without, at the time of entering the order, having the reasonable expectation of settling any trade that would result from the execution of the order.<sup>64</sup> As such, “naked short selling”, as that term is sometimes understood, is not permitted under UMIR.<sup>65</sup>

IROC monitors for potentially abusive trading activity. For example, in the context of short selling activity, IROC uses algorithms to monitor for unusual levels of short selling coupled with significant price movements and reviews alerts to determine the cause of the price movement and whether there is an indication of manipulative trading activities. These reviews may include a review of social media or chatrooms as well as Extended Failed Trades reports for indications of settlement issues. If appropriate, referral to the enforcement branch of the appropriate CSA jurisdiction for investigation may also occur.

As set out in Part I, securities legislation also contains provisions which address prohibitions on manipulative activity that apply to all market participants, including activist short sellers.

## **C. International Regulatory Frameworks**

The most notable difference among the regulatory frameworks that apply to activist short selling in the European Union (EU) and Australia relates to the reporting and disclosure of position size and the identity of short sellers generally.<sup>66</sup>

The European Securities and Markets Authority (ESMA) requires that net short positions (including direct and synthetic shorts) of “natural or legal persons” be made first to the regulator at 0.2% and that the position be publicly disclosed if the position reaches 0.5% of the issued share capital of the company concerned, and each 0.1% above that.<sup>67</sup> Anyone can therefore view the

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<sup>63</sup> The Short Sale Trading Statistics Summary Report is based on data for trades marked “short sale” supplied by each marketplace that IROC monitors. The report is published twice monthly.

<sup>64</sup> See: Companion Policy to National Instrument 23-101- *Trading Rules*, s 3.1(3)(f); UMIR, *Part 2 – Abusive Trading, Manipulative and Deceptive Activities*, Policy 2.2 at Part 2 (g)-(h).

<sup>65</sup> As previously noted in IROC Notice 12-0078 - *Provisions Respecting Regulation of Short Sales and Failed Trades*, *supra* note 19, there is no universally accepted definition of “naked short selling”. The most common usage is in connection with a short sale when the seller has intentionally chosen not to make arrangements to borrow any securities that may be required to settle the resulting trade. Some commentators use a more restrictive interpretation that describes any short sale when the seller has not pre-borrowed the securities necessary for settlement.

<sup>66</sup> Note, in the US, only the short selling volume for individual securities is published daily and individual short sale transactional information is published on a one-month delay but does not contain short seller details.

<sup>67</sup> See *Regulation (EU) No 236/2012* of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps (2012). Note, in 2017 ESMA considered whether to further increase transparency of short positions by publishing aggregate short positions that are currently still confidential. See: European Securities and Markets Authority, Final Report, *Technical Advice on the Evaluation of Certain Elements of the Short Selling Regulation* (21 December 2017). On the issue of transparency, the technical advice made by ESMA to the European Commission was: “practical

identity of holders of short positions that meet these position-level thresholds for an EU security.<sup>68</sup> This is more granular public transparency compared to aggregated data that is publicly available in Canada. Requiring disclosure of this nature was seen as an alternative policy tool to short selling bans, with the similar aim of introducing a constraint on short selling activity. Indeed, the relevant EU regulation was created primarily in response to the financial crises and the sovereign debt crisis, with the goal of promoting market stability.<sup>69</sup>

In Australia, there are short selling reporting requirements for both transactions<sup>70</sup> and positions above a certain threshold.<sup>71</sup> Based on this information, the total of short positions for financial products on a given reporting day will be published on the Australian Securities and Investments Commission's website, and the Australian Securities Exchange website will publish the transaction reports. These reports will not contain short seller details but will provide an indication of the proportion of trades in a particular security that are short sales and the aggregate level of short positions for each security.<sup>72</sup>

#### D. Analysis and Consultation Questions

Concerns have been raised that Canadian issuers are vulnerable to abusive short selling based on the perception that the Canadian regulatory framework for short selling is “permissive and lax.”<sup>73</sup> We note that while the regulatory framework in Canada differs in some ways from other jurisdictions, it is consistent with the four IOSCO principles for the effective regulation of short selling.<sup>74</sup>

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improvements of the current regime including building a centralised notification and publication system across Europe...[and] supports requiring the LEI for the identification of certain position holders.” More specifically, for the area discussed in the paper, “ESMA also recommends that NCAs should be allowed to periodically publish anonymised aggregated net short positions by issuer on a voluntarily basis when they consider that the issues described above can be adequately addressed in their jurisdiction.”

