SHORT SELLING IN CANADA: REGULATIONS ARE WEAK AND A NEW PATH FORWARD IS NEEDED TO REDUCE SYSTEMIC RISK

Posted on November 11, 2019

Categories: Insights, Publications

Short selling is a rather narrow topic, but one that creates strong and often diametrically opposed opinions. We undertook a lengthy study of the regulation of short selling in Canada (the "**Short Sale Analysis**"), including the regulations governing short sales in the Universal Market Integrity Rules ("**UMIR**") of the Investment Industry Regulatory Organization of Canada ("**IIROC").** This bulletin summarizes our concerns and conclusions with respect to the Canadian short selling regulatory regime.[1]

McMillan will hold a conference on the Canadian short selling landscape on November 19, 2019. More information and registration for CPD and CLE credit eligibility can be found here.

The benefits and importance of short selling in providing liquidity and facilitating price discovery are undeniable. Short selling is critical to the vibrancy and efficiency of Canada's relatively small capital markets. As a result, Canadian securities regulators and IIROC have historically taken a hands-off approach to short sales, ostensibly to preserve these benefits. This has happened even as securities regulators in other jurisdictions (such as in the United States under Regulation SHO) have enhanced their regulation of short sales, particularly following the financial crisis in 2008.

Based on our research, it is clear that IIROC's largely non-interventionist approach and its focus on maintaining liquidity have made Canadian companies attractive targets for short campaigns. From 2015 to 2018 there was an increase in the number of short campaigns in Canada, while generally in other jurisdictions there was a decrease. Additionally, the number of short campaigns in Canada is utterly disproportionate to the size of our capital markets when compared to the United States, the European Union and Australia (as examples). The reason for this seems clear: short selling regulations in Canada are out of step with regulations in those other jurisdictions - see Schedule A attached hereto. As a result of inherent weaknesses in the Canadian short sale regulatory regime, short sellers may well be attracted to the Canadian capital markets.

Background

The concept of a short sale is relatively straightforward: a short seller is a person who sells shares it does not own at the time of the trade. The trade is usually, but not always, accomplished by borrowing the securities

that are sold short so that the seller can make delivery to the purchaser on the settlement date (which is usually two trading days after the trade date for exchange-traded securities in Canada). The short seller hopes to take advantage of a decline in share price and acquire shares to return to the lender at a cost lower than the price at which it sold the shares. A short campaign is an investment strategy where an investor or group of investors (a "**short campaigner**") takes a short position in a target company and releases negative information to the market in respect of the company or its management to justify the short campaigner's short position. If the market finds this information credible, the target company's share price will go down, increasing the returns made by the short campaigner. A short campaign can be undertaken legally or illegally, depending on whether the negative information released by the short campaigner is true, or is information that the short campaigner knows to be misleading or false. While a short campaign can be a beneficial exercise in price discovery, it can also decimate the target company's market capitalization and long-term investor value.

Short sales can be described as "covered" or "naked". A short seller may already have located or arranged to borrow or acquire the shares when the short sale is made. This is a covered short. On the other hand, the short seller may have sold shares it does not own, and which it has made no prior arrangements to borrow or acquire, but hopes to obtain before it must settle the trade. This practice is frequently called naked shorting. While short selling serves a vital function in the efficient operation of capital markets, naked shorting carries with it particular risks – including an increase in failed trades, the distortion of share prices and the creation of phantom shares. At its worst, naked shorting can be a tool for unscrupulous short campaigners deliberately spreading misinformation to drive down the target's share price ("**short and distort**" campaigns). A short and distort campaign involving naked shorting requires less capital investment, as the short campaigner avoids paying the borrowing fees typically required in covered short sales, and is not constrained by the existence of shares available to be borrowed. In 2009, a technical committee of the International Organization of Securities Commissions ("**IOSCO**") made specific recommendations for the regulation of short sales and naked short selling.[2] While the Ontario Securities Commission (the "**OSC**") and the Québec authorité des marches financiers (the "**AMF**") were both members of such committee, IIROC (with the apparent support of the Canadian Securities Administrators (the "**CSA**") (including the OSC and AMF)) has steadfastly refused to adopt key recommendations of IOSCO for the regulation of short sales.

