

RESPONSE TO THE CANADIAN SECURITIES ADMINISTRATORS CONSULTATION PAPER 25-403

To: British Columbia Securities Commission

Alberta Securities Commission

Financial and Consumer Affairs Authority of Saskatchewan

The Manitoba Securities Commission

Ontario Securities Commission

Autorite des marches financiers

Financial and Consumer Services Commission (New Brunswick)

Superintendent of Securities, Prince Edward Island

Nova Scotia Securities Commission

Superintendent of Securities, Newfoundland and Labrador

Superintendent of Securities, Yukon Territory

Superintendent of Securities, Northwest Territories

Superintendent of Securities, Nunavut

I commend the CSA for addressing the issue of activist short selling. Activist short sellers can destroy the integrity of the Canadian stock market with their aggressive and manipulative short and distort campaigns.

It is not the number of campaigns brought against the companies listed on the Canadian exchanges that matters. It's the depth of the damage done to the companies that are targeted that creates the damage to the overall market.

One brutal short selling campaign can cause a tremendous loss of confidence in the market by potential new issuers and potential and current investors.

I believe that it is important for the CSA to distinguish between short selling and activist short selling, which they have done in the consultation paper.

When the American activist short sellers started their campaigns of destruction in Canada the regulators seemed to defend their behaviour behind the proposition that short selling is a necessary part of any financial market and that short selling often provides liquidity that bolsters the market. This may be true about short selling. This is definitely not true about short

and distort campaigns. Regular short sellers do not carry out “public campaigns”. While activist short selling is all about carrying out public campaigns that are ugly and destructive and that destroy share values which ultimately destroy investor confidence.

CSA Consultation Paper 25-403 addresses almost all the issues involving short and distort campaigns. The paper addresses both street level practical issues and corporate board room issues. But I believe some of the issues discussed require further clarification or further amendments.

An overriding issue that should be addressed and that is always ignored is the role Accounting Rules and Regulations play in all short and distort campaigns. The general public, and most investors, perceive that accounting is an exact science. That accounting is either right or wrong. Of course, nothing could be further from the truth. But activist short sellers use this perception as one of their major weapons in their campaign. The activist short sellers’ campaign gains credibility when they attack accounting policies. It looks like they are pointing out a major flaw in the company’s financial statements when in fact they are simply making a judgement on a policy that may be very subjective, and more importantly, that may **be immaterial.**

Financial statements are prepared based on accounting rules that are based on estimates and assumptions and rules and guidelines that are subjective and that are dramatically different in different industries. Other than a few basic items reported on a financial statement, it is a rare situation where the reported accounting item is absolute fact.

A financial statement may reflect a building that is recorded at a cost. Or, it may reflect a building that is recorded at fair market value based on an appraisal that is based on numerous assumptions, some of which may not be accurate or may only be accurate for a limited time.

Lease accounting is a very complicated subject that most investors wouldn’t understand. Lease accounting requires numerous assumptions and guidelines to be applied to the recording of lease payments. For example, some lease payments are written off as expenses while other lease payments are recorded as capital, depending upon how the lease agreement is written up. There are very specific accounting rules that distinguish between operating leases and capital leases, but these rules require subjective assumptions about the life of the leased asset and the terms included in the lease agreement.

Revenue recognition seems like a very simple concept. Very few investors would think of the incredible complexity and subjectivity of accounting rules when it comes to the timing and the quantum of recording revenue. How does Canadian Tire record revenue from Canadian Tire money? How does Air Canada record revenue from Air Miles? How do companies that earn revenue under long term contracts record the revenue from those contracts? When does the company record reserves for revenue that looks like it will not be collected?

These are just a few simple examples of how accounting can be subjective and complicated. Activist short sellers use the subjective nature of accounting rules to attack public companies.

They use the media to highlight what they believe to be huge mistakes on financial statements when in fact the mistakes are simply the subjective application of generally accepted accounting rules.