<sup>68</sup> In the context of activist short sellers, additional disclosure may be required by the market abuse regulations which provide that conflicts of interest be disclosed by any entity issuing recommendations where it holds a net short or long position of 0.5% or more of the capital of the company concerned by the recommendation. See *Market Abuse Regulation – Regulation 596/2014* of the European Parliament and of the Council.

<sup>69</sup> Corrado Malberti, Stephane Rousseau & Konstantinos Sergakis, “The Regulation of Short Selling: A Transatlantic Discussion on Policy Issues and Instruments” (October 6, 2018), *Corporate Finance and Capital Markets Law Review*, RTDF No. 4-2018. [Malberti, Rousseau & Sergakis]

<sup>70</sup> Short sale transaction reporting is the reporting of daily volumes of products that are short sold in the market.

<sup>71</sup> A person may be required to report a short position, i.e., where the quantity of the product that a person has, when acting in a particular capacity, is less than the quantity of the product that the person has an obligation to deliver when acting in the same capacity. Short position reporting is exempt where the seller's short position is less than or equal to (a) \$100,000; and (b) 0.01% of the total quantity of securities or products in the relevant class of securities or products. The total of short positions for financial products on a given reporting day will be published on the ASIC website four days after the reporting day (T+4). These reports will not contain short seller details.

<sup>72</sup> Australian Securities & Investments Commission, “Regulatory Guide 196: Short Selling” (October 2018), see Reg. 196.8.

<sup>73</sup> *Harrington*, *supra* note 11.

<sup>74</sup> See IOSCO report entitled “Regulation of Short Selling – Final Report” (June 2009), which articulates four high-level principles for the effective regulation of short selling and is designed to assist regulators in the management of risk through a regulatory regime for short selling. See also Joint Notice 23-312 *supra* note 19. Note the International Monetary Fund's Financial Sector Assessment Program Report “*Canada : Financial Sector Assessment Program-IOSCO Objectives and Principles of Securities Regulation-Detailed Assessment of Implementation*” which reviewed Canada's short selling regime as part of Principle 37 (Regulation should aim to ensure the proper management of large exposures, default risk and market disruption) and it was found to be “fully implemented” (March 7, 2014). See p. 18, 27 and 239-243.



Over the years, IIROC has reviewed the regulatory regime governing short sales to determine whether it continues to be appropriate. In 2012, a number of amendments to UMIR regarding short sales and failed trades were approved by the CSA and implemented.<sup>75</sup> These amendments included:

- repealing the “tick test”;<sup>76</sup>
- imposition of pre-borrow requirements for short sales made in certain circumstances; and
- introduction of the “short-marking exempt” designation.<sup>77</sup>

The amendments were part of an overall strategy on regulation of short sales and failed trades that included increasing transparency around information regarding short sale activity and failed trades, monitoring regulatory arbitrage opportunities related to short sales and enhancing monitoring of short sales and failed trades. It was also at this time that the pre-borrow requirements for short sales in certain circumstances were introduced as another mechanism to monitor and address potentially problematic short selling.

Also at the time of these amendments, the CSA and IIROC published a request for comment to solicit feedback on aspects of disclosure and transparency measures regarding short sales and failed trades.<sup>78</sup> After consideration of comments received and of the data on short sales and failed trades,<sup>79</sup> it was determined that no additional regulatory requirements were needed at that time.<sup>80</sup> It is important to note that failed trades occur in both long and short sales for a variety of reasons. Failed trades are not always evidence of abusive or naked short selling. There are many justifiable reasons why a trade fails, and failures may be more common for thinly traded or illiquid stocks.<sup>81</sup> IIROC indicated that it would continue to monitor international developments in the regulation of short selling and failed trades related issues. It has recently commenced looking into required data sources to initiate its work on a new broader and more granular failed trade study.<sup>82</sup>

Concerns around short selling regulation have seen a resurgence both in Canada and abroad.<sup>83</sup> Internationally, we have also seen that heightened concerns around short selling activities have led some foreign public and private actors to impose restrictions or bans on short selling and related

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<sup>75</sup> IIROC Notice 12-0078 *supra* note 20.

