CHAPTER 04

Short Selling in Canada: A New Avenue for Investor Activism

Over the past few years, short-seller activism has grown from a "low profile affair" to a major challenge for securities regulators and governing boards – and Canadian markets are no exception. In many cases, the consequences of a short-selling activism campaign for a company can be profound: a plunge in share price, the diversion of valuable time and resources, the need to rebuild the company's reputation and, in some instances, the initiation of a formal regulatory investigation based on the allegations made in the campaign. In this chapter, we examine the emergence of short-selling activism, review the legal and regulatory landscape governing its practice in Canada, compare some regulatory approaches in other jurisdictions and explore the potential responses available to boards of targeted companies. We also discuss some trends in short-selling activity in Canada, and spotlight three prominent examples over the past several years.

The Rise of Short Selling in Canada

Short selling has existed for (almost) as long as stocks have been freely traded. In the past several years, however, as can be seen in Figure 4-1, Canadian markets have witnessed a new trend: an overall rise in short-selling campaigns targeting public companies. Canadian companies in such diverse sectors as cannabis (Aphria Inc.), mining (Asanko Gold Inc.), retail (Dollarama Inc.), insurance (Manulife Financial Corporation) and aerospace (Maxar Technologies Inc.) have all found themselves the target of activist short sellers. The market capitalization of the targeted companies has ranged substantially, from approximately $171 million to $46.6 billion.

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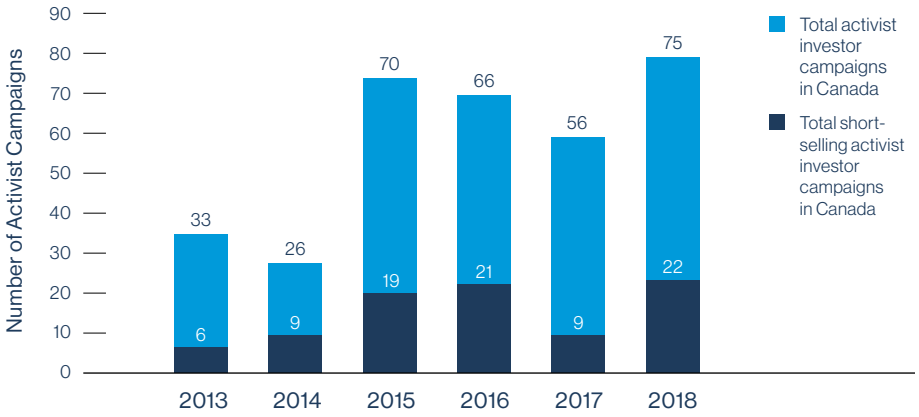
FIGURE 4-1:
Short-Selling Campaigns in Canada (2013–2018)



Source: Activist Insight[75]

Spotlight: The Citron Research Fraud Allegations Against Shopify

Beginning in late 2017, Toronto Stock Exchange (TSX)- and New York Stock Exchange (NYSE)-listed Shopify Inc. was the target of a campaign launched by Citron Research, which claimed that Shopify should be investigated by the U.S. Federal Trade Commission for fraud and lack of disclosure. Citron Research alleged that Shopify's claim that it would make its customers millionaires through the use of its online platform was not true and that Shopify's predicted revenues would collapse. Citron Research subsequently asserted that the company's partnership with Facebook, which had generated important growth, was highly dependent on Facebook not changing its privacy policy.[76] In the aftermath of the two published Citron Research reports, Shopify's share price fell by approximately 11% and 12%, respectively. However, its share price rebounded by almost 48% in 2018 (an increase analysts largely attributed to its strong growth in sales), leaving the company almost unscarred by the short-selling campaigns. Nonetheless, Citron Research has continued to predict a downturn in Shopify's share price as recently as April 2019.[77]

What Is Short Selling?

Short selling is the practice of selling a security that an investor does not own. When shorting a security, the investor anticipates that it can buy back the security at a later date for a lower price in order to cover the initial sale. Rather than buying low and selling high, the investor is hoping to sell high and then buy low. These transactions typically take one of two forms:

– In a "covered" short sale, the short seller borrows the relevant securities (often from its broker) and then sells them on the open market. The short seller is hoping that the shares it just sold will decline in value, allowing it to purchase them on the open market at a lower price than the price of the initial sale. The short seller then returns the newly purchased securities to the lending party in order to cover its initial short position. While the short seller risks losing money on the trade if the security's price rises rather than falls, the underlying share lending arrangement ensures that the sales contract will be completed.

