Court File No. CV-17-587463-00CL

***ONTARIO***
**SUPERIOR COURT OF JUSTICE**
**COMMERCIAL LIST**

B E T W E E N:

THE CATALYST CAPITAL GROUP INC. and
CALLIDUS CAPITAL CORPORATION

Plaintiffs

- and -

WEST FACE CAPITAL INC., GREGORY BOLAND, M5V ADVISORS INC. C.O.B. ANSON GROUP CANADA, ADMIRALTY ADVISORS LLC, FRIGATE VENTURES LP, ANSON INVESTMENTS LP, ANSON CAPITAL LP, ANSON INVESTMENTS MASTER FUND LP, AIMF GP, ANSON CATALYST MASTER FUND LP, ACF GP, MOEZ KASSAM, ADAM SPEARS, SUNNY PURI, CLARITYSPRING INC., NATHAN ANDERSON, BRUCE LANGSTAFF, ROB COPELAND, KEVIN BAUMANN, JEFFREY MCFARLANE, DARRYL LEVITT, RICHARD MOLYNEUX, GERALD DUHAMEL, GEORGE WESLEY VOORHEIS, BRUCE LIVESEY and JOHN DOES #4-10

Defendants

**SUPPLEMENTARY WRITTEN SUBMISSIONS OF THE DEFENDANTS, NATHAN ANDERSON AND CLARITYSPRING INC.**

**APPENDIX "C": LITERATURE ON THE ROLE OF SHORT-SELLERS**

**(MOTION RETURNABLE DECEMBER 16, 2020)**

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# TAB 1

CSA ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

# 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.[1] We have also heard concerns from stakeholders about potential regulatory intervention inhibiting beneficial short selling activity and detracting from the price discovery process.[2]

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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[1] 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)

[2] 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.[3] Activist short sellers are a subset of "directional" short sellers.[4] 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.[5] 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.[6]

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."[7] 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. [8]

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[3] 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.

[4] 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.

[5] See Adam Kornblum "11 Tweets that Turned the Stock Market Upside Down" *Ogilvy Insights* (13 August 2018).

[6] Michael P. Regan, "The Tiny Activist Fund That Reaped 24% Return by Unearthing 'Cockroaches", *Bloomberg Markets* (20 May 2019).

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

[8] 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.[9] These concerns appear to be based on perceptions that:

- There is an increasing number of activist short selling Campaigns in Canada[10];
- The Canadian regulatory framework addressing short selling is less strict in comparison to other jurisdictions[11]; 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.[12]

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

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.

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[9] As discussed in Part III.D, concerns about short selling and activist short selling have also seen a resurgence in other jurisdictions.

[10] See e.g., Shecter, *supra* note 1; Pasparakis, Soliman & Bricker, *supra* note 1; Evans *supra* note 1.

[11] 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]

[12] 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.]

[13] See e.g., Shecter, *supra* note 1.

[14] 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).

[15] See Safkhet 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."

### 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 not own either directly or through an agent or trustee.[16] 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.[17] 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.[18] Short selling can also be an important part of an investor's hedging and investment risk management strategy.[19] 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)[20] 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.[21] Further, many Canadian listed issuers trade infrequently[22] 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.[23] Similarly,

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[16] Universal Market Integrity Rule (UMIR), Part 1 - *Definitions and Interpretation*, Rule 1.1.

[17] 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.

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

[19] 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].

[20] 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.

[21] 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].

[22] 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.)

[23] 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

it can also be difficult to take a synthetic short position as the listed derivatives market for derivatives with an underlying equity is relatively small in Canada, representing only a small proportion of listed equity securities.[24]

### C. Activist Short Selling

In most CSA jurisdictions, activist short sellers are not currently subject to specific regulatory requirements,[25] 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.[26]

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.[27] 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.[28]

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;

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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).

[24] 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.

[25] 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).

[26] 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).

[27] 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 & Partnov, *supra* note 8 at 12.

[28] 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").

- 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 platforms to spread information to the market is not limited to activist short selling. The CSA has acknowledged that social media can present challenges when used for sharing information with the market.[29] 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,[30] 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.[31]

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).[32] Anonymous or pseudonymous short sellers, or those with only a presence on SeekingAlpha.com (SA),[33] account for less than 20% of the 48 activist short sellers that have targeted Canadian issuers since 2010. [34]

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[29] 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*.

[30] 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.

[31] 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).

[32] 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.

[33] 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.

[34] 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

## 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.[35] 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.[36] 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)[37] are still active according to AI.[38] 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.[39] 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.[40]

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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.

[35] 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.

[36] 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.

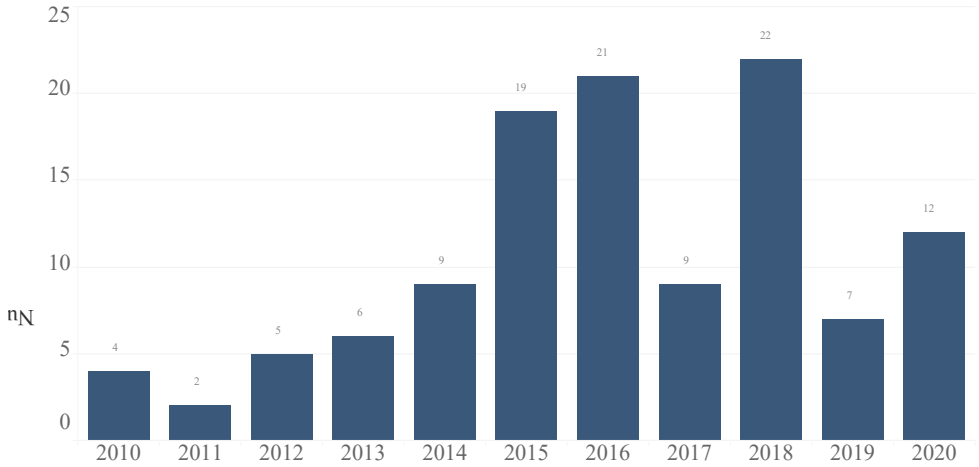
[37] In 2020, there have been twelve Campaigns identified as of September 30, 2020.

[38] 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".

[39] 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.

[40] See *Ibid.*

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

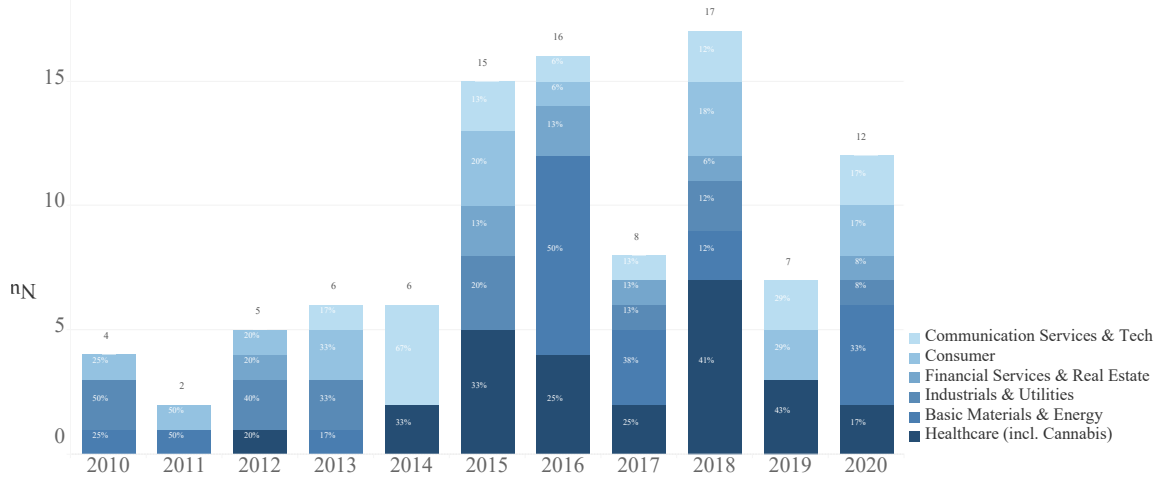



For the small number of Canadian targets identified, annual Campaign activity appears to be highly cyclical as evidenced in Figure 1. In general, short sellers gravitate towards the securities of issuers and sectors where there is a perceived overvaluation (See Figure 2).[41] In peak Campaign years, 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.[42] 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.

[41] Ekkehart Boehmer, Charles M Jones & Xiaoyan Zhang, "Which Shorts are Informed?" (February 4, 2007). AFA 2007 Chicago Meetings Paper, available at SSRN.

[42] 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.

**Figure 2 - Activist Short Seller Targets by Sector (2010 – Sept. 2020)[43]**




## 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[44]) compared to the broader Canadian market.[45] 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.[46]

### *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.[47]

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

[44] 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.