<sup>76</sup> The tick test was a requirement under UMIR that a short sale not be made at a price which is less than the last sale price of the security.

<sup>77</sup> See footnote 55.

<sup>78</sup> Joint Notice 23-312, *supra* note 19.

<sup>79</sup> See IIROC *Study on the Impact of the Prohibition on the Short Sale of Inter-listed Financial Sector Issuers* (February 2009) [IIROC Study].

<sup>80</sup> CSA/IIROC Notice 23-315 *Summary of Comments on CSA IIROC Notice 23-312 Request for Comments – Transparency of Short Selling and Failed Trades*, (28 February 2013).

<sup>81</sup> See Securities and Exchange Commission, 2016a. *Frequently Requested FOIA Document: Fails-to-Deliver Data — Archive Data*. See also Talis J Putnins, “Naked Short Sales and Fails to Deliver: An Overview of Clearing and Settlement Procedures for Stock Trades in the US” (October 27, 2009). *Journal of Securities Operations and Custody*, Forthcoming, available at SSRN.

<sup>82</sup> Note ESMA has adopted new rules related to failed trades set to come into effect next year. Trades that fail to settle — usually within a window of two or three days — face a mandatory “buy-in” to close the deal and cash penalties on failed transactions. Commission Delegated Regulation (EU) 2018/1229 of 25 May 2018 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on settlement discipline. See ESMA Final Report - *CSDR RTS on Settlement Discipline – postponed entry into force* (4 February 2020).

<sup>83</sup> E.g. Issues around transparency and disclosure of short selling information, lack of locate requirement and lack of a tick test in Canada. See: Davis et al, *supra* note 12.

activities.<sup>84</sup> For example, in December 2019, the world's largest pension fund, the Japanese Government Pension Investment Fund announced that it had suspended stock lending activities relating to its portfolio of non-Japanese equity securities 'until further notice.'<sup>85</sup> Earlier in 2019, ESMA backed Germany's two-month short sale ban on payment firm Wirecard following a report of financial irregularities by certain Wirecard critics.<sup>86</sup> Other jurisdictions have called for increased transparency and disclosure. In October 2019, the National Assembly in France released a report on activist investors recommending that France should increase disclosure requirements when activist investors and short sellers take large positions in French companies.<sup>87</sup>

In Canada, there appears to be perception by some that the current regulatory environment is disproportionately conducive to problematic activist short selling. Some who have raised concerns have suggested increased transparency around short selling as a response to these concerns, similar to the approach that currently exists in the EU. In their view, this type of disclosure can equip issuers and investors with additional information upon which to trade, as well as act as a constraint on inappropriate short selling. However, some studies have noted that such disclosure obligations may have undesirable effects, such as compromising the strategies short sellers use, which would inevitably lead to decreased market liquidity or price discovery.<sup>88</sup> Increased transparency on the identity of a short seller may also expose them to litigation and regulatory action, potentially stifling legitimate short selling activity.<sup>89</sup> One study found that when required to disclose their positions short sellers simply remain below the public disclosure threshold (0.5%) deliberately to protect their private information.<sup>90</sup> The impact of additional disclosure around short selling must be considered in light of these issues to determine whether this tool meets the policy outcome desired without introducing undue constraints on legitimate short selling and activist short selling activity.

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<sup>84</sup> Lawrence Delevingne, Simon Jessop, & Jonathan Spicer, "Return of short-selling bans: market protection of 'war against truth'?", *Reuters* (19 November 2019).