– In a "naked" short sale, the short seller sells securities without any firm commitment to borrow them and often without even ensuring they are available to be purchased or borrowed. Instead, the short seller hopes to purchase the securities on the open market to cover its position before delivery is due under the sales contract. There is therefore an additional risk that the investor will not be able to buy the securities necessary to cover the trade, potentially leading to a failure to deliver.

While some market participants and most issuers view shorting with considerable skepticism, short sellers can serve useful market purposes. For example, short sellers can uncover poor corporate governance practices, unsustainable business strategies or outright fraud, thereby increasing the efficiency of capital markets, correcting sometimes inappropriately inflated stock prices and fostering market liquidity. In this way, like other more traditional activist investors, short sellers provide an important check on issuers and their management. A short-seller activist, upon discovering reasons a company's shares may be overvalued, takes a short position in the company's securities and releases the information to the public, usually by publishing a negative report accompanied by a news release and social media posts, in the hopes that the market price will adjust accordingly. The activist benefits to the extent of the difference between the selling price of the shorted securities and the price of the securities it uses to close out its short position. On this basis, the market benefits from the increased transparency generated regarding the company's operations. In fact, a short seller has incentive to build a track record of success in having its allegations proven as that in turn lends credibility to its next campaign.

Although activist short sellers can serve a valuable function in increasing market transparency, modern technologies allow investors to easily publish anonymous, and potentially devastating, allegations to a large audience, leading to concerns by some that some short sellers may be engaging in abusive campaigns, pejoratively referred to as "short and distort" campaigns. The concern is that, rather than targeting genuine strategic or governance problems, some allegedly abusive short sellers deliberately circulate false or misleading information to drive down a stock's price in order to quickly profit from their short positions.

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Spotlight: Muddy Waters Continues to Target Canadian Companies

The most prominent case of short-selling activism in Canada remains a report released by San Francisco–based hedge fund Muddy Waters LLC targeting Sino-Forest in 2011. Muddy Waters released a report claiming, among other things, that Sino-Forest was a "multi-billion dollar Ponzi scheme [...] accompanied by substantial theft."[78] The Sino-Forest scandal dramatically shook Canadian capital markets and resulted in civil actions and criminal and securities law charges against Sino-Forest and its affiliates. In March 2018, an Ontario court awarded plaintiffs US$2.63 billion in a civil case against Sino-Forest's co-founder and CEO Allen Chan.[79]

Since Sino-Forest, it appears investors and the market have placed significant stock in activists' reports. The market response to short sellers' allegations can be substantial and immediate. In 2017, Muddy Waters posted a tweet promising the release of a new short report on another Canadian public company, and speculation about the target's identity led TSX-listed Element Fleet Management's share price to fall sharply, ultimately losing 40% of its previous value. However, Muddy Waters was in fact targeting another Canadian issuer, Asanko. Element Fleet's share price has largely recovered, while Asanko's share price fell by half following the release of the report in 2017.[80]

While releasing unsubstantiated reports that have the effect of disrupting trading in a stock could constitute market manipulation (which is illegal under provincial securities laws), it is difficult to prove the intention to manipulate a stock, and it is difficult to prosecute short sellers on that basis when reports are based on opinion or even when they may contain misleading or misrepresented facts.[81] On August 15, 2018, for example, a panel of the Alberta Securities Commission (ASC) dismissed an interim cease trade application by ASC staff to temporarily block short seller Marc Cohodes from trading in TSX-listed Badger Daylighting Ltd. on the grounds that the ASC's enforcement staff failed to prove an urgent need for the interim order.[82]

While it can be difficult to objectively distinguish between legitimate and abusive short-selling campaigns, both can have costly effects on targets. For example, a 2018 study on the impact of public disclosure of short positions found that the disclosure was associated with changes in stakeholder behaviour and abnormal, negative returns for the target company, which persisted beyond the 100 days immediately following the announcement.[83]