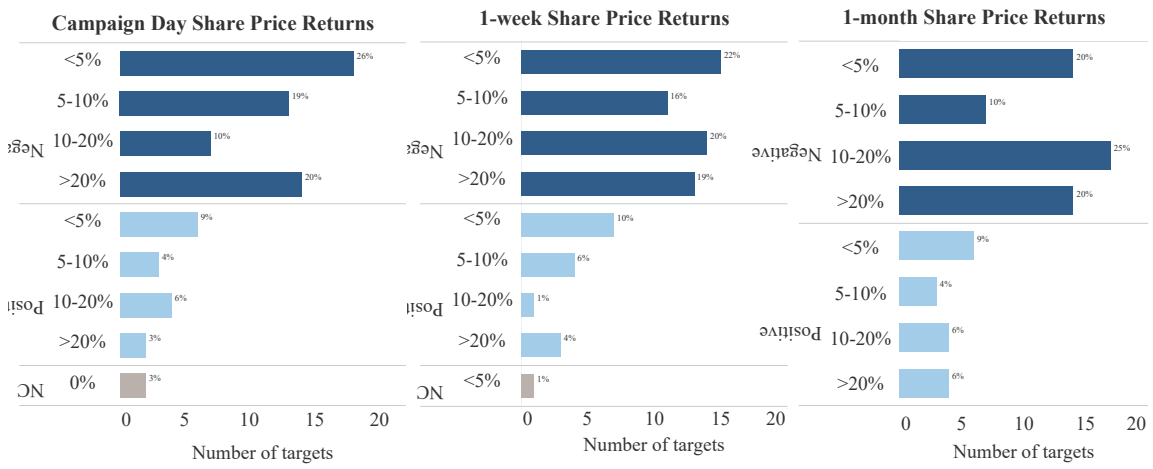
[45] In contrast, the year-end median market capitalization of all TSX issuers from 2014 to 2019 was between $112 million and $153 million. As of September 30, 2020, approximately 64% of TSX issuers had a market capitalization of $300 million or less and 92% of TSXV issuers had a market capitalization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

[46] 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.

[47] 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).

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).[48]

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



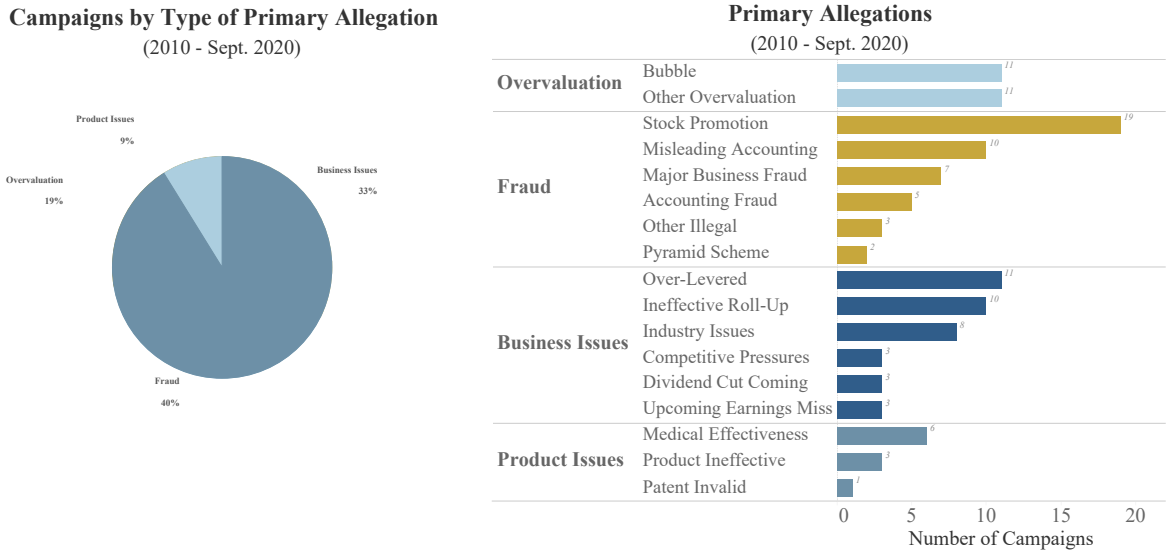

*iii. Campaign Allegations*

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).[49] 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.

[48] *Ibid.*

[49] Based on AI's assessment of the Campaigns.

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




*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.[50]

**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.[51] 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

[50] Issuer responses identified from AI data.

[51] This is consistent with campaign outcomes for foreign issuers in foreign markets as well (see Figure 5).

foreign (21%) targets).[52] 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.[53]

### C. Analysis and Consultation Questions

There appears to be a perception that activist short selling is on the rise in Canada[54] 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. 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

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[52] 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.

[53] 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.

[54] For example, see: Schecter, *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].

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";[55]
- a requirement to disclose "Extended Failed Trades" to IIROC;[56]
- a requirement that, if an Extended Failed Trade report is filed with IIROC, further short sales generally cannot be made by that Participant[57](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);[58] and
- the ability for IIROC to designate a security as a "Short Sale Ineligible Security."[59]

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.[60] 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, [61] which IIROC then publishes on its website.[62] IIROC also aggregates trades marked

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[55] 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.

[56] 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.

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

[58] "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).

[59] "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).

[60] 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.

[61] UMIR, *Part 10 – Compliance*, *Report of Short Positions*, Rule 10.10.

[62] 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

"short sale" from all of the marketplaces it monitors, consolidates that information, and publishes a semi-monthly report showing the total industry short sales for each security over the reporting period.[63] 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 IIROC 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.[64] As such, "naked short selling", as that term is sometimes understood, is not permitted under UMIR.[65]

IIROC monitors for potentially abusive trading activity. For example, in the context of short selling activity, IIROC 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.[66]

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

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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.

[63] The Short Sale Trading Statistics Summary Report is based on data for trades marked "short sale" supplied by each marketplace that IIROC monitors. The report is published twice monthly.

[64] 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).

[65] As previously noted in IIROC 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.

[66] 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.

capital of the company concerned, and each 0.1% above that.[67] Anyone can therefore view the identity of holders of short positions that meet these position-level thresholds for an EU security.[68] 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.[69]

In Australia, there are short selling reporting requirements for both transactions[70] and positions above a certain threshold.[71] 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.[72]

### 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."[73] We note that while the regulatory framework in Canada differs in some ways from other

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[67] 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 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."

[68] 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.

[69] 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]

[70] Short sale transaction reporting is the reporting of daily volumes of products that are short sold in the market.

[71] 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.

[72] Australian Securities & Investments Commission, "Regulatory Guide 196: Short Selling" (October 2018), see Reg. 196.8.

[73] *Harrington*, *supra* note 11.

jurisdictions, it is consistent with the four IOSCO principles for the effective regulation of short selling.[74]

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.[75] These amendments included:

- repealing the "tick test";[76]
- imposition of pre-borrow requirements for short sales made in certain circumstances; and
- introduction of the "short-marking exempt" designation.[77]

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.[78] After consideration of comments received and of the data on short sales and failed trades,[79] it was determined that no additional regulatory requirements were needed at that time.[80] 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.[81] IIROC indicated that it would continue to monitor international developments in the regulation of

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[74] 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.

[75] IIROC Notice 12-0078 *supra* note 20.

[76] 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.

[77] See footnote 55.

[78] Joint Notice 23-312, *supra* note 19.

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

[80] 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).

[81] 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.

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.[82]

Concerns around short selling regulation have seen a resurgence both in Canada and abroad.[83] 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 activities.[84] 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.'[85] 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.[86] 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.[87]

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.[88] Increased transparency on the

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[82] 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).

[83] 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.

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

[85] 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).

[86] 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."

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

[88] 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

identity of a short seller may also expose them to litigation and regulatory action, potentially stifling legitimate short selling activity.[89] 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.[90] 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.

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.[91] 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.[92] The rationale for such a requirement being that when a short seller voluntary 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."[93] 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.[94]

**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.

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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."

[89] 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.

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

[91] Bliss, Molk & Partnoy, *supra* note 8 at 46-47.

[92] 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).

[93] *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.

[94] Mark Cohodes, "Pump-and-dump stock trading needs new rules for the digital age", FT Online, April 26, 2020.

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?

## 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.[95] 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.[96] 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.[97]

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.[98]

Canadian securities legislation also contains fraud and market manipulation prohibitions[99] 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,[100] that:

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[95] 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.

[96] See e.g., *Re Cohodes*, 2018 ABASC 161 [*Cohodes*].

[97] See e.g., *Securities Act* (Ontario), RSO c S.5, s 126.2.

[98] *BCSA Amendments*, section 50(3), *supra* note 26.

[99] See e.g., subsection 126.1(1) of the *Securities Act* (Ontario).

[100] See e.g., *Derivatives Act* (Québec), CQLR c. I-14.01, s. 151, *Securities Act* (Ontario), s. 126.1(1)

- 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
- perpetrates a fraud on any person or company.[101]

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.[102]

### 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.[103] 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.[104]

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.[105] This may be due to the practical and evidentiary challenges of civil litigation.[106]

### 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.[107] From an enforcement perspective, securities

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[101] 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.

[102] *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.

[103] 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).

[104] 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).

[105] Most of the judicial decisions dealing with activist short selling are defamation or libel actions against activist short sellers.

[106] 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.

[107] 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.

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 unlawful conduct *and* materiality *and* market impact related to a statement must be proven.[108] 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,[109] 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.[110] 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?

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[108] See footnote 97.

[109] For example, see *Harrington supra* note 11.

[110] 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.

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?

**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:

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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), the Ontario Securities Commission (www.osc.gov.on.ca), and the Alberta Securities Commission (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:

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Financial and Consumer Affairs Authority of Saskatchewan
The Manitoba Securities Commission
Ontario Securities Commission
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# TAB 2

# “A positive economics view of short selling”


| | |
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# A positive economics view of short selling


## Abstract

One of the most hotly contested investment practices during the global financial crisis (GFC) was short selling, with the strategy receiving attention approaching histrionic proportions from corporate executives, investors, media, regulators and politicians alike. This paper examines the practice of short selling through the lens of positive economics, examining the largely normative debate surrounding this unorthodox market behavior and its role in society. In exploring the economics of short selling, the authors examine a number of arguments from both the long and short side of the market and consider whether the central arguments levelled against the strategy are specific to short sellers or whether these issues relate to all market participants. We posit that short sellers assist in making markets less opaque, with these traders fulfilling an important price discovery role.