<sup>85</sup> GPIF claimed that the current framework lacks transparency over who is the "ultimate borrower" of a stock after a short seller sells the shares loaned to them and added that a third party could vote GPIF shares contrary to GPIF's policies or interests. GPIF has not ruled out returning to the stock lending space in the future but clarified that "improvements" to "enhance transparency" would need to be introduced first. See: Billy Nauman & Leo Lewis, "This is a decision between making cash immediately or being better stewards for our constituency", *The Financial Times* (12 December 2019). This decision was not without cost, as it has been estimated the GPIF earned approximately US\$115 million in fees annually through stock lending. See Tim Kelly, "World's largest pension fund halts stock lending to short sellers," *Reuters* (3 December 2019).

<sup>86</sup> Note that in 2020, following the short sale ban and a subsequent special audit by KPMG it was uncovered that approximately €1.9 billion on Wirecard's balance sheet could not be verified, and likely did not exist. This accounting scandal has not only resulted in the collapse of Wirecard, but also prompted ESMA to assess the supervisory response of Germany's financial regulator and oversight bodies in the events leading up to its collapse. On November 3, 2020, ESMA published the results of its Fast Track Peer Review. See: "Fast Track Peer Review on the Application of the Guidelines on the Enforcement of Financial Information (ESMA/2014/1293) by BaFin and FREP in the Context of Wirecard."

<sup>87</sup> David Keohane and Harriet Agnew, "France seeks crackdown on short sellers and activist investors", *FT Online* (2 October 2019); Woerth Report, *supra* note 54.

<sup>88</sup> Malberti, Rousseau & Sergakis, *supra* note 69; Julien Mazzacurati "The public disclosure of net short positions" in *ESMA Report on Trends, Risks, Vulnerabilities*, No 1 (2018) at 60. See also at ESMA *Final Report - Technical Advice on the evaluation of certain elements of the Short Selling Regulation* (December 21, 2017) at p. 51. ESMA confirmed that "some investors avoid crossing the 0.5% threshold, as reflected in the lower frequency of short position increases and relatively longer duration of positions just below the threshold."

<sup>89</sup> Bliss, Molk & Partnoy, *supra* note 8 at 14, 17. "Owen Lamont provides evidence that firms take legal and regulatory action against shorts sellers, by alleging criminal conduct, suing them, hiring private investigators, asking public authorities to investigate them, and manipulating securities markets to impede short selling." See: Lamont, *supra* note 21.

<sup>90</sup> Rients Galema and Dirk Gerritsen, "The effect of the accidental disclosure of confidential short sales positions" (2018) Finance Research Letters, Forthcoming.

As discussed in Part I, short sellers already face significant risks and costs in taking such positions and these risks are amplified for activist short sellers. Some academics have suggested that policy makers should consider efforts to reduce the difficulties and costs associated with short selling given the potential for improvements in market efficiencies introduced by campaigns.<sup>91</sup> Others have suggested alternative approaches to the EU model of disclosure that more directly addresses concerns raised around problematic conduct by activist short sellers as well as the implications of social media on promotional activities, whether short or long. For example, a group of U.S. academics recently petitioned the SEC to impose a “duty to update” a short position when there has been a voluntary disclosure of that short position.<sup>92</sup> The rationale for such a requirement being that when a short seller voluntarily discloses a short position, failure to disclose the position closed is “doubly misleading” because their original disclosure of being short is no longer accurate and the short seller’s “negative opinion lacks the skin in the game element that gives market participants reason to believe the underlying claims are true.”<sup>93</sup> Another example is a proposal for a ten-day minimum holding period that would apply to any stock promoter or short seller who opens a large position and disseminates market-moving information, irrespective of the medium. The theory behind this proposal is that a holding period could provide the market with an opportunity to evaluate the quality and credibility of the information.<sup>94</sup>