The most violent and damaging short and distort campaigns in Canada have been brought on by American short sellers. They find Canada fertile grounds for their campaigns of hate and distortion. They can easily manipulate the media in Canada and, in most situations, they find the media as an asset to their campaign. And while activist short sellers always say that they are doing the markets a favor by disclosing the maleficence they uncover; I find it incredibly insincere and arrogant for American activist short sellers to feel that they are helping Canadians with their short and distort campaigns. I think Canadian short sellers can protect Canadian investors, without the Americans help. And without all the damage the Americans impose on our companies and our investors. The American short sellers know how thinly traded Canadian stocks are compared to the US stocks. They know how shallow the Canadian market is. And they know how easy it is to manipulate Canadian media as opposed to the US media. They also know how the regulatory bodies in Canada are limited in their depth of management.

While the public companies' the short sellers attack (including Canadian Banks in 2019) have to adhere to strict regulatory bodies and are subject to legal exposure for any public statements they release, the activist short sellers operate in an open environment where they are not accountable to anyone except their investors. Everything is weighted in their favor.

Consultation Questions

1. What is your perception about activist short sellers? Please describe the basis of that perception.

My perception of activist short sellers is that they are destructive to the Canadian stock market and that they are destroyers of shareholder value for the sole purpose of the activist short sellers' bottom line. Furthermore, in Canada the only real activist short sellers are American investors who find Canada an easy target.

The activist short sellers attacked Home Capital, Canadian Tire, Badger Daylight and a few other Canadian companies with such public aggression that the stocks, employees and investors were devastated. Once they achieved the level of destruction they were trying to achieve they left the market as quickly as they arrived.

The two most offensive aspects of the short and distort campaigns are:

- l) How the campaigns are almost identical using all the exact same tactics over and over. You can read—Selling America Short, written by Richard C. Sauer—which was written after the mortgage-backed security crisis in 2008 and note that the short and distort

campaigns detailed in the book are the exact same as the campaigns carried out in Canada by some of the same activist short sellers as noted in the book.

- II) How most, if not all, the claims made by the activist short sellers are materially false. The activist short sellers pile up numerous issues that usually deal with managements subjective decisions but that the activist short sellers say are all wrong. A good example of this is the activist short sellers attack on Canadian Tire. They thought: there were too many stores close to each other, and that the fact they didn't do home deliveries was a terrible policy, and that the inventory was old and they accused the management of financial manipulation because they changed their depreciation policy. These are just a few ridiculous items that they kept repeating to the press and the Canadian press kept providing them with a platform for repeating their claims.

2. Can you give examples of conduct activist short selling Campaigns that you view as problematic?

- I) Using and abusing the media, especially BNN. During the activist short seller's campaign against Home Capital the short seller was a regular ongoing guest on BNN. He was allowed to say anything and everything he wanted against the company. Meanwhile the company could not go on BNN, with any regularity, to defend themselves just in case they violated a disclosure regulation. The short seller described a portfolio of mortgages that were missing certain parts of information on the applications. They described the huge losses that would be incurred by the company. The stock plummeted and the confidence in the company was eroded. Fast forward about a year and the company did not incur any losses from that portfolio. But the damage caused to the company was devastating. The stock dropped from roughly \$35 to roughly \$10 at which point in time Warren Buffet stepped in to support the company and watch the stock rise to roughly \$18 before his departure. The stock currently trades at roughly \$30.
- II) Using previous and current disgruntled employees to access private corporate information that is typically not materially damaging information but that can be construed as material after the activist has blown it way out of proportion.
- III) Attacking senior executives while the executives are defenceless because they are governed by security regulations, while the activist is not accountable to any regulatory body. Often the executives, who have many years of experience at the company and who have devoted long-term working hours to improve the company's

performance are fired because of accusations by the activists. These are often great Canadian executives losing their jobs because of American activist short sellers' campaigns of destruction.

- IV) In 2018 an activist short seller attacked Badger Daylighting, a great Alberta company. He used his standard revolting tactics to bring down the shares of the company. As usual, he made tons of baseless accusations. Badger fought back. They brought in a third-party firm to audit the financial statements and prove that the short sellers' financial accusations were baseless. The stock got devastated and investors lost money and management got distracted by the attack. Management had to spend huge sums of money to defend themselves. While the short seller spent nothing (other than the cost of shorting the shares) and just used his aggressive tactics in the media to profit from his short selling. One encouraging aspect of the Badger situation is that the Alberta Stock Exchange stepped in and tried to protect the company and they tried to put a cease trade order on the short seller but with little success.

3. Given the focus of the available data 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 a short and distort Campaigns?