**Keywords:** short selling, market efficiency.
**JEL Classification:** G01, G14, G18, G29.

## Introduction

*"... short selling is beneficial to the makets not only in the technical aspects of proving liquidity or a hedge against long positions, but also as an important bulwark against hyperbole, irrational exuberance, and corporate fraud."*

James Chanos, President of Kynikos Associates
U.S. Securities and Exchange Commission
Roundtable on Hedge Funds (May 15, 2003)

The collapse of the U.S. sub-prime mortgage market in 2007 was one of the key triggers for the global financial crisis (GFC) – a form of financial tsunami – the impact of which is still being felt around the world today. The continued strain on the global financial architecture during the 'great recession' saw the demise of long standing investment houses such as Bear Stearns (March, 2008) and Lehman Brothers (September, 2008). During the darkest days of this period of falling stock markets and corporate collapse, many company executives and government agencies attributed much of the blame for falling share prices to market participants known as 'short sellers'. The weekend of September 13-14, 2008 marked an inflection point in the short selling debate as the collapse of Lehman Brothers saw a worldwide government response to save their nations' banking system by attempting to stabilize the equity value of the banking sector. In an effort to protect these financial institutions from a sharply declining value in their equity base, the world witnessed the announcements of multiple short selling bans across numerous jurisdictions. So what is the modus operandi of a short seller? Speculative short sellers are market participants who expect asset prices to decline and to potentially profit from this expectation. Short sellers express their negative sentiment by constructing a speculative short position in their market of choice and, as such, 'success' is the result of falling asset prices. Traditionally, investors go long (attempting to profit through a strategy of buy low/sell high), whereas short sellers go short (attempting to profit through a strategy of sell high/buy low). Media commentators, corporate executives, politicians and government regulators have, at times, employed rhetoric that has approached histrionic levels to demonize these market participants by running the normative argument that short sellers profit from the misery of others (that is, the current shareholder or market participants with long positions)[1]. It is against this backdrop that this paper aims to contribute to the short selling debate through a consideration of the economic considerations of this unorthodox market practice. To achieve these objectives, we take a 'positive economics' approach to the short selling debate, finding that a number of the key arguments levelled at short selling can also apply to those holding long positions. We posit that short sellers assist in making markets less opaque, with these traders fulfilling an important price discovery role. We commence the paper by examining the 'anatomy' of a short sale transaction.

## 1. The anatomy of a short sale

To understand the economics of the short selling debate, it is important to consider the mechanics of short selling and the difference between the two types of short selling, namely, covered short selling and naked short selling. To construct a short sale, there are two parts to a short sale transaction, namely, the repurchase agreement and the sale of the shares.

**1.1. Repurchase agreement.** Perhaps the key point of differentiation between the traditional long-only (buy low/sell high) investor and the short seller is that, in


The authors gratefully acknowledge the support of the New Research Initiatives Program (NRIP) in Superannuation and Funds Management at Griffith University. We acknowledge and thank an anonymous reviewer for helpful comments which improved the paper. Any remaining errors are our own.

[1] By way of example, see "Sheared by the Shorts: How Short Sellers Fleece Investors", accessed on February, 2, 2012, http://www.huffingtonpost.com/ellen-brown/short-sellers-investors_b_985701.html.

opening the trade with a short (sell high/buy low), the investor does not own the securities (say, a stock) in which the trade is occurring. The short seller commences the transaction by seeking a counterparty that owns the stock and engages in a stock lending transaction known as a stock repurchase agreement (repo). Under this fully collateralized transaction, the short seller receives the stock from the original shareholder and, in return, the short seller transfers cash to the original owner of the shares of the amount equal to the market value of the shares. In the repo, the short seller bears an additional cost for borrowing the stock which is paid to the original owner of the shares. The short seller earns the overnight cash rate less a margin on the cash lent to the original shareholder. The margin reflects the additional cost to the short seller for borrowing the stock, which is effectively paid as a stock lending fee to the original shareholder. The difference between the market 11 a.m. overnight rate and the repo rate reflects the stock lending margin which is driven by the demand and supply for every share and this margin varies over time.

**1.2. Sale of the stock.** With the repo transaction completed, the short seller now holds the stock, which they sell at the prevailing market price via the respective stock exchange (sell to open). Between the transaction date on which the short occurred and some future date, the short seller must purchase this stock back from the market in order to deliver the asset back to the original shareholder at the maturity date of the repo agreement (buy to close). If stock prices rise during this time, then the short seller will suffer a financial loss (sell low/buy high). If the short seller is correct and the stock price falls, a financial profit is earned through short selling (sell high/buy low).

Within the mechanics of a short sale, there are two forms of transactions, namely, covered short selling and naked short selling. Covered short selling refers to the sale of the share with the full knowledge that the short seller can guarantee settlement of the stock because the short seller has completed the repo transaction. A covered short sale transaction signifies that the short seller has access to the shares thereby ensuring a successful delivery of the shares to the stock exchange on the settlement date.

Conversely, a 'naked short selling' transaction means that the short seller has sold the shares via the stock exchange on the transaction date without first securing the availability of the shares via the repo transaction. This means that the short seller cannot guarantee that they have access to the stock to deliver to the stock exchange on the settlement date of the transaction. As a result, there is a probability that the settlement of the share transaction at the stock exchange may fail if the naked short seller cannot borrow the stock via a repo.

## 2. Short selling: theory and evidence

To further understand the practice of short selling and its role in society, we review the theory of this strategy and the current evidence in the financial economics literature. One of the first issues relating to the practice of short selling relates to the motivation for opening the transaction with a sale of securities. A short selling transaction can be employed as a speculative position or it can be used as a hedging tool to offset an opposing exposure within any legal structure or entity (for instance, a farmer is long wheat and shorts (sells to open) wheat futures to hedge the future price of their harvest). Due to differing motivations to enter a short selling transaction, the practice is commonly employed in many markets around the world including shares, bonds, global foreign exchange, gold bullion, futures and options markets for both risk transfer (hedging) and speculation.

**2.1. Theoretical foundations.** The theory of short selling originated from Miller (1977) who argued that short sale constraints restrict the transmission of negative information to the market, thereby impairing price discovery. The argument follows that, due to information asymmetry, stock prices will transact at levels greater than fair value. Miller's (1977) contribution provides an important framework for this paper in that one of the economic functions of short sellers is to mitigate the issue of information symmetry, which lies at the heart of informationally competitive markets. Further contributions by Diamond and Verrecchia (1987) corroborate Miller's (1977) proposition that short sale restrictions increase both the magnitude of overpricing and the subsequent market correction when that negative information is finally transmitted into stock prices. Further, work by Hong and Stein (2003) suggests that negative information becomes present in a short sale constrained market after stock prices begin to decline, thereby resulting in market crashes.

**2.2. Empirical evidence.** The theory of short selling provides a framework to evaluate the behavior of short sellers and their role in capital markets. Some of the first empirical studies by Figlewski (1981) and Bris, Goetzmann and Zhu (2007) find that short sellers cause lower stock prices. The work of Bris et al. (2007) is particularly comprehensive. Using a sample of 46 equity markets, Bris et al. (2007) find some evidence that prices incorporate negative information faster in countries where short sales are allowed and practiced. They find strong evidence that in markets where short selling is either prohibited or not practiced, market returns display significantly less negative skewness. Albert, Smaby and Robison (1997) corroborate these findings, arguing that the downward impact of short sellers facilitated

fairer share prices even during the bubble years of the NASDAQ dot-com boom in the 1990s. In the Australian setting, Aitken, Frino, McCorry and Swan (1998) show that the speed of negative information from short selling becomes embedded in the stock price within 15 minutes of the short sale transaction. These studies provide some evidence that short sellers transmit negative information into the capital markets, resulting in lower asset prices.

A further strand of work has examined whether short sellers exhibit investment manager skill in correctly selecting these overvalued stocks. Studies by Dechow, Hutton, Meulbroek and Sloan (2001) in the U.S. (supported subsequently by Takahashi (2010) in the Japanese setting) suggest that short sellers are indeed skilled at selecting companies that exhibit lower expected future returns. Connolly and Hutchinson (2012) examines short biased hedge funds finding evidence of significant alpha (risk-adjusted stock selection skill) exhibited by these short selling fund managers. These results are particularly important to the short selling debate, as Connolly and Hutchinson (2012) find that during the GFC dedicated short bias (DSB) hedge funds exhibited extremely strong results while many other hedge fund strategies suffered badly. Investigating DSB hedge fund performance 1994 through 2008, Connolly and Hutchinson (2012) report that (using both linear and non-liner estimation techniques) DSB hedge funds provided a significant source of diversification for equity market investors and produced statistically significant levels of alpha. These findings reported in these studies suggest that short sellers possess skill at detecting overvalued companies that exhibit a tendency for their stock price to decline, that is, they are successfully employing a sell high/buy low investment strategy.

The two major themes that emerge from these studies – short sellers cause stock prices to decline and they tend to exhibit skill in identifying overvalued companies – leads us to ask, do these short sellers employ their skills for good or evil? Put another way, do short sellers drive share prices from an overvalued price down to fair market value, or, do they push a stock from fair market value to below fair market value, thereby engaging in market manipulation? When any sort of trading activity (including both short selling) results in an under/overvalued share moving to fair value, then the allocative role of markets is enhanced. On the other hand, market participants that engage in market manipulation by artificially driving up/down stock prices beyond their fair value impair the efficiency of markets.