As we explain in our Short Sale Analysis, despite IIROC's insistence to the contrary, naked short selling is legal in Canada. UMIR allows naked short selling without any specific safeguards or requirements, so long as the short sale order is appropriately marked and the short seller can say that it had a reasonable expectation of acquiring the shares needed to settle the short sale order. Naked shorting flies entirely under the regulatory radar unless the short fails to settle for a period of 10 trading days after the expected settlement date.[3]

The Basic Rules and Mechanics of Short Sales in Canada

Every short sale on a Canadian marketplace must be marked "short" unless the sale is from a certain type of account (generally described as directionally neutral accounts), in which case it must be marked "SME" (short-marking exempt).[4] An order marked with the SME designation can be a short or a long sale. Beyond these requirements, a short seller is generally not restricted from selling shares it does not own.[5] UMIR does not impose general pre-borrow or locate requirements (although IIROC can impose specific pre-borrow requirements for specific securities).[6] A short sale can be made by a seller who does not have an existing ability to settle the trade, so long as the seller has a "reasonable expectation" that it will be able to settle the trade.[7] The "reasonable expectation" requirement in the policies accompanying UMIR 2.2, however, does not require that prior to making the sale the short seller actually locate and arrange to have the shares available for delivery on settlement. Rather, a "reasonable expectation" exists so long as the short seller does not know that it cannot borrow the shares and takes reasonable steps to locate them.

If the short sale cannot be settled within two trading days of the order (T+2), it is a failed trade.[8] However, the short seller has 10 trading days (T+12) to locate and deliver the shares before the failed trade must be reported to IIROC as an extended failed trade.[9] There are no regulatory consequences for an extended failed trade, although an extended failed trade may prevent further short sales (either by the client or non-client with any ongoing extended failed trade in any security, or by the broker on its own account in the same security).[10] Trades settled through CDS Clearing and Depository Services Inc. ("**CDS**") are subject to CDS' own settlement rules for failed trades. CDS imposes a daily fee for a failure to deliver shares to settle an outstanding settlement position in its continuous net settlement system and provides a buy-in process which allows a buyer who has not received the purchased shares to force settlement. However, these fees and buy-in requirements carry no regulatory sanction.

In contrast, as outlined in Schedule A hereto, both the United States and European Union have pre-borrow or locate requirements for short sales as well as mandatory close-out or buy-in provisions. In Australia, short sellers must have an exercisable and unconditional right to acquire the shares and deliver title prior to conducting a short sale.

Canadian Regime is Based on Flawed (or Questionable) Assumptions

IIROC believes that the unique attributes of the Canadian market justifies a different, more lenient, regulatory regime for short selling as compared with other jurisdictions. IIROC's assessment is based on several studies which purportedly show that most failed trades result from administrative errors. Additionally, in IIROC's view, the historic low failed trade rates reflected in these studies make it unnecessary to impose general locate or pre-borrow requirements. Interestingly, IIROC does not expressly extrapolate from these studies to conclude that failed trade rates will remain low in the future, and in fact gives no substantive reason for the historic low rates. Instead, IIROC appears content to rely on existing methods from its regulatory toolbox to address specific

problems in the future on an *ad hoc* basis. The studies, which IIROC uses to support the factual assumptions underlying UMIR, are reviewed in great detail in the Short Sale Analysis. Upon review, we conclude that the IIROC studies are either flawed or do not support certain conclusions reached by IIROC.

Regardless of the conclusions reached by the IIROC studies, it is simply not enough for IIROC to say that its studies show no relationship between failed trades and short sales. Historic low failed trade rates do not indicate an absence of, let alone provide a defence to, systemic risk. Systemic risk usually starts with a particular sector or a large financial institution, and then spreads. While IIROC has regulatory tools to respond to unusual trading activity, there remains a risk in any short campaign of "overshooting" on the downside, taking down the target company. This could not only lead to the risk of insolvency for the target company, but also to systemic risk with serious and long-lasting consequences to the Canadian economy if it happens to a sufficiently large company or financial institution.