### Consultation Questions

9. Is the existing regulatory framework adequate to address the risks associated with problematic activist short selling? Please explain why or why not and provide specific examples of concerns and areas where, in your view, the regulatory framework may not be adequate.
10. Have there been market developments or new information since 2012, when UMIR amendments regarding short selling and failed trades were implemented, that would warrant revisiting the existing regulatory framework for short selling? If so, please describe these new developments or information and indicate, providing evidence to support your views:
  - a. whether, in your view, there is a connection between failed trades and activist short selling;
  - b. what changes should be considered and why, and specifically with respect to potentially problematic activist short selling activities; and
  - c. whether there are relevant regulatory requirements in other jurisdictions that should be considered and why.
11. Is the existing disclosure regime for short selling activities adequate? Please explain why or why not, indicating:

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<sup>91</sup> Bliss, Molk & Partnoy, *supra* note 8 at 46-47.

<sup>92</sup> See *Petition for Rule Making on Short and Distort*, Letter to Vanessa Countryman, Secretary of U.S. Securities and Exchange Commission (February 16, 2020); John Coffee Jr & Joshua Mitts, “Petition for Rule Making on Short and Distort”, *The CLS Blue Sky Blog* (February 18, 2020).

<sup>93</sup> *Ibid.* The authors have also asked the SEC to confirm that rapidly closing a position after publishing a report, without specifically disclosing an intent to do so can constitute fraud in violation of Rule 10b-5, and propose a safe harbour provision for closing at a price that is the equal to or lower the valuation stated or implied in the report.

<sup>94</sup> Mark Cohodes, “Pump-and-dump stock trading needs new rules for the digital age”, FT Online, April 26, 2020.

- a. what disclosure requirements would address risks associated with potentially problematic activist short selling and how would such requirements improve deterrence;
- b. what should be the trigger and the timing of any additional disclosure;
- c. how can additional disclosure be meaningful without negatively impacting market liquidity; and
- d. do you foresee any issues with imposing a duty to update once there has been a voluntary disclosure of a short position?

## IV. Enforcement and Remedies

### A. Oversight of Activist Short Sellers

In most CSA jurisdictions, there is no mechanism under securities law that explicitly regulates the activities of activist short sellers or the form or content of their public statements.<sup>95</sup> However, there is potential for the conduct and statement of an activist short seller to fall offside of securities legislation if it involves making materially misleading or untrue statements to the market.<sup>96</sup> Securities legislation generally requires that a person or company not make a statement that they know, or reasonably ought to know,

- (a) in a material respect and at the time and in the light of the circumstances under which it is made, is misleading or untrue or does not state a fact that is required to be stated or that is necessary to make the statement not misleading; and
- (b) would reasonably be expected to have a significant effect on the market price or value of a security, derivative or underlying interest of a derivative.<sup>97</sup>

Recent B.C. *Securities Act* amendments introduced an additional prohibition for those engaged in promotional activities. Under this prohibition, a person engaged in a promotional activity must not make a statement or provide information that is false or misleading in circumstances where a reasonable investor/person would consider that statement or information important when making an investment decision. Unlike other securities law prohibitions against making a misrepresentation, this prohibition does not require that the statement or the information:

- be materially misleading or untrue;
- be reasonably expected to have a significant effect on the market price or value of a security.<sup>98</sup>

Canadian securities legislation also contains fraud and market manipulation prohibitions<sup>99</sup> that could, in appropriate circumstances, be used to address misconduct by activist short sellers. In general, these provisions prohibit persons from directly or indirectly engaging in acts relating to securities, and in some cases derivatives,<sup>100</sup> that:

- the person knows (or reasonably ought to know), results in or contributes to a misleading appearance of trading activity or an artificial price for a security, or

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<sup>95</sup> In British Columbia recent amendments to section 1(1) of the *Securities Act* introduced a new definition of “promotional activities.” “Promotional activities” is defined to include any activity / communication that encourages or could reasonably encourage a person to purchase, not purchase, trade or not trade a security or derivative. Note the definition of “promotional activities” provides the British Columbia Securities Commission with rulemaking authority to prescribe that certain activities are not promotional activities. Section 183 generally, section 183 (12.2) and section 184 (1)(b) provide rulemaking authority to make rules imposing disclosure requirements on a person engaging in promotional activities and to impose different requirements, restrictions or prohibitions on different classes of persons engaging in promotional activity. *BCSA Amendments supra* note 26.