A number of studies have examined whether short sellers are guardians of informational efficiency or whether they are indeed market manipulators. The empirical work from Wooldridge and Dickinson (1994) finds that short sellers increase their short positions as stock prices rise, thereby enhancing market liquidity. More importantly, Wooldridge and Dickinson (1994) show that short sellers enhance market liquidity by unwinding their positions by purchasing back these shares as prices decline. This behavior was documented in the Australian setting by Data Explorers (2008) whereby short sellers were accused of market gouging in the case of ABC Learning Centres Ltd (ABC) during the period of 2007-2008. Data Explorers (2008) find from ABC transaction records that short sellers were net buyers in the market as the share price declined over the period in question. In another study, Curtis and Fargher (2008) demonstrate that short sellers do not magnify price declines, but rather, they align prices to their fair market valuation price. Curtis and Fargher (2008) report that, when stock returns are conditioned on fundamental value, there is no reliable evidence that the targets of short-sellers trade below respective fundamental values. Interestingly, Curtis and Fargher (2008) note that a significant proportion of short-sellers' positions are concentrated in stocks that appear overvalued relative to their fundamentals. While there is significant heterogeneity in the positions of short-sellers, including large positions in stocks with price declines, Curtis and Fargher (2008) find compelling evidence that a significant proportion of short positions following price declines appear to align prices with fundamentals rather than force prices below fundamental values. These studies seem to suggest that short sellers play an important informational role in capital markets, driving the prices of overvalued companies towards fair value. Ironically, it is market participants following the traditional approach (buy low/sell high) that have to actually sell to close a position, whereas short sellers (sell high/buy low) have to buy to close. So, when markets are falling precipitously, short sellers are providing liquidity by purchasing stock. We consider these ideas in the context of the GFC and move to consider the arguments for and against short selling.

## 3. Lessons from the 2008 short selling bans

If there was ever a time in financial history to examine the economics of short selling then the GFC is the 'case study par excellence'. The following quote from the SEC captures the sentiment in the United States immediately following the collapse of Lehman Brothers on the September 14, 2008 and the subsequent falls in stock prices around the globe: *"The Commission is committed to use every weapon in its arsenal to combat market manipulation that threatens investors and capital markets. The emergency order temporarily banning short selling of*

*financial stocks will restore equilibrium to markets. This action, which would not be necessary in a well-functioning market, is temporary in nature and part of the comprehensive set of steps taken by the Federal Reserve, the Treasury, and the Congress"*, SEC (September 19, 2008).

However, within three months of this strongly worded statement, the SEC's view of the decision to impose the ban had changed radically. In an interview with Reuters on December 31, 2008, the outgoing SEC Chairman Christopher Cox reflected on the decisions made in the midst of the GFC, making the following comments: *"The SEC's Office of Economic Analysis was still evaluating data from the temporary ban, and that preliminary findings point to several unintended market consequences and side effects. While the actual effects of this temporary action will not be fully understood for many more months, if not years... knowing what we know now, I believe on balance the Commission would not do it again"*, Christopher Cox, SEC Chairman, Phone Interview with Reuters (December 31, 2008).

Furthermore, one month later, the newly appointed SEC Commissioner Kathleen Casey made the following statement in relation to the short selling ban in September 2008: *"While the effects of the ban, as well as the previous emergency orders, are still being formally studied, we know, based on the review of the SEC's Office of Economic Analysis, as well as studies and feedback from both academics and market participants, that the short selling ban created significant disruptions and distortions in markets and across the business activities of a wide spectrum of financial market participants. At the time, undertaking such action required us to balance several important considerations. We had real fears about the downside of such a ban. While extraordinary market conditions and great pressure led us to impose these temporary measures, we sought to carefully balance concerns about potentially abusive short selling against the likelihood of increased volatility, diminished liquidity, and inhibited price discovery. We also know that emergency actions by their very nature can add a further element of uncertainty to an already sensitive market environment and that such uncertainty may actually contribute to market instability"*, Kathleen L. Casey, SEC Commissioner (January 14, 2009).

To be fair to those involved invoking short selling bans, it would not be the first time in history when an action motivated by good intentions had unintended consequences. However, one would think that the short selling bans invoked in 2008 may be closely followed by court litigations and legal prosecution by regulators against the short sellers who were engaging in the spreading of false rumours and the perpetrators of market manipulation. At the time of writing this paper, the SEC and the Australian Securities and Investments Commission (ASIC) has yet to take to trial or prosecute any individual or organization for opportunistic bear raids or market manipulation during the period of the 2008 GFC[1].

The emerging body of literature post the GFC by Boehmer, Jones and Zhang (2008), Autore, Billingsley and Kovacs (2011) and Battalio and Schultz (2011) finds that the 2008 short selling ban resulted in large negative liquidity impacts in the markets in which they were enforced. The work of Battalio and Schultz (2011) makes a key contribution to the debate. Battalio and Schultz (2011) examine how the September 2008 short sale restrictions and the accompanying confusion and regulatory uncertainty impacted equity option markets, finding that the short sale ban was associated with dramatically increased bid-ask spreads for options on banned stocks. Moreover, Battalio and Schultz (2011) report that synthetic share prices for banned stocks became significantly lower than actual share prices during the ban. These studies suggest that the bans resulted in larger price declines in the stocks when the short selling bans were eventually lifted. Moreover, the research provides evidence that bid-ask spreads widened considerably for stocks protected by the short selling ban which created large liquidity shocks when transacting in and out of these specific stocks. Put simply, when the short selling bans were lifted, the stocks protected by the short selling ban suffered the largest price declines due to the illiquidity shock caused by the ban itself. In the Australian setting, the work of Hamson, Wanzare, Smith and Garners (2008) report evidence that the short selling ban on the ASX resulted in a decrease in liquidity, higher intra-day volatility and higher idiosyncratic volatility. More recently, Saffi and Sigurdsson (2011) has examined a sample of stocks from 31 countries from 2005 to 2008 finding that that short selling bans do not achieve the policy objective of stabilizing stock prices and thereby reduce market efficiency.

## 4. Positive and normative views of short selling

To this point, we have examined the short selling debate from theoretical and empirical perspectives. We use this as a foundation to motivate our central concern regarding the major controversies surrounding short selling. In exploring the economic dimensions of short selling, we examine a number of ar-

[1] For instance, in January 2012, Goldman Sachs Group Inc. and Bank of America Corp. persuaded a State Judge (California) to dismiss Overstock.com Inc. (OSTK)'s lawsuit alleging they manipulated short sales of the online retailer's stock from 2005 to 2007, see: http://mobile.bloomberg.com/news/2012-01-11/goldman-sachs-wins-dismissal-of-overstock-s-short-sale-suit-1.

guments from both the long (buy low/sell high) and short (sell high/buy low) side of the market and consider whether the central arguments levelled against the strategy are specific to short sellers or whether these issues relate to all market participants.

**4.1. Short sellers profit when others suffer.** Irvine (2002) argues that profits are ill-gotten when they involve the misery of others. This argument is refined for the short selling setting by Angel and McCabe (2009), who posit that the profits from short sellers come from the financial suffering of other investors. We explore this idea through a hypothetical transaction. Assume that short sellers push a stock price (Stock A) down from an overvalued price of say $100 per share to the fair value of $90 per share. The loss of $10 per share is from the perspective of the *current* (long) shareholder. Let's now examine the economics of the same transaction from the viewpoint of a *prospective* shareholder interested in becoming a shareholder of this company. Assume that you are a value-investor and you favor Stock A, however, you also believe that $100 stock price is too expensive; therefore, you will not allocate your investment capital to become an owner of this stock until the price of Stock A falls from the current price of $100 to your appraised fair-value of $90. As a value-investor, you will not purchase Stock A as you believe that it is too expensive and you will keep your investment capital in cash earning the risk-free rate of return. In a short selling constrained world, the beneficiary here is the noise trader who is still happy to own the $100 share and is uninformed that the stock is actually overpriced. In this hypothetical transaction, the losers are the informed investors (that is, the short seller and the value investor) who suffer from a misallocation of capital and investment skills that cannot be deployed to correct the mispricing of Stock A. Conversely, the beneficiary is the current investor who has claim to these ill-gotten profits.

In the months preceding the GFC, the Australian corporate environment saw publicly listed firms operate with highly leveraged capital structures. Firms that were viewed to hold too much debt on their balance sheet saw short sellers enter the market and short these shares as they believed that the equity of these companies was overvalued given the market and the economic outlook for 2008 and beyond. The passage of time has demonstrated that these short sellers accurately identified the overvalued nature of the equity in these highly leveraged publicly listed firms. This negative information from short sellers was transmitted to the market, which was then incorporated into the decisions of all market participants.

It is not surprising that many Boards and corporate executives of publicly listed companies hold a natural dislike for short sellers. A share that is being short sold sends a market signal that short sellers are bearish regarding the prospects of that company and that the current market price is, in the opinion of the short seller, above fair market value (in fact, so far above market value that, if correct, the trade would more than compensate the short seller for transaction costs, the costs of becoming informed and the risk borne). However, whilst acknowledging the adversarial nature of the relationship between corporate executives and short sellers, it is important to note that poor corporate management decisions due to excessive risk taking and highly leveraged balance sheets are not made by short sellers. The short seller is taking a position based on their view of the efficacy of the decisions of corporate executives given the current market value of the company. The corollary to this is that share prices of many, many publicly listed companies declined during 2008; however, many well-managed companies were never given attention by short sellers. The Australian firms that were most associated with significant short selling activity included ABC and Allco Finance Group. Interestingly, these firms were highly leveraged and are subject to various legal proceedings relating to their corporate governance since 2008[1].

A number of points need to be emphasized in terms of a positive economic view of short selling and whether these market participants truly profit from the misery of others. The work of Curtis and Fargher (2008) and Wooldridge and Dickinson (1994) finds that short sellers, on aggregate, increase their short positions as stock prices rise and they close their short positions by purchasing back their shares as prices decline. The demonisation of short sellers by some corporate executives is in stark contrast to the actual behavior of short sellers during periods of market decline. In fact, the empirical evidence suggests that short sellers are on the buy side of the market during periods of falling stock prices – therefore, the selling pressure is coming from those who were long to open and are selling to close (or, the case where the traditional buy low/sell high strategy goes awry).