- I) Less prominent short sellers are just that—less prominent. They are not using the press and insiders and former employees to advance their cause. They are not using the lack of regulations placed upon them to advance their cause against people and companies that have their hands tied. They can be identified by the regulators who track the short positions in the Canadian market. If they are executing short and distort campaigns, the targeted company should have a group or a division at the security regulators office that they can report the shorts actions to and that has the authority to review the shorts actions and that can ban them from trading on the Canadian exchange, if appropriate.

One of the most offensive parts of the short and distort campaigns is that they are carried out by Americans against Canadians who are defenceless. And if they say they are doing it to protect investors, why in the world would Americans care about protecting Canadian investors. Why would they attack Canada when the US market is multiple times larger than the Canadian market?

4. What empirical data sources related to Campaigns should we consider?

- I) Hopefully the regulators can distinguish between Canadian buyers and US buyers. The moment a US buyer starts to short a Canadian stock there should be an alarm.
- II) Short sales are currently tracked by the regulators. When the short position increases by a certain percentage as compared to the average daily trades over the last 30 or 60 days an alarm should be sounded.
- III) Stock prices experiencing sudden drops without related press releases should be monitored.
- IV) Stock volumes should be monitored. I would suspect that sudden increases in volume combined with a sudden drop in a stock price could be a signal that the shorts have arrived.
- V) With the power of computers, the monitoring of trading activities to perform exception reporting should be easy.

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.

The activist short sellers are predominantly, if not always, from the US. In a year when the regulators in the US clamp down on activist short sellers you can imagine that the activist short sellers would take a look at the Canadian market.

In addition, in a year when the Canadian markets are frothy one would expect an increase in activist short selling. As markets skyrocket the potential for Canadian stocks to be overvalued increases and the ease with which activist short sellers can attack a company grows. The activist short seller shorts the “overpriced stock” and then starts their short and distort campaign finding any little items that seem to be unusual in a more conservative market. They can attack what they believe to be inflated projections and then attack CEO’s for their aggressive growth targets and various accounting policies that look to be too aggressive and that look like they are contributing to what they feel is an over inflated stock. They don’t need verifiable information; they just need a good story. And what better time to create a good negative story than when markets are taking off. When markets are dropping the activist short sellers are not good at creating their stories.

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 (i.e.: 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.

My knowledge would be limited to Canadian and American markets. I am not familiar with markets in other countries. The vulnerability of the Canadian markets is dramatically greater than the vulnerability of the US market.

- a) First of all, the small size of the Canadian market and the lack of liquidity in the Canadian market make Canadian stocks an easy target for activist short sellers. An example of this is on 2/2/21 Bank of America traded 47,381,162 shares compared to Royal Bank trading 5,220,526. It would be very difficult for a short seller to have an impact on Bank of America, but easy to impact Royal Bank. Also, on 2/2/21 Apple traded 81,834,000 shares while Blackberry traded 14,422,800 on what would be a very active day for Blackberry. Again, easy to have an impact on BlackBerry but very difficult to have an impact on Apple. And the huge difference in the market capitalizations of US companies compared to Canadian companies make the US companies much stronger on a number of fronts when it comes to fighting activist short sellers.
- b) The regulatory bodies in Canada are not close to as deep as the regulators in the US. The US regulators can have more depth because of the depth of their markets and their ability to charge fees to listed companies. In addition, the substantial fines paid by US companies can fill the coffers of the US regulators whereas the fines in Canada are minimal, relatively speaking.
- c) In the past the media in Canada (especially BNN) has been an arm of the activist short sellers and they provide tremendous access to investors. I am not sure if it is because the network has a shortage of news stories but the number of times BNN has provided a platform for activist short sellers is absolutely incredible. There are specific reporters who seem to favor bashing Canadian companies based on stories created by the activist short sellers. They would not be given such free reign and so many repeated visits on the US networks. And if they were, they would just blend into one of the hundreds of stories discussed each and everyday.
- d) Canada has an overweight of commodity related businesses. These types of businesses can be very volatile and can be subject to complicated accounting practices that can be very subjective. Valuing assets of these companies can be creative and open to either manipulation or such huge subjectivity that they invite activist short sellers to question the companies accounting. Something activist short sellers love to do and something the average investor has no idea about the intricacies of