<sup>96</sup> See e.g., *Re Cohodes*, 2018 ABASC 161 [*Cohodes*].

<sup>97</sup> See e.g., *Securities Act* (Ontario), RSO c S.5, s 126.2.

<sup>98</sup> *BCSA Amendments*, section 50(3), *supra* note 26.

<sup>99</sup> See e.g., subsection 126.1(1) of the *Securities Act* (Ontario).

<sup>100</sup> See e.g., *Derivatives Act* (Québec), CQLR c. I-14.01, s. 151, *Securities Act* (Ontario), s. 126.1(1)

- perpetrates a fraud on any person or company.<sup>101</sup>

In Québec, it is also an offence to influence or attempt to influence the market price or the value of securities by means of unfair, improper or fraudulent practices.<sup>102</sup>

## B. Remedies

In Canada, there is no mechanism under securities law for issuers or investors to seek damages against activist short sellers for statements made in the context of campaigns.<sup>103</sup> Some jurisdictions like Australia have provisions under their corporate or securities legislation which provide a private right of action for certain contraventions, including prohibitions on the making or dissemination of false or misleading information and statements by any person, which could capture activist short selling activity.<sup>104</sup>

Apart from statutory remedies under securities law, there may be common law or civil code remedies available to issuers and/or investors who wish to commence legal proceedings for damages arising from allegations of problematic conduct by activist short sellers. There are, however, very few recent Canadian judicial decisions that deal with activist short selling.<sup>105</sup> This may be due to the practical and evidentiary challenges of civil litigation.<sup>106</sup>

## C. Analysis and Consultation Questions

There is a concern that limited regulatory proceedings in Canada arising from the conduct of activist short sellers may contribute to a perception that current enforcement tools are ineffective in addressing or deterring problematic conduct.<sup>107</sup> From an enforcement perspective, securities regulators have tools to address activist short seller behaviour that constitutes fraud, market manipulation or making a misleading statement to the market. However, for many of the misleading statement offences under Canadian securities legislation, evidence of a threshold of

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<sup>101</sup> In some jurisdictions, including British Columbia, Alberta, Québec and Ontario, it is also an offence to attempt to engage in a fraud or market manipulation.

<sup>102</sup> *Securities Act* (Québec), CQLR c V-1.1, s. 195.2 and *Derivatives Act* (Québec), CQLR c. I-14.01, s. 150. It is also an offence, for [e]very person who, not being registered as a dealer, adviser or representative, gives out information to investors which could influence their investment decisions and derives advantage therefrom separate from his ordinary remuneration. See *Securities Act* (Québec), section 200.

<sup>103</sup> Depending on circumstances, statutory civil liability for misrepresentations generally only attaches to statements made by issuers, their directors, certain officers and other “influential persons.” See e.g., Part XXIII and Part XXIII.1 of *Securities Act* (Ontario) and Division II of Chapter II of Title VIII of *Securities Act* (Québec).

<sup>104</sup> See e.g., *Rural Funds Management Limited as Responsible Entity for the Rural Funds Trust and RF Active v Bonitas Research LLC* [2020] NSWSC 61, 12 February 2020. Note also that Singapore securities legislation also provides a private right of action for contravention of its legislation. *Securities and Futures Act* (Sing), Cap 289 (2006 rev ed), ss 199, 234(1A).

<sup>105</sup> Most of the judicial decisions dealing with activist short selling are defamation or libel actions against activist short sellers.

<sup>106</sup> For example, some Canadian jurisdictions have passed what is known as ‘Anti-SLAPP’ legislation which provides a preliminary, pretrial procedure for a defendant to seek dismissal of a defamation suit when they are brought for tactical reasons (e.g., to silence critics or suppress debate or publication on matters of public interest). Recently, the Ontario Court of Appeal provided some assurances to analysts who write reports critical of issuers when it struck down a defamation suit brought by an issuer against an analyst (*Fortress Real Developments Inc. v Rabidoux*, 2017 ONSC 167). These applications are, however, highly fact-driven and courts have also ruled against a prominent short seller in his Anti-SLAPP application, notwithstanding the acknowledgement that information on “management of publicly traded corporations is a matter of public interest”. See: *Thompson v Cohodes*, 2017 ONSC 2590.