Further, when compared to other regulatory regimes, the lack of transparency and the limited enforcement activity by IIROC raise significant issues related to investor confidence and market integrity, with IIROC once again deviating from key aspects of the IOSCO principles.

The onus should be on IIROC and the CSA to justify why the deviations from the regulatory standards recommended by IOSCO (including the OSC and the AMF) and adopted by other regulatory authorities in similar capital markets do not increase systemic risk in the Canadian market. So far, they have not met this onus.

Canada is a Haven for Short Campaigners

Independent analysis has shown that there has been an increase in the number of short campaigns in Canada since 2015. Notably, the number of short campaigns in Canada generally increased from 2015 to 2018, whereas the numbers in other jurisdictions generally decreased. The number of short campaigns in Canada is disproportionate to the number occurring in the United States, given the relative sizes of their respective markets. Additionally, there were more short campaigns in Canada from 2015 through 2019 than in the European Union, and far more than in Australia, which has capital markets of comparable size and value.[11] The most obvious explanation is the lax regulation of short sales in Canada. In addition, the lack of any meaningful penalties for abusive short selling is likely a draw for short campaigners engaging in illegal short selling. There have been no significant regulatory prosecutions of short sellers conducting short and distort campaigns[12] and few enforcement proceedings where short sellers were penalized for naked short selling.[13] Similarly, target corporations and shareholders have virtually no meaningful way to recover their losses, through civil actions (such as claims for defamation or conspiracy), from short campaigners who engage in bad acts. The combination of lax regulation, low capital costs and few consequences provides virtually no

disincentive for short campaigners to focus on targets in Canada.

Regulatory Changes are Needed

While we see a need for regulators to better address systemic risk in relation to the current short selling regime, there is no doubt that additional restrictions on short selling, even for the purpose of reducing systemic risk, must be carefully thought through and drafted so as not to curtail liquidity, which is a critical issue in the relatively small Canadian capital markets. Keeping these factors in mind, we conclude the Short Sale Analysis by outlining recommendations for change that we believe are necessary to improve investor confidence and market efficiency while appropriately reducing systemic risk. Our hope is that, at the very least, the following recommendations will ignite a healthy debate on the regulatory regime governing short selling in Canada and will eventually lead to modifications to the current regime:

- First, we would recommend that the following revisions be made to UMIR:
  - impose locate or pre-borrow requirements with respect to short sales, subject to limited exceptions;
  - require daily publication of aggregate short sale volume and position and trade data per issuer;
  - require daily publication of failed trade data;
  - to the extent extended failed trades (and corresponding reports) remain part of UMIR, lower the window for reporting extended failed trades from 10 trading days; and
  - impose monetary penalties in connection with failed trades.
- In addition, we would recommend that the CSA institute regulations requiring:
  - Canadian market participants currently exempt from short sale reporting regulations (such as custodians or other institutions that are members of CDS) to disclose daily short trading data; and
  - all Canadian trading venues to disclose short volume data per issuer daily.

Strategies to Address Short Campaigns and Evaluating Meaningful Recourse for Target Companies and Shareholders

We set out a number of strategies companies can take, both proactive in order to decrease the likelihood that they will become targets of short and distort campaigns, and in response to a short campaign. Ongoing shareholder engagement, combined with monitoring, good governance and transparency, are important pre-emptive or preventative measures against short campaigns. It is also critically important to have in place a response team that at the very least includes external counsel, a key group of independent directors, key management personnel that should include a spokesperson, communications advisors and an investigation firm with relevant experience. In responding to a short campaign, a target company will have to first identify who is behind the short campaign in order to decide whether and how to engage and respond to the

information distributed by the short campaigner. Once a short campaign begins, other strategies, such as share buy-backs, increasing dividend payments, value-maximizing transactions or even asking shareholders to take their securities in certificate form, may encourage or allow existing shareholders to weather the storm. Faced with a clear short and distort campaign, the target company may even go so far as to seek regulatory intervention or try to successfully prosecute civil claims against the short campaigners.