Short-Selling Regulation in Canada

Short selling is a legal investment strategy in Canada, which boasts relatively lenient regulations compared with other jurisdictions.[84] For example, naked short selling is generally permitted in Canada; to enter a short sale, subject to limited exceptions, the investor does not need to pre-borrow the securities necessary for settlement, provided that there is a "reasonable expectation" that the investor will cover its short position.[85] Moreover, unlike the United States, Canada has not reinstated a (modified) "uptick rule," which would effectively impose a stop on short selling when a share price continuously declines over a specified length of time. Finally, unlike conventional shareholders, short sellers in Canada are not required to publicly disclose their short positions under securities laws, regardless of how extensive they are relative to the company's outstanding shares. However, the Investment Industry Regulatory Organization of Canada (IIROC), which oversees all investment dealers and trading activity on debt and equity marketplaces in Canada does have mandatory short-sales reporting requirements for both exchanges and market participants and, as of January 2019, has been publishing bimonthly reports on the aggregate short positions in public companies. While these reports do not include the identities of individual short sellers, they do allow companies to monitor activity and changes in the short positions held with respect to their shares.

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It will be interesting to see if the positive trend in short-selling activism will continue in Canada and how the legislatures, regulators and prosecutors will respond. On November 29, 2018, the *Financial Post* reported that the Canadian Securities Administrators (CSA), the body that represents Canada's 13 securities commissions or similar regulatory authorities, was in the preliminary stages of a project that involves reviewing "the nature and extent of abusive short-selling in Canadian capital markets."[86] While it is too soon to know what the CSA's recommendations might be as a result of the study, a review of regulatory approaches in other jurisdictions provides useful comparisons and may offer guidance on the future of Canadian regulation.

Short-Selling Regulation Across Jurisdictions

As highlighted in Table 4-1, short-selling regulations vary across jurisdictions. In the European Union (EU), for example, legislation introduced in 2012 banned naked short sales and introduced greater transparency to short positions. EU requirements now mandate that short sellers (i) report their short position to the relevant national authority when they reach or exceed 0.2% of the company's issued share capital and (ii) disclose their short position to the public when they reach or exceed 0.5% of the company's issued share capital, with ongoing disclosure obligations at 0.1% intervals. The net short position must be calculated for the corporate group as a whole to prevent circumventing the disclosure rules. To meet the EU requirements, the disclosure must include the size, relevant issuer and originating date of the short position.[87]

A BRIEF HISTORY OF THE UPTICK RULE OR TICK TEST

In 1938, the U.S. Securities and Exchange Commission introduced Rule 10a-1, otherwise known as the "uptick rule," which remained in force until 2007. The uptick rule applied to all NYSE stocks and required short sales to take place on an uptick (at a price higher than the last reported transaction price). The rule was later relaxed to also allow short sales on a zero-plus tick (at the same price as the last reported transaction price if the most recent price change was positive). At its simplest, the rule was designed to prevent successive short sales at progressively lower prices; instead, traders could short-sell shares only on a price uptick or zero-plus tick.[88] In 2007, U.S. regulators eliminated the uptick rule, and in 2012, Canadian regulators followed suit. Although a modified uptick rule (prohibiting short selling on securities whose price had fallen by more than 10% in a trading day) was reintroduced to U.S. markets in 2010, Canada has not reintroduced any uptick rule. Views on the efficacy of the uptick rule are mixed. Following the market crash in 2008, critics attributed increased market volatility to the repeal of the uptick rule. On the other hand, some empirical studies have indicated that "the rule hindered short selling's efficiency aspect, did not halt price declines, and could have an adverse effect on the execution quality of short sale orders." [89]

TABLE 4-1:
Short-Selling Regulation Across Select Jurisdictions

Country/ Supranational Organization	Federally Mandated Disclosure Requirement?	Are Covered Short Sales Permitted?	Are Naked Short Sales Permitted?	Is There an Uptick Rule (or Equivalent)?
Canada	No	Yes	Yes	No
European Union	Yes	Yes	No	No
United States	No	Yes	No	Yes
Australia	Yes	Yes	No	No
Singapore	Yes	Yes	Yes (if closed within 1 day)	No

Much like the EU, Singapore and Australia have short-selling disclosure requirements mandated by federal legislation.[90] Unlike the EU, however, both countries require that reports only provide the total short position in a security, not the identities of the individual short sellers. On the other hand, the United States does not have a centralized disclosure obligation with respect to short sales. However, self-regulating organizations, including stock exchanges, have begun collecting and publishing information on the volume of short sales relative to total trades.[91] Regardless of any formal disclosure obligations, short sellers may nonetheless voluntarily publicize their short positions in order to lend credibility to their thesis by showing they have "skin in the game."