Perhaps the challenge in this debate centers on the issue of whether falling stock prices are a bad outcome. Short sellers provide an opposing view to the positive long-term expectation inherent in stock market returns. This optimism comes from studies such as Dimson, Marsh and Staunton (2002), Mehra and Prescott (1985) and Siegel (1992) who demonstrate that an equity risk premium can be garnered

[1] For instance, a discussion of the class actions following the collapse of both ABC Learning Pty Ltd is available at http://www.abc.net.au/news/2011-01-24/legal-action-against-abc-learning-begins/1915896; and Allco Finance Group at http://www.theaustralian.com.au/business/breaking-news/angry-investors-in-allco-action/story-e6frg90f-1111117955371.

over the long-term, that is, the 'triumph' of the buy low/sell high strategy for long-term investors. In contrast, short sellers advocate a more sceptical view of stocks as they provide the market with an opposing opinion over the short to medium term. Influential industry practitioners such as Warren Buffet (2006) believe that short sellers serve an important function in forensic accounting in weeding out firms that engage in fraudulent and unscrupulous corporate activity. In 2008, publicly listed financial stocks such as Bear Stearns were under pressure as short sellers revealed unscrupulous corporate activity that was deemed to regard the firm as overvalued[1]. A number of corporate executives of U.S. investment banks during this period demonized short sellers as these corporate managers believed that their companies were operating efficiently with high standards of financial management and corporate governance[2]. Financial history informs us that the information signal from short sellers in 2008 was more accurate than the media releases of 'comfort' (including Lehman declaring a dividend to equity holders five days before filing for Chapter 11) being released by these firms into the market[3]. As we wind the clock forward to 2012, many of these same firms are in the mire of litigation or have entered bankruptcy.

**4.2. Short selling encourages unethical behavior.** The work of Angel and McCabe (2009) makes the argument that short selling incentivises unethical behavior whereby short sale positions are constructed and then negative smear campaigns of misinformation to 'short and distort' the asset price down are instigated in order to gouge profits from the declining asset price. Whilst this perspective is important in terms of the short selling debate, the empirical studies published to date do not support this assertion, and the paucity of successfully prosecuted litigation suggests that short sellers do not engage in this type of unscrupulous practice in general.

However, we acknowledge Angel and McCabe's (2009) point that it would be naïve to imagine that no individual short seller has attempted to pursue this form of market manipulation. If we assume for a moment that this unethical behavior exists, then we need to ask ourselves whether this form of market manipulation is unique to short selling. Again, we find that the central tenets of Angel and McCabe's (2009) argument can be made against the buy low/sell high strategy, with fraudsters engaged in 'pump and dump' strategies of long stock positions. Pump and dump behavior is a well known U.S. stock fraud perpetrated in 'boiler room' organisations who operate in the Over-the-Counter Bulletin Board (OTCBB) and Pink Sheet markets. Bollen and Christie (2009) study these micro capitalization firms who cannot afford the costs to list on a typical U.S. stock exchange, who raise capital through these over-the-counter markets where price discovery, market efficiency and liquidity is provided on a 'best endeavors' basis. A pump and dump scheme involves artificially inflating stock prices of these micro capitalization firms through false and misleading positive information which allows early holders of the stock to sell the shares to the misinformed market[4]. Eventually, the market absorbs the true information and the overinflated stock price collapses to a lower equilibrium price.

It is our conjecture that the incentives for market manipulation by short sellers are equally valid for those following a buy low/sell high strategy, as we have witnessed with pump and dump activities that artificially drive stock prices upwards. It follows that bear market conditions enhance profitability for sell high/buy low; as bull markets are beneficial for the buy low/sell high strategy. Given the equal and opposite drivers of profitability of the two strategies, short selling may encourage unethical behavior in the same way that the potential exists for unethical behavior of market participants who endeavor to overinflate stock prices. Given the symmetry of the argument, it is our conjecture that short sellers have the identical incentives for unethical behavior as market participants who hold long positions.

**4.3. Short selling speculators are just plain bad.** It appears that society's understanding of the role of speculation has been diluted over recent decades. In periods of strong global economic growth, we seem to conveniently ignore the genuine role of specula-

[1] Two former Bear Stearns hedge fund managers (whose funds held securities backed by risky home loans) recently settled a civil lawsuit brought by regulators (SEC v. Cioffi, in the U.S. District Court for the Eastern District of New York, 08-2457), see http://www.reuters.com/article/2012/02/13/us-bearstearns-fundmanagers-idUSTRE81C1EI20120213.

[2] In prepared Congressional testimony, former Lehman Brothers Holdings CEO Dick Fuld wrote, *"The naked shorts and rumor mongers succeeded in bringing down Bear Stearns. And I believe that unsubstantiated rumours in the marketplace caused significant harm to Lehman Brothers"* see: http://blogs.wsj.com/deals/2008/10/07/dick-fulds-vendetta-against-short-sellers-and-goldman-sachs/tab/article/.

[3] Only five days prior to filing for Chapter 11 bankruptcy protection, Lehman Brothers Holdings (September 10, 2008) issued a media released with headlines such as *"Lehman brothers announces preliminary third quarter results and strategic restructuring: Comprehensive Set of Actions to Significantly Reduce Commercial Real Estate, Residential Mortgage and Other Less Liquid Asset Exposures", Chairman and Chief Executive Officer Richard S. Fuld, Jr. said, "The strategic initiatives we have announced today reflect our determination to fundamentally reposition Lehman Brothers by dramatically reducing balance sheet risk, reinforcing our focus on our client-facing businesses and returning the Firm to profitability"* and, perhaps most striking, the declaration of a (albeit reduced) dividend to equity holders *"Annual Dividend to be Reduced to $0.05 Per Share"*, a full copy of the media release is available at: http://www.ft.com/cms/e0b164a0-7f32-11dd-a3da-000077b07658.pdf.

[4] In 2011, the SEC charged a Santa Ana-based company and three executives with a $10 million boiler room fraud, see: http://www.sec.gov/litigation/litreleases/2011/lr21944.htm.

tors in markets. When a nation's economy falters due to excessive bank lending practices and/or poor fiscal policy, it is convenient (yet unproven) to blame 'speculators' for these sub-optimal financial market outcomes[1]. The ethical issue of short sellers requires us to review our understanding of speculation and its vital role in society. Economists including Adam Smith, John Maynard Keynes, Ludwig Von Mises and Leon Walras have all documented the critically important role of speculators in a well functioning market. Speculators take on risk which others are unwilling to bear. Risk is transferred from one party to the speculator in a market transaction. Speculation involves risk and therefore they are compensated with returns when their financial decisions are proven to be correct. The unfortunate news for speculators comes from the seminal work of Bachelier (1900) who stated: "*The mathematical expectation of the speculator is zero*", Bachelier (1900).

After many decades of empirical work, Black (1986) neatly summarized that there are both informed traders and noise (that is, uninformed) traders in the market. In the world of speculation, profits are earned by those with information and these profits are extracted from the uninformed noise traders. Studies such as Jacks (2007) shows that the introduction to a futures market leads to increased speculation which has been shown to reduce the levels of commodity price volatility. Other studies by Edwards (1988a) and Bessembinder and Sequin (1993) provides similar findings that demonstrate that stock returns were more volatile before the introduction of the stock index futures market. The same conclusions have been observed in bond market studies such as Bortz (1984) and Edwards (1988b). In short, empirical studies demonstrate that the introduction of speculators in markets leads to more efficient and stable markets than otherwise.

The ethical issue of short selling is whether those engaging in the practice genuinely serve markets and society in their role as speculators. When we consider both buy low/sell high and sell high/buy low strategies, we can again see that there is a symmetrical argument that can be made with long-based speculators as well as short sellers. The ethical issue for these strategies is that both sets of market participants fulfil their role by bearing risk that is transferred from hedgers and investors wishing to enter and exit the market at the prevailing market prices. For instance, a farmer who is producing wheat and wishes to have certainty of price in the future needs to sell to open, say, a futures contract. Moreover, the same principle applies from the long perspective (where the agent is short in the physical market and goes long in the synthetic to hedge the position – a carpet manufacturer agrees to deliver carpet at a future date and enters a long wool futures contract today to hedge price risk). Here we see that both of these hedging transactions need both buyers and sellers of contracts on the other side of the transaction to fulfil the risk transfer function and, in many cases, this is fulfilled by speculators.

**4.4. Naked short sellers are demons in suits.** Some critics have argued that naked short sellers were to blame for the collapse of a number of financial institutions, including Lehman Brothers, and this was the catalyst for broader market losses through the GFC[2]. Recent research considering this period of extreme market dislocation has suggested that naked short selling appears to have little to no impact on the stock price of Lehman Brothers and other stocks allegedly affected. Fotak, Raman and Yadav (2011) investigate the claims of short selling manipulation of Lehman Brothers shares and others in U.S. markets and find no evidence that the price declines in 2008 were caused by naked shorting. Fotak et al. (2011) argue that despite recent regulatory and media concern that has focused heavily on the potentially manipulative distortion of market prices associated with naked short selling, shorting can also have beneficial effects for liquidity and pricing efficiency. Using a sample of the US financial institutions hardest hit by the GFC, Fotak et al. (2011) test for the impact of naked short-selling on market quality, finding that that naked shorting leads to significant reduction in positive pricing errors, the volatility of stock price returns, bid-ask spreads, and pricing error volatility. Fotak et al. (2011) also study the impact of the SEC ban on naked short selling of financial securities during July and August 2008, and find that the ban did not slow the price decline of those securities and had a negative impact on liquidity and pricing efficiency. The empirical findings of Fotak et al. (2011) lead the researchers to conclude that their results are in sharp contrast with the extremely negative pre-conceptions that appear to exist among media commentators and market regulators in relation to naked shortselling. Furthermore, the work of Boulton and Braga-Alves (2009) also finds no evidence that naked short sellers exacerbated downwards movements in stock prices. To date, no evidence has been marshalled to empirically support that naked short sellers engage in predatory behavior to destabilize stock prices.