<sup>107</sup> For example, see *Re Carnes*, 2015 BCSECCOM 187; *Cohodes*, *supra* note 96. However, it should also be noted that this issue is not unique to Canada. There are very few enforcement cases against activist short sellers in other jurisdictions as well.

unlawful conduct *and* materiality *and* market impact related to a statement must be proven.<sup>108</sup> The use of social media to convey information has also introduced new complexities, including in terms of understanding and demonstrating market impact of a particular statement.

An additional means of deterrence, statutory civil liability for misrepresentations in the context of a campaign, does not currently exist in Canada. Initiating civil proceedings has also not been widely used by issuers or investors in relation to allegations of problematic conduct. This may be due to difficulties in the civil litigation process,<sup>109</sup> including challenges in pursuing defamation and/or libel claims. It could also reflect an issuer's desire to simply put an end to the issue rather than to prolong it through litigation. In most cases, it seems litigation is an undesirable route to seek meaningful and timely redress.<sup>110</sup> The concern is therefore whether a lack of meaningful remedial options provides further incentives for activist short sellers to engage in problematic conduct. A statutory provision which addresses some of the practical complexities of seeking redress in the civil courts may provide an additional means of deterring problematic conduct, however, this would be somewhat novel and may have corresponding unintended liability for others, including analysts.

### Consultation Questions

12. In your view, do the existing enforcement mechanisms adequately deter problematic activist short selling? If so, why? If not, why not?
  - a. Can deterrence be improved through specific regulation of activist short sellers? If so, how?
13. Are there additional or different regulatory or remedial provisions that could be considered to improve deterrence of problematic conduct? If so, what are these provisions?
14. Can you provide examples of specific activist short selling conduct that in your view is problematic but may not fall within the scope of existing securities offences such as market manipulation and misrepresentation/misleading statements? In your view, how should this problematic conduct be addressed by securities regulators?
15. Is it important that a statement have actual market impact to trigger enforcement action by securities regulators?
  - a. Should another standard be used? For example, in your view is the "reasonable investor" standard a preferable approach (e.g., would a reasonable investor consider that statement important when making an investment decision)? If so, why? What are the potential implications of such a change?

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<sup>108</sup> See footnote 97.

<sup>109</sup> For example, see *Harrington supra* note 11.

<sup>110</sup> As noted, "When a short-seller seriously attacks the integrity of a company's senior executives or Board members, the temptation to sue for defamation is almost impossible to overcome. Some believe that they almost have to sue for defamation, for fear that their failure to do so will be viewed as an admission of the short-seller's claims. Canadian CEOs and companies have accordingly sued in the past over critical reports. But the business wisdom of pursuing such a claim is not universally supported, and the efficacy of such defamation claims is disputed. ... Moreover, there is a risk that the short-seller will maintain its position in the company for a longer period of time after being hit with a defamation claim, in order to avoid reputational risk" Bell, Derek and Ellins, Katelyn, "Get Shorty: Defamation and Regulatory Claims in Canada" (*DLA Piper Canada*), July 26, 2017.