In addition to the absence of federally mandated short-sale disclosure requirements, Canada is distinguishable for permitting naked short sales, which have been banned in the EU, the United States and Australia, and limited in Singapore. As noted above, naked short selling increases the risk that the trader will fail to deliver on the initial sales contract, potentially increasing market uncertainty.

Based on the comparative policies elsewhere, both disclosure requirements and the legality of naked short selling could be the subject of review and commentary by the CSA. In our view, however, any regulatory reform should be based on a quantitative analysis of the relative benefits and risks associated with short selling. Until a new regulatory framework is introduced, companies and their governing boards should tailor their responses to short-selling campaigns to the current regulatory framework.

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Spotlight: The Spruce Point Campaign Against Dollarama

At the Robin Hood Investors Conference in October 2018, Ben Axler, founder and chief investment officer of the activist investment firm Spruce Point Capital Management, described Dollarama as a "strong sell" based on the company's products and "troublesome management and governance red flags."[92] The following day, Spruce Point published a report outlining concerns with the company's shift to higher priced items, the saturation of the market and the "inexplicably high and likely unsustainable" margins. While the report contained a legal disclaimer that Spruce Point had taken a short position in Dollarama and "therefore [stood] to realize significant gains in the event that the price of its stock [declined]," Spruce Point did not publish the size of its short position nor the date when its short position ended. As a result, it is unclear whether Spruce Point realized a profit (and if so, to what extent) on the Dollarama campaign. Although Spruce Point's report predicted Dollarama's share price would fall as much as 40%,[93] the stock has been steadily increasing following an initial downturn in response to the report. Nonetheless, the fund is not finished with Canadian companies: Axler promised in March 2019 that "[Spruce Point is] going to do more Canadian activism, definitely.[94]

How Can Boards Respond?

Under the current Canadian regulatory regime, the board of a targeted issuer essentially has two avenues of response: (i) legal and (ii) commercial. Unfortunately, many barriers to an effective legal response exist, including difficulties in attributing sometimes anonymous reports to any source, the potential for formal investigations based on the allegations and responses, and the risk that prolonged and costly litigation may not address falling share prices in a sufficiently timely manner. Additionally, provisions restricting market manipulation in Canadian securities law do not provide a statutory civil remedy; a targeted issuer would typically need to rely on defamation laws or other common law torts to bring a claim directly against the short-seller activist, and such claims can be difficult to prove.

Strategic commercial responses may therefore be a preferable alternative, or useful companion, to a legal response. Where the issuer has maintained active shareholder engagement on, and transparency into, its business strategies and financial condition, the board will find itself better positioned to leverage its internal and external relationships, as compared with those who seek support for the first time in the face of activism of any sort. A board may turn to third parties for public support, including long-term investors willing to increase their stake or stock analysts offering an alternative to the short seller's assessment. While an immediate public statement without a full internal review could inadvertently worsen the situation by drawing greater attention to the short seller's campaign, reaching out to shareholders directly can allow a board to gauge the impact of the allegations. Additionally, as with responses to any form of activism (as discussed in Chapter 3, Shareholder Activism: 2019 Trends and Major Developments), a board should consider engaging a small internal response team to review the short seller's allegations and to develop a plan for the issuer's strategic response, pinpointing vulnerabilities in the issuer's conduct or the short seller's report. Finally, the board may take actions to demonstrate confidence in the company's future. For example, when faced with a short-selling campaign in 2015, TSX-listed Home Capital Group Inc. bought back shares and raised dividends, which not only demonstrated confidence in its business but also forced short sellers to pay additional fees to cover the dividend.[95]

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Our Take: Short Selling Will Remain a Legitimate Form of Activism

After several years of significant short-seller activism in Canada, governing boards should expect the practice to continue in the years to come. While new CSA regulations may emerge and alter the landscape of short selling and the avenues of effective response, they are unlikely to curb the practice entirely. As a result, boards should consider developing a framework to anticipate and respond to activist investors generally, and short-seller activism in particular, not dissimilar from our guidance offered in Chapter 3, Shareholder Activism: 2019 Trends and Major Developments.