[1] In 2010, the world's financial press ran with headlines such as *"Greek PM to urge Barack Obama to crack down on speculators"*. Greek officials have indicated that the Prime Minister Papandreou requested U.S. President Barack Obama to impose stricter regulations on hedge funds and currency traders, who they blame for aggravating their problems and making it harder for Greece to borrow money, see: http://www.guardian.co.uk/business/2010/mar/09/greek-pm-meet-barack-obama.

[2] See footnote 2, p. 37.

When asset prices fall, there is a human tendency to rationalize the cause of falling markets onto a macroeconomic/financial variable or to demonize a specific market participant. In the bear market of 2008, naked short sellers were blamed for the declining stock prices of heavily leveraged firms such as Lehman Brothers in the U.S. and ABC and Babcock and Brown in Australia[1]. However, the emerging empirical evidence suggests otherwise. In the end, the market dynamics of 2008 informs us that the marginal sellers of these shares were more willing to transact at lower prices and that the vast majority of these sellers were those following a traditional buy low/sell high strategy gone very much awry.

## Conclusion

The practice of short selling remains a controversial and delicate topic for arbitrageurs, speculators, politicians, corporate executives and government agencies alike. In a bull market, there is no attention paid to short sellers as financial markets drive up the valuation of asset prices, making the sell high/buy low strategy unprofitable. However, the evidence to date demonstrates that at the point of bullish exuberance, short sellers employ their skills to seek out and identify overvalued companies. As rising markets eventually turn and investors experience falling asset prices, it becomes a corporate and political convenience to blame declining asset prices on short sellers. We conceded that the practice of short selling quickly turns into a heated normative debate when markets crash and blame is conveniently apportioned to the short seller in the market rather than to the excessive risk and mismanagement by corporate executives. Short sellers play a vital role as forensic accountants who seek to identify overvalued assets. It was the short sellers that detected the questionable accounting practices of Enron, WorldCom, HealthSouth and ABC long before the entire market and government regulators were aware of the corporate frauds and non-disclosure being committed[2]. The short seller ensures that markets are less opaque as they search to uncover accounting irregularities. As a result, short sellers make financial markets stronger and more efficient. As history has shown sometimes, just sometimes, we can engage in witch hunts without witches. Both buy low/sell high and sell high/buy low investment strategies are seeking to profit from either a bullish or bearish outlook and both motivations are needed for efficient and effective price discovery.

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[1] In a heated memo written to employees in 2008, John Mack, CEO of Morgan Stanley stated *"… what's happening out there? It's very clear to me – we're in the midst of a market controlled by fear and rumors, and short sellers are driving our stock down"*, see: http://www.time.com/time/business/article/0,8599,1842499,00.html.

[2] In testimony to the SEC five years prior to the GFC, James Chanos stated, *"… many of the major corporate frauds and bankruptcies of the past quarter century were first exposed by short sellers doing fundamental research: Enron, Tyco, Sunbeam, Boston Chicken, Baldwin United, MicroStrategies, Conseco, ZZZZBest and Crazy Eddie are a few examples of this phenomenon"*, see: http://www.sec.gov/spotlight/hedgefunds/hedge-chanos.htm.

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# TAB 3

# Short Selling's Positive Impact on Markets and the Consequences of Short-Sale Restrictions

## I. Introduction

Short selling plays an important role in efficient capital markets, conferring positive benefits by facilitating secondary market trading of securities through improved price discovery and liquidity, while also positively impacting corporate governance and, ultimately, the real economy. However, short selling and short sellers have received negative attention over the years, primarily due to general concerns that short selling is purely speculative and potentially destabilizing for markets.[1] Short sellers are often scapegoats in a market down cycle,[2] while firm management is also generally wary of short sellers, as short selling positions pay off when a firm's stock price declines.[3] However, to the extent that short selling improves the efficiency of capital markets, many of these criticisms appear to be unwarranted.

Recent policy proposals and discussions on the role of short selling in our capital markets focus on mandatory public disclosure requirements for short sale transactions. The "Brokaw Act," introduced in the Senate Banking Committee in August 2017, would require short sellers to file public disclosure statements after accumulating short interests of 5% or more of a company's stock.[4] Advocates of this proposal point to the disclosure requirements for long positions, arguing that a similar requirement for short positions would be appropriate.[5] However, the rationale for disclosure requirements for long positions are related to voting rights and control, and there is no analogous rationale for short positions, as those powers do not accrue to short sellers.

More recently, a similar legislative proposal has been pushed by a group of proponents that includes the New York Stock Exchange and NASDAQ. Their proposal would mandate disclosure

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[1] *See* Massimo Massa, Bohui Zhang & Hong Zhang, *The Invisible Hand of Short Selling: Does Short Selling Discipline Earnings Management?*, Rev. of Fin. Studies, 2014.
[2] *See* Ekkehart Boehmer, Charles M. Jones & Xiaoyan Zhang, *Shackling Short Sellers: The 2008 Shorting Ban*, Rev. of Fin. Studies 2013; *and see*, Kinsey Grant, "NYSE President Tom Farley Blasts Short Sellers, Call Them 'Un-American' and 'Icky', thestreet.com, Jun. 27, 2017.
[3] *See e.g.*, Time, Sept. 18, 2008 (quoting Morgan Stanley CEO John Mack, "It's very clear to me-we're in the midst of a market controlled by fear and rumors, and short sellers are driving our stock down.")
[4] *See* S. 1744, August 3, 2017.
[5] *See e.g.*, Wachtell, Lipton, Rosen & Katz, Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934, submitted to the Securities and Exchange Commission, Mar. 7, 2011.

of a short position that exceeded 5% of a stock's weekly average trading volume.[6] Since the disclosure requirements for long positions are not based on trading volume, the mandate for short positions would be unique, naturally leading to a question as to why this would be appropriate for short sales. As of this writing, this proposal has yet to receive any congressional backing.[7] The common feature of each of the short selling disclosure proposals is a public disclosure requirement for short sellers, identifying individual positions along with the identity of the short seller, rather than simply disclosing overall short selling activity. Overall short selling activity is already disclosed fairly extensively under SRO rules. Pursuant to discussions with the SEC, U.S. exchanges publish on their websites daily aggregate short selling volumes on a per security basis.[8] Additionally, exchanges publicly disclose data on individual short sale transactions, with a one-month lag.[9] FINRA rules also mandate public reporting of off-exchange short sale volumes, requiring member firms to "report total short positions in all customer and proprietary firm accounts in all equity securities to FINRA on a bi-monthly basis."[10] FINRA publicly releases aggregate data on a per security basis, pursuant to a request by the SEC.[11]

Considering these recent proposals, the policy discussions surrounding short sales should include both an examination of the role of short selling in financial markets and the potential negative consequences of a mandatory disclosure rule. It is particularly important to weigh the motivations for the proposals (and whether they would have their desired effect) against the consequences. Empirical studies on short selling help inform us of the consequences, confirming multiple benefits associated with shorting activity. Short selling improves both price efficiency and liquidity in the stock market, improving overall market quality. Short selling activity also serves as an external discipling mechanism on firm management, thereby improving corporate governance. Relatedly, restrictions on short selling – including outright bans of the practice - have been found to impact markets negatively, primarily due to the loss of the benefits listed above. If

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[6] *See* Michelle Celarier, *The Dangers of Short-Selling Disclosure*, Institutional Investor, Mar. 29, 2018.
[7] Id.
[8] SEC Release 2009-172, SEC Takes Steps to Curtail Abusive Short Sales and Increase Market Transparency, Jul 27, 2009, available at http://www.sec.gov/news/press/2009/2009-172.htm.
[9] Id.
[10] FINRA, *Short Reporting Instructions*, *available at* http://www.finra.org/industry/short-interest/short-interest-reporting-instructions.
[11] *See* FINRA Information Notice, *Publication of Daily and Monthly Short Sale Reports on the FINRA Web Site*, Sep. 29, 2009.

the proposed mandatory disclosure requirements become *de facto* restrictions on short selling, then our capital markets may suffer similar negative consequences. Recent research supports these concerns, finding that mandating disclosures of short positions can indeed chill short sale activity, harming capital market efficiency and quality. Given the recent policy discussions aimed at short sellers, the Committee on Capital Markets Regulations thinks it is important to highlight the current state of the academic research on the effects of short selling on financial markets and the potential unintended consequences of mandatory disclosure rules.

## II. Market Benefits of Short Selling

Short selling confers several benefits both *directly* to the capital markets themselves and *indirectly* to the real economy. Theoretical and empirical studies have shown that short selling improves overall market quality by contributing to (i) price efficiency, (ii) liquidity, and (iii) corporate governance.[12] In addition, examinations of the impact of various short-selling bans and restrictions have shown overwhelming negative effects on market quality, further exemplifying the importance of short selling in financial markets. Given the potential for disclosure regulations to serve as a *de facto* short sale restriction, it is important to understand the benefits of short selling that are at stake.