Finally, beyond addressing systemic risk, we conclude in the Short Sale Analysis that it is time for the CSA to begin discussions about how to compensate those who are harmed by short and distort campaigns. Regulatory enforcement and civil remedies can combine to provide effective deterrents to abusive market activity. Well over 20 years ago, the Allen Committee[14] identified the need to improve continuous disclosure and recommended a statutory remedy for purchasers of shares on the secondary market. This led to the CSA proposal for a civil remedy for misleading secondary market disclosure, and resulted in the eventual introduction of Part XXIII.1 of the Ontario *Securities Act*. It is time to consider the wisdom of a similar statutory remedy in order to deter abusive short selling. In the Short Sale Analysis, we set out what we believe to be some of the key considerations in establishing such a statutory regime.

Schedule A

The following chart provides a comparative overview of the relevant regulations in Canada, the United States, the European Union and Australia regarding short selling:

Rule/ Requirement	Canada	US	EU	Australia
Requirements to Conduct Short Sale (Prior to Effecting Sale)	• Reasonable expectation to settle (no knowledge of an inability to settle)	• Locate requirement	• Reasonable expectation of settlement • Must be covered by: - actual borrowing; - having agreements to borrow; or - arrangements with a third party confirming the location of borrowed shares and the short seller having taken measures via a third party such that there is a reasonable expectation that the settlement can be effected when due	• The seller must always have a presently exercisable and unconditional right to vest the products in the buyer, specifically the power to have the absolute ability to give the buyer title to the product

Initial Margin Requirement	• Yes	• Yes	• Yes	• No
Exemptions from Short Sale Requirement	• SME order designation accounts (certain types of accounts with non-directional trading activity)	• *Bona fide* market-making	• Market-making activities	• Exemptions may include: - prior purchase agreement; - trades by market makers; - exercise of exchange-traded options; - deferred purchase agreements; - deferred settlement trading in specific circumstances (e.g., public offers); - client facilitation services (i.e., a broker may make a short sale in response to a client's buy order); - government bonds; - corporate bonds if the value on issue is over AU$100 million; and - selling CDIs[15] before conversion
Designating Trades (at the Time the Order is Placed)	• Short or SME order	• Long, short or short exempt • Short exempt acts only as an exception to the price restriction test	• None	• None, but see below for reporting requirements when a short sale is being made

Close-out/Buy-in Procedures	• None under UMIR • CDS participants can force settlement through CDS buy-in provisions • Exchanges may also have optional buy-in requirements	• Mandatory close-out at T+3, or T+5 for bona fide market-making activities • When a position is not closed out, the broker or dealer may not effect further short sales in a security without borrowing or entering into a bona fide agreement to borrow the security • If the failed trade remains for 13 consecutive days, participants of registered clearing agencies must immediately purchase securities to close out failed trades in securities with large and persistent failures to deliver (referred to as "threshold securities"') • The purchaser that failed to receive stocks can force a buy-in	• Mandatory buy-in procedures are automatically triggered if the seller is not able to deliver shares for settlement on T+6 • The rules are changing in September 2020; the timing will remain the same for buy-ins and a maximum of seven business days will be permitted for illiquid financial instruments	• None
Price Restriction Test	• None	• Yes, a price decrease of 10% of more triggers a price restriction to short sale orders for the remainder of day and the following day, unless exceptions apply	• None	• None

Consequences for Failed Trades or Extended Failed Trades	• Pre-borrow requirements are automatically imposed on: - a client or non-client making a short sale if that person has previously filed an EFTR[16] for any security, unless the Participant[17] or Access Person,[18] acting as agent is satisfied after reasonable inquiry that the reason for any prior failed trade was not the result of an intentional or negligent act of the person; and - a Participant or Access Person acting as principal for a particular security if that security is one for which there is a prior EFTR (absent an IIROC exemption). • IIROC may designate a security as a "Pre-Borrow Security" • IIROC may designate a security as being a "Short Sale Ineligible Security" • CDS charges a fee of $1,000 per day per settlement position	• Prohibited from further short sales without pre-borrowing • DTC[19] has failure-to-settle charges for participants effective January 1, 2019, which consist of fee interest and a flat fee	• If a buy-in is not possible, the seller is required to pay the buyer an amount based on the value of the shares to be delivered, plus the amount for losses incurred by the buyer as a result of failure • Daily cash penalties until the end of a buy-in procedure will apply to participants by central securities depositories and participants may be suspended for failing to consistently and systemically deliver securities commencing in September 2020	• The CHESS,[20] pursuant to guidelines of the ASX,[21] levies a fail fee on participants who enter a settlement with a shortfall of any financial product they have an obligation to settle. The fee penalty is calculated on the shortfall outstanding on each settlement day, accumulated daily and charged monthly. The fee is calculated on an *ad valorem* basis (at 0.10% of the value of the shortfall), subject to a minimum (AU$100.00) and maximum (AU$5,000) per settlement holding