One of the greatest challenges many companies face in responding to short-seller activism is the lack of advance warning. Building and maintaining a high-performing board – with a robust oversight function and effective processes – can be an effective tool to guard against short-selling threats. A board that is committed to ongoing, meaningful shareholder engagement and debate over the strategy and performance of the company may be more likely to identify and address in advance any potential weaknesses that may be raised by activists (through a "vulnerability analysis"). Strong shareholder engagement, coupled with ongoing monitoring of IIROC short-sale reports for unusual trading activity, can also allow a board to identify perceived weaknesses before the company is subject to a short-selling campaign, thereby minimizing the risk of sudden drops in share price and allowing the board to develop effective strategies for the company as a whole.

Notes

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80 Barbara Shecter, "Activist Short-Sellers Are Increasingly Targeting Canadian Companies – Is Canada Ready?" *Financial Post* (October 6, 2017), online: https://business.financialpost.com/news/fp-street/rise-of-the-shorts-activist-short-sellers-are-increasingly-targeting-canadian-companies.

81 In a 2017 interview, Maureen Jensen, Chair of the Ontario Securities Commission, confirmed that all regulators were monitoring short campaigns for fraudulent statements. She stated, "If people are acting in concert to spread lies, that's really market manipulation, but you have to be able to prove that, and that's very difficult to prove." Barbara Shecter, "Ontario Regulator on the Lookout for 'Short and Distort' Campaigns That Aim to Drive Down Stock Prices," *Financial Post* (December 20, 2017), online: https://business.financialpost.com/news/fp-street/we-have-to-find-the-right-case-osc-committed-to-scrutinizing-short-selling-but-warns-bar-is-high-for-enforcement-action.

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83 Ian Appel, Jordan Bulka and Vyacheslav Fos, "Public Short Selling by Activist Hedge Funds" (October 1, 2018), online: https://corpgov.law.harvard.edu/2018/10/01/public-short-selling-by-activist-hedge-funds/.

84 In Canada, securities legislation is a provincial and territorial matter. With respect to short selling, IIROC's Universal Market Integrity Rules (UMIR) apply to any trades made on Canadian exchanges (with limited exceptions). IIROC, "About IIROC" (Accessed June 19, 2019), online: https://www.iiroc.ca/about/Pages/default.aspx; and IIROC, "Annotated Universal Market Integrity Rules" (November 7, 2018), online: https://www.iiroc.ca/industry/rulebook/Pages/UMIR-Marketplace-Rules.aspx, at Part 11.9.

85 Rule 2.2 of IIROC's UMIR deals with activities that are considered to be "manipulative and deceptive" and, as such, prohibited. Entering an order for the sale of a security without, at that time, having a reasonable expectation of settling any trade that would result from the execution of the order constitutes a violation of the rule. The provisions of Rule 2.2 of UMIR do not require the Participant or Access Person that is entering a short sale to have made a "positive affirmation" prior to entering the order that it can borrow or otherwise obtain the securities that would be required to settle a short sale. However, even when the person entering an order has "reasonable expectations" of being able to settle any resulting trade, there may be circumstances in which the person should be required to have made arrangements to "pre-borrow" the securities that are the subject of a short sale. IIROC, "Annotated Universal Market Integrity Rules" (November 7, 2018), online: https://www.iiroc.ca/industry/rulebook/Pages/UMIR-Marketplace-Rules.aspx, at Part 3.2 and Policy 2.2 Part 2(h).

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92 Svea Herbst-Bayliss, "Spruce Point Sees Dim Future for Dollarama, Share Price Drop" (October 31, 2018), online: https://ca.reuters.com/article/businessNews/idCAKCN1N51H3-OCABS.

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