### *(i) Price Efficiency Benefits*

Short selling contributes to the accuracy and efficiency of prices in securities markets, primarily by ensuring that both positive and negative public information about firms are promptly reflected in prices.[13] Absent a short selling mechanism, security prices would face an upward bias and would not completely reflect a security's underlying fundamentals. Diamond and Verrecchia (1987) offer a voting analogy to illustrate this bias.[14] If voting on a referendum is unconstrained, i.e. voters can either vote "yes" or "no," then an unbiased result is achieved. However, if a voter is constrained to voting either "yes" or otherwise abstaining entirely, then an upward bias on the results would be introduced in favor of "yes" voters. The final tally would not reflect the collective

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[12] *See, e.g.* Katherine McGavin, Short Selling in a Financial Crisis: The Regulation of Short Sales in the United Kingdom and the United States, 30 Nw. J. Int'l L. & Bus. 201 (2010).
[13] *See* Diamond & Verrecchia (1987).
[14] Diamond & Verrecchia, *Constraints on Short-Selling and Asset Price Adjustment to Private Information*, J. of Fin. Econ. 18, 1987.

will of the electorate. Similarly, removing the ability of short sellers to transact in the market would introduce bias on securities prices, since short sellers would be restricted from trading on their information. Security prices would not be fully reflective of underlying fundamentals.

In theoretical models of short selling, short sellers are considered rational, informed traders, i.e., traders with "value-relevant information."[15] Short sellers, therefore, should theoretically contribute to pricing efficiency by trading on superior information, thus pushing mispriced stocks closer to their fundamental value.[16] Alternative theoretical models, however, posit a contrasting view, claiming that short sellers may use their superior information to engage in manipulative and predatory trading that harms price discovery.[17] While it could be the case that both theoretical views persist in the market, i.e., some short sellers contribute positively to market quality and others behave more perversely, the empirical evidence from recent academic studies strongly supports the more positive view of short selling's impact on price efficiency. The studies find that short sellers are indeed informed traders,[18] and more importantly, that short selling activity helps correct valuation errors.[19]

Boehmer and Wu (2013) find that short selling by informed short sellers facilitates rational price discovery in multiple respects. The study examines the impact of short selling on efficient prices by decomposing a stock's transaction price into its *efficient price* plus its *pricing error:*[20]

*current stock price = efficient price + pricing error*

The pricing error represents the temporary deviation between the current stock price and its efficient price. In a perfectly efficient market, the pricing error would be zero and the current stock price would equal its efficient price. The pricing error, therefore, serves as a measure of price efficiency: the *lower* the pricing error, the *more efficient* the current stock price. The Boehmer and Wu empirical study finds that short selling activity leads to more efficient prices. Specifically, *higher* short sale volumes for a stock lead to *lower* pricing errors, i.e. more efficient prices. The

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[15] Boehmer & Wu (2013).
[16] *See e.g.,* Diamond & Verrecchia (1987).
[17] For theoretical models of this theory, *see e.g.* Goldstein and Guembel (2008).
[18] *See e.g.*, Christophe, Ferri, and Angel (2004), Boehmer, Jones and Zhang (2008), and Diether, Lee and Werner (2008).
[19] Boehmer & Wu (2013).
[20] Note the efficient price is the component of the stock price that follows a random walk.

result is both statistically significant and economically significant. Stocks with the median volume of shorting activity (approximately 18.4% of daily trading volume) experience pricing errors that are 20% less than stocks with no shorting activity.

The Boehmer and Wu study also examines the speed with which public information is incorporated into stock prices, finding that more active short selling leads to faster incorporation of information into prices. Stocks in the top 10% of shorting activity by volume incorporate new fundamental information into current stock prices at *double* the speed of stocks in the bottom 10% of shorting activity (0.8 days for the top 10% versus 1.6 days for the bottom 10%).

Boehmer and Wu (2013) also find that there is no evidence supporting claims that short selling exacerbates large stock price declines.[21] Conversely, it finds that short selling *improves* the accuracy of prices, particularly on the most volatile of trading days. Overall, Boehmer and Wu (2013) provide compelling evidence that short selling has a significantly positive impact on price discovery.

Other recent empirical studies provide further evidence of the important role of short selling in improving price efficiency. Saffi and Sigurdsson (2011) shows that when short selling is restricted for certain stocks, the mispricing of those stocks is more persistent and pronounced.[22] Choi, Getmansky and Tookes (2009) show that short selling improves price discovery in the convertible bond market, thus demonstrating the importance of short selling in securities other than stocks.[23]

A common criticism of short selling is that it exacerbates crises by artificially depressing stock prices during a market decline. If this concern were valid, then increased shorting activity should correspond closely with *negative* returns. The shorting activity would be destabilizing since it would contribute to an accelerating downward spiral in prices. However, Bailey and Zhang (2013) find the opposite effect.[24] Short selling volumes are typically higher on days with *positive* returns than on days with negative returns, showing that short sellers do not increase short positions

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[21] Boehmer & Wu (2013).
[22] Saffi & Sigurdsson (2011).
[23] Choi, Getmansky & Tookes, *Convertible Bond Arbitrage, Liquidity Externalities, and Stock Prices*, J. of Fin. Econ. 91, 2009.
[24] *See*, Bailey & Zhang, *Banks, Bears, and the Financial Crisis*, Jour. of Fin. Serv. Res. (2013).

when stock prices fall (which would exacerbate declines), but rather when they rise. By trading in the opposite direction of price movements, short sellers tend to correct market overreactions and bring prices more in line with fundamental supply and demand. Short sellers, therefore, have a stabilizing effect on prices during crisis periods.[25]

To the extent there is legitimate concern about the potential of short-selling to drive the market down during periods of steep declines over a short period of time, the SEC has already addressed it through its 2010 amendment to Regulation SHO, which instituted a short-sale circuit break in the form of the alternative up-tick rule.[26] The alternative uptick rule is aimed at preventing short selling from further pushing down a firm's stock price if the price has already dropped more than 10 percent in a day.[27] Specifically, the rule mandates that a trading center must adopt policies and procedures to prevent short sales at prices below or equal to the current national best bid price if the stock has dropped 10% or more since the prior day.[28] While the merits of the uptick rule and short sale-related circuit breakers can be debated, those rules are a much more effective approach than the proposed mandatory disclosure requirements.

*(ii) Liquidity Benefits*

Short selling also positively impacts overall market quality through improvements in market liquidity. The primary liquidity measures impacted by short selling include (i) bid-ask spreads and (ii) price impacts, proxied by the Amihud illiquidity measure (which measures the average daily ratio of a stock's return to its volume). Theoretical models of short selling suggest that short selling should improve each of these liquidity measures. If short selling were restricted in a stock, informed short sellers would be prevented from trading on negative fundamental information.[29] This would reduce price efficiency, as explained above, causing prices at any given moment to be less reflective of current information and contain higher pricing errors. As a result, liquidity providers in the stock must be compensated for the higher pricing errors, reflected through a higher bid-ask spread. The higher bid-ask spread imposes higher trading costs for the stock, reducing its liquidity. Similarly, the Amihud illiquidity measure would also be negatively impacted

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[25] Boehmer et al. (2013) (referencing Bailey & Zhang (2013)).
[26] SEC Release No. 34-61595, Amendments to Regulation SHO, May 2010.
[27] Id.
[28] Id.
[29] *See* Diamond & Verrechia (1987).

by restrictions on short sale activity. Recent empirical studies confirm both of these theoretical predictions.

Beber and Pagano (2013) examine the liquidity impacts of short selling bans across 30 countries, finding a decline in liquidity when shorting constraints are more severe.[30] The study finds that a complete ban on all short sales leads to an increase of 1.98% in the bid-ask spread. The effect is both statistically significant and economically significant, given that the average bid-ask spread in the study's sample was 4.05%. The study also looks at the effect of short sale bans on the Amihud illiquidity measure, finding that banning short sales leads to significant deterioration in the liquidity measure.[31]

*(iii) Corporate Governance Benefits*

Short selling also contributes positively to strong corporate governance by serving as an external disciplining mechanism on firm management. In theory, since short sellers are motivated to uncover wrongdoing by management (and then trade on that information through short sales), the probability and speed with which corporate misconduct is discovered increase.[32] As a result, there is less incentive for management to engage in such misconduct, thus improving the corporate governance of the firm.

Massa, Zhang and Zhang (2015) examine the corporate governance impact of short selling, finding that the presence of short sellers does indeed improve the behavior of firm managers. The study looks at the degree of shorting potential for a given stock (the "short-selling potential" or "SSP"), proxied by the total supply of shares that are available to be lent for short sales. The study finds that the higher the SSP, the less likely that firm management manipulates corporate earnings, thus illustrating the disciplining effect of short sales. The Massa et al. study also examines the effects of short selling bans globally, finding that regulations that restrict short-selling lead to greater earnings manipulation, i.e., weakened corporate governance when short selling is restricted by regulation. Moreover, the disciplining impact of short selling has increased over time, corresponding with an increase in shorting activity. Importantly, the results of the Massa et al.

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[30] Beber & Pagano (2013).
[31] Beber & Pagano (2013).
[32] Massa et al. (2015).

study show that it is the mere *possibility* of short sale activity that disciplines firm managers, regardless of whether short sales are actually conducted in the firm's stock. Therefore, any rules that serve to reduce even the possibility of short sales, such as the mandatory disclosure rules under discussion, will likely harm corporate governance.

## III. Effects of Mandatory Disclosure of Individual Short Positions

Short selling clearly has an important role in capital markets, as evidenced in part by the impact of short sale restrictions on price efficiency, liquidity, and corporate governance. While disclosure of overall short-sale activity (i.e. aggregate volumes of all short positions at a given time) does help inform markets in a worthwhile manner, disclosure requirements for *individual* investors' short positions would be much more disruptive. Mandatory disclosure of individual short sale positions is not a direct restriction on short selling, but it may serve as a *de facto* restriction by chilling short sale activity. Short sellers are generally motivated to maintain a high degree of secrecy and anonymity given (i) concerns about revealing proprietary trading strategies, which could increase the costs of implementing the strategy, (ii) fears of potential litigation initiated by the shorted firm, and (iii) the potential loss of access to the shorted firm's management, arguably the most important concern for overall market efficiency. Firm management can retaliate against holders of short positions and effectively inhibit their ability to properly analyze a firm's fundamentals, impairing the fundamentally-driven research and analysis that is vital to efficient markets.

Short sellers are arguably even more sensitive about revealing trading positions to competitors than investors taking long positions, since short positions are always part of an active trading strategy, while long positions can be part of an active or passive strategy. Short strategies are also typically short-term in nature, while long positions are often held over a longer term (but can be short-term as well). Therefore, short sellers are highly motivated to remain below a disclosure threshold, more so than long holders of equity.[33] To the extent that mandatory disclosure serves as a restriction on short selling, due to the chilling effect of disclosure rules, many of the benefits of short selling discussed above may be reduced or lost entirely.

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[33] Of course, some short sellers intentionally disclsose their short positions as part of an activist short campaign. *See* Zhao, *Activist Short Selling*, Jan. 2, 2018 *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2852041.

The SEC previously noted these concerns in a 2014 study on short sale transparency.[34] In the study, which was mandated by the 2010 Dodd-Frank Act, the SEC examined the costs and benefits of a real-time short position reporting program, looking at both public reporting and reporting only to the SEC and FINRA. The report identified the concern that public reporting could "facilitate copycat and order anticipation strategies that could discourage liquidity supply, fundamental analysis vital to price efficiency, and hedging that facilitates capital formation."[35] Overall, the SEC determined that "[t]he potential net effect of a [public reporting requirement] on market quality and capital formation is unclear."[36] Ultimately, the SEC report opposed a real-time public reporting requirement.[37]

A recent empirical study examines these potential concerns of mandatory disclosure. Jank, Roling and Smajlbegovic (2016) analyze the effects of mandatory short sale disclosure in the European Union, which imposed a mandatory disclosure rule for short positions in 2012.[38] The EU rule requires short sellers to notify regulators if a short position reaches 0.2% of the stock's issued share capital and publicly disclose any short positions that reach 0.5%. The study tests whether the EU's disclosure thresholds effectively restrict shorting activity, finding three notable effects.

First, short sellers have indeed restricted short selling activity in the face of the regulation, evidenced by a significant percentage of short sellers specifically avoiding crossing the disclosure thresholds. Second, those short sellers who avoid crossing the disclosure threshold tend to be better informed with superior information about a stock's fundamentals. Third, given that it is the informed short sellers who limit shorting activity due to the disclosure mandate, price discovery is negatively impacted since the fundamental information held by informed short sellers does not get incorporated into prices as efficiently as if short selling were not impeded. Even more, the de facto short-sale restriction may exacerbate the loss of informational efficiency, since investors will be less incentivized to collect and analyze fundamental information in the first place. Overall, Jank et al. document that the EU's mandatory disclosure requirements have caused a deterioration in

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[34] SEC, Short Sale Position and Transaction Reporting, 2014.
[35] SEC Report at iv.
[36] SEC Report at iv.
[37] SEC Report at Vii
[38] Jank et al. (2016); EU Regulation on Short Selling (No 236/2012).

market quality, noting that the transparency regulation has "impose[d] a negative externality on the informational efficiency of stock prices."[39]

## IV. Conclusion

The academic evidence on the effects of short selling on our capital markets is overwhelmingly positive. Short selling improves the efficiency of security prices, increases liquidity, and positively impacts corporate governance. Historical bans and restrictions on short selling have proved to negate many of these benefits, to the detriment of overall market quality. As policymakers evaluate proposals to mandate disclosure of individual short selling activity, the potential unintended consequences on market quality must be carefully considered.

[39] Jank et al. (2016).

# TAB 4

THE GLOBE AND MAIL

# Regulations to rein in short-sellers must not overlook the good they do

LARRY MACDONALD

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FOR SUBSCRIBERS



'Short-sellers' actions can be a corrective force for when bad apples slip through the accounting and auditing cracks – look, for example, at how Sino-Forest Corp. and Valeant Pharmaceuticals were brought to light,' Al Rosen, head of forensic-accounting firm Rosen & Associates Ltd., said.

DEBORAH BAIC

A thick hide is a necessary qualification for the job of activist short-seller. When Spruce Point Capital Management released a negative report on Canadian Tire Corp. Ltd. in late 2019, it prompted Yvan Allaire, the executive chair of the Institute for Governance of Private and Public Organizations, to fire back in the

Financial Post: “What one never finds in these short-seller hatchet jobs is concern for anything other than a quick profit.” This was followed with several suggestions for reining in short-sellers.

Mr. Allaire is not the only one proposing restrictions – indeed, there appears to be an upswing in such calls from a number of sources recently. The danger here is that the urge to impose new regulations could go too far and choke off the good things that academic studies have found short-sellers provide to financial markets.

Only seven campaigns were launched in Canada by activist short-sellers in 2019, according to financial data firm Breakout Point. This was the lowest tally since financial analytics firm Activist Insight began keeping records in 2015: In most of those years, the number of new campaigns ranged from 19 to 22. It appears some short-sellers may have gone to the sidelines during 2019 to wait out the bullish tide flowing through the stock market.

### Activist short selling campaigns launched against Canadian companies in 2019

| COMPANY | SHORT SELLER |
|---|---|
| Aurora Cannabis Inc. | Night Market Research |
| Canadian Tire Corp. | Spruce Point Capital |
| FSD Pharma | White Diamond |
| Hexo Corp. | The Friendly Bear |
| Trulieve Cannabis Corp. | Grizzly Research |
| Tucows Inc. | Kerrisdale Capital |
| Village Farms International | Citron Research |

Data source: Breakout Point. Notes: Some positions may now be closed

Even though Canada’s activist short sales plunged last year, the count was still higher than in other countries, excluding the United States. Indeed, Canadian firms have been disproportionately targeted for several years: From 2015 to late 2019 there were 76 campaigns, compared with 17 in Australia and 57 in the European Union.

#### ACTIVIST SHORT-SELLERS ON THE ROPES

Perhaps the most notable of recommendations to curtail-short sellers came in a November report released by law firm McMillan LLP. It claimed that the regulatory framework in Canada for short-sale trades was “out of step” with other countries and some tightening up was needed to make it more difficult to engage in abusive transactions, particularly naked short-selling (which can result in illegal situations where the number of short sales exceeds the actual number of tradable shares).

The regulator in charge of trading rules, the Investment Industry Regulatory Organization of Canada, however, has pointed out that its studies have found little evidence of abusive short-selling in Canada. Moreover, assessments of IIROC's regulatory framework by the International Monetary Fund and World Bank concluded that it met international standards.

Several other sources have forwarded their own proposals. They include bringing back the uptick rule (short sales can only be made on an uptick in share price), giving companies civil remedies to combat "short and distort" campaigns, and having institutional investors cut back on lending securities to short-sellers. (Companies can currently sue short-sellers on a criminal basis but civil remedies would be preferable because of their lower burden of proof.)

## LET'S KEEP SHORT-SELLERS IN THE FIGHT

The McMillan report and other critical commentary appear to overlook a key explanation for why Canada has attracted more than its share of activist short-selling campaigns – namely, it likely has more to do with the way financial results are reported in this country. If so, that would entail a different set of conclusions.

"We have the easier-to-manipulate IFRS accounting framework and auditors that have been relieved of legal liability toward investors by a Supreme Court ruling," Al Rosen, head of forensic-accounting firm Rosen & Associates Ltd., said in an interview. "Along with minimal oversight and prosecutions, this arrangement gives Canadian companies more leeway in presenting financial results in a favourable light to mask operating problems, unethical practices and fraud."

"Uneconomic companies can continue raising money in financial markets for a longer time than they otherwise should, diverting capital away from more productive uses," Mr. Rosen continues. "Short-sellers' actions can be a corrective force for when bad apples slip through the accounting and auditing cracks – look, for example, at how Sino-Forest Corp. and Valeant Pharmaceuticals were brought to light."

Adds Mark Rosen, head of independent investment-research firm Accountability Research Corp.: "Academic studies find that short-selling plays an important role in providing liquidity to financial markets. It also assists with price discovery – meaning it serves as an offset to the preponderance of bullish viewpoints arising from the dearth of independent research in Canada. It would be inadvisable to restrict short-sellers to the point where these benefits are diluted."

Short-sellers are sometimes accused of conducting "short and distort" campaigns that spread false information to manipulate the market. But these are likely to be isolated cases, argues Stephen Bainbridge, a professor at the UCLA School of Law in Los Angeles. As he writes on his blog: "The risk of liability – coupled with the risk of the company's stock not falling – should encourage the shorts to make sure that they have a strong case."

THE CATALYST CAPITAL GROUP INC., et al. and WEST FACE CAPITAL INC., et al.

Court File No.: CV-17-587463-00CL

Plaintiffs Defendants

***ONTARIO***
**SUPERIOR COURT OF JUSTICE**
**- COMMERCIAL LIST**

Proceeding commenced at Toronto.

**SUPPLEMENTARY WRITTEN SUBMISSIONS OF THE DEFENDANTS, NATHAN ANDERSON AND CLARITYSPRING INC.**

**APPENDIX "C": LITERATURE ON THE ROLE OF SHORT-SELLERS**

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