Reporting & Publishing Regime for Short Volume	• IIROC publishes the Consolidated Short Position Report twice monthly with aggregate data on the gross short position reporting on a per-security basis and provides a change in position from the reporting date	• Brokers must report gross short positions twice a month to FINRA[22] (once collected, FINRA publishes the statistics twice a month) • Exchanges provide gross short position reporting twice monthly (a user fee is sometimes applicable)	• Short sellers must notify the relevant competent authority for significant net short positions that are at least equal to 0.2% of a company's issued share capital and every 0.1% over that • Short sellers must make public disclosure of net short positions above 0.5% of the company's issued share capital and every 0.1% above that	• The short seller is required to report net short positions greater than (a) AU$100,000 or (b) 0.01% of the total quantity of securities or products in the relevant class of securities or products • ASIC[23] publishes the total of short positions in a security issued by a listed entity that were disclosed to it on the previous trading day • If a person has created a short position in a security as at 7:00 p.m. (Sydney time) (or alternatively at the global end calendar time) on a reporting day, the position must be reported to ASIC no later than 9:00 a.m. (Sydney time) on T+3
Reporting and Publishing of failed traded and EFT Data	• Participants and Access Persons must report extended failed trades after T+12 if securities are not available or if arrangements to borrow securities to settle the trade have not been made • No public disclosure	• The SEC[24] publishes fail-to-deliver information for each trading day twice monthly	• Failed trades will be reported publicly by central securities depositories commencing in September 2020 on an annual basis	• The ASX website publishes the number of settlements scheduled, the percentage that have initially failed to settle and the percentage of settlements rescheduled to the next settlement day for each trading day in a month. The report also contains the average fail percentage rate of initial fails for the completed previous month(s) (without a breakdown per trading day) and the average of the current month to date

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[1] The views expressed in this bulletin are those of the authors and under no circumstances should they be considered to be the views of McMillan LLP or that of McMillan's clients.

[2] IOSCO, *Regulation of Short Selling Final Report*. In this report, IOSCO identifies four principles for the

effective regulation of short selling. The first recommendation is directly relevant to naked shorting; IOSCO recommends that market regulators impose, at a minimum, a strict settlement requirement for failed trades. These could be supported at the "front" end through pre-borrow or locate requirements, or made at the "back" end through mandatory buy-in or close-out provisions. IIROC did not adopt this recommendation for a number of reasons, including based on its view that there is no correlation in Canada between failed trades and short sales. The second recommendation is that short selling should be subject to timely reporting requirements to the market or market regulator, bringing more transparency. IIROC and the CSA concluded in 2012 (following a joint CSA/IIROC notice requesting comments on disclosure and transparency on Canadian reporting of short sales and failed trades) that there was no consensus in Canada that any improvements were needed to increase transparency. The third recommendation is that short selling be subject to an effective compliance and enforcement regime that includes monitoring and inspection of settlement failure and a flagging regime to identify potential market abuses and systemic risk. The fourth recommendation is that short selling regulation should provide for appropriate and clearly defined exemptions to allow for desirable market transactions.

[3] See *Definitions*, Universal Market Integrity Rule 1.1, online: *Investment Industry Regulatory Organization of Canada* [*UMIR 1.1*], definition of "Extended Failed Trade".