## CONSULTATION QUESTIONS

1. What is your perception about activist short sellers? Please describe the basis of that perception.
2. Can you give examples of conduct in activist short selling Campaigns that you view as problematic?
3. Given the focus of the available data is on prominent activist short sellers, what is your view regarding less prominent activist short sellers or pseudonymous activist short sellers targeting Canadian issuers? How can they be identified? Is there any evidence that they are engaging in short and distort campaigns?
4. What empirical data sources related to Campaigns should we consider?
5. In 2019, there was a large drop in the number of Canadian issuers targeted by prominent activist short sellers compared to the year before. Are there market conditions or other circumstances that in your view could lead to an increase? Please explain.
6. Is there any specific evidence that would suggest that Canadian markets are more vulnerable to activist short selling, including potentially problematic activist short selling (e.g., size and type of issuers, industries/sectors represented or other market conditions)?
  - a. Please provide specific examples of these vulnerabilities, and how they differ from other jurisdictions.
7. Do issuers have practical limitations in terms of their ability to respond to allegations made in a Campaign? If so, what are these limitations, and do you have any recommendations on how to alleviate them?
8. Are issuers reluctant to approach regulators when they believe that they are being unfairly targeted by an activist short seller? If so, why? If not, why not?
9. Is the existing regulatory framework adequate to address the risks associated with problematic activist short selling? Please explain why or why not and provide specific examples of concerns and areas where, in your view, the regulatory framework may not be adequate.
10. Have there been market developments or new information since 2012, when UMIR amendments regarding short selling and failed trades were implemented, that would warrant revisiting the existing regulatory framework for short selling? If so, please describe these new developments or information and indicate, providing evidence to support your views:
  - a. whether, in your view, there is a connection between failed trades and activist short selling;
  - b. what changes should be considered and why, and specifically with respect to potentially problematic activist short selling activities; and
  - c. whether there are relevant regulatory requirements in other jurisdictions that should be considered and why.
11. Is the existing disclosure regime for short selling activities adequate? Please explain why or why not, indicating:



- a. what disclosure requirements would address risks associated with potentially problematic activist short selling and how would such requirements improve deterrence;
  - b. what should be the trigger and the timing of any additional disclosure;
  - c. how can additional disclosure be meaningful without negatively impacting market liquidity; and
  - d. do you foresee any issues with imposing a duty to update once there has been a voluntary disclosure of a short position?
12. In your view, do the existing enforcement mechanisms adequately deter problematic activist short selling? If so, why? If not, why not?
- a. Can deterrence be improved through specific regulation of activist short sellers? If so, how?
13. Are there additional or different regulatory or remedial provisions that could be considered to improve deterrence of problematic conduct? If so, what are these provisions?
14. Can you provide examples of specific activist short selling conduct that in your view is problematic but may not fall within the scope of existing securities offences such as market manipulation and misrepresentation/misleading statements? In your view, how should this problematic conduct be addressed by regulators?
15. Is it important that a statement have actual market impact to trigger enforcement action by securities regulators?
- a. Should another standard be used? For example, in your view is the “reasonable investor” standard a preferable approach (e.g., would a reasonable investor consider that statement important when making an investment decision)? If so, why? What are the potential implications of such a change?

### **Comments and submissions**

The Committee invites participants to provide input on the issues outlined in this public consultation paper. You may provide written comments in hard copy or electronic form. The consultation period expires **March 3, 2021**.

#### **Statement for consultation paper**

Certain CSA regulators require publication of the written comments received during the comment period. We will publish all responses received on the websites of the Autorité des marchés financiers ([www.lautorite.qc.ca](http://www.lautorite.qc.ca)), the Ontario Securities Commission ([www.osc.gov.on.ca](http://www.osc.gov.on.ca)), and the Alberta Securities Commission ([www.albertasecurities.com](http://www.albertasecurities.com)). Therefore, you should not include personal information directly in comments to be published. It is important that you state on whose behalf you are making the submission.

Please submit your comments in writing on or before March 3, 2021. Please send your comments by email in Microsoft Word format.

Please address your submission to all members of the CSA as follows:

British Columbia Securities Commission  
Alberta Securities Commission  
Financial and Consumer Affairs Authority of Saskatchewan  
The Manitoba Securities Commission  
Ontario Securities Commission  
Autorité des marchés financiers  
Financial and Consumer Services Commission (New Brunswick)  
Superintendent of Securities, Prince Edward Island  
Nova Scotia Securities Commission  
Superintendent of Securities, Newfoundland and Labrador  
Superintendent of Securities, Yukon Territory  
Superintendent of Securities, Northwest Territories  
Superintendent of Securities, Nunavut

Please deliver your comments only to the addresses below. Your comments will be distributed to the other participating CSA members.

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