[4] See *UMIR 1.1 supra* note 3, definitions of "short sale" and "short-marking exempt order". See also *Prohibition on the Entry of Orders,* Universal Market Integrity Rule 3.2, online: Investment Industry Regulatory Organization of Canada [*UMIR 3.2*].

[5] There are of course specific requirements under UMIR for certain circumstances. For example, see UMIR 6.1, which sets out when different pre-borrow requirements apply. Brokers also have reporting obligations in various circumstances, such as filing bi-monthly short position reports and extended failed trade reports. See *Entry of Orders to a Marketplace*, Universal Market Integrity Rule 6.1, online: Investment Industry Regulatory Organization of Canada [UMIR 6.1]; Report of Short Positions, Universal Market Integrity Rule 10.10 at 2, online: Investment Industry Regulatory Organization of Canada [UMIR 10.10]; Extended Failed Trades, Universal Market Integrity Rule 7.10 at (1), online: Investment Industry Regulatory Organization of Canada [UMIR 7.10].

[6] See *UMIR 1.1 supra* note 3, definitions for "Pre-Borrow Security" and "Short Sale Ineligible Security". IIROC has the power to intervene in short sales, although it rarely, if ever, has used such power. Securities can be put on a short sale ineligible list (which to our understanding has never been done) and IIROC can impose a regulatory halt on the sale of a particular stock if a short campaign leads to a dramatic drop in the price of a security.

[7] *Manipulative and Deceptive Activities,* Universal Market Integrity Rule 2.2 at 2, online: Investment Industry Regulatory Organization of Canada [*UMIR 2.2*]. Under subsection (h) of Part 2 of UMIR Policy 2.2, it is a false or

misleading practice to enter into "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".

[8] See *UMIR 1.1 supra* note 3, definition of "failed trade".

[9] See *UMIR 7.10 supra* note 5.

[10] See *UMIR 6.1 supra* note 5.

[11] Based on data provided by Activist Insight on short campaigns from January 1, 2015 to October 31, 2019, in 2015 there were 19 short campaigns in Canada, compared with 3 in Australia, 189 in the United States and 17 in the European Union. In 2016, there were 21 short campaigns in Canada, compared with 3 in Australia, 187 in the United States, and 13 in the European Union. In 2017, there were 9 short campaigns in Canada, compared with 2 in Australia, 141 in the United States, and 11 in the European Union. In 2018, there were 22 in Canada, compared with 5 in Australia, 99 in the United States and 12 in the European Union. As of October 31, 2019, in 2019 there were 5 short campaigns in Canada, compared with 4 in Australia, 102 in the United States and 4 in the European Union.

[12] *Re Carnes*, 2015 BCSECCOM 187 found that the short campaign conducted in respect of Silvercorp Metals Inc. involved unsavoury conduct and that the reports published by the short seller did not provide a full and fair picture of a consultant's report, but his conduct fell short of deceit or falsehood, or even being clearly abusive to capital markets. Similarly, in *Re Cohodes,* 2018 ABSAC 161, a short seller orchestrated a short campaign against Badger Daylighting Ltd. which included releasing misleading tweets and postings on a website that was critical of the company. While certain of these statements were untrue, the Alberta Securities Commission concluded that the short seller did not have sufficient credibility or respect among market participants to find that he affected the company's share price, and as such did not commit actionable misrepresentation.

[13] See for example, *Re W Scott Leckie*, (2005), 28 OSCB 6364.

[14] The Allen Committee is the Toronto Stock Exchange Committee on Corporate Disclosure, which was established to review and assess the adequacy of continuous disclosure by public companies in Canada. The Final Report of the Allen Committee was issued in March 1997.

[15] Australian Clearing House Electronic Subregister System Depository Interests.

[16] Extended failed trade report.

[17] Registered investment dealers that are members of IIROC.

[18] A person other than Participant who is: (a) a subscriber; or (b) a user.

[19] The Depository Trust Company.

[20] Australian Clearing House Electronic Subregister System.

[21] Australian Securities Exchange.

[22] United States Financial Industry Regulatory Authority.

[23] Australian Securities and Investments Commission.

[24] United States Securities and Exchange Commission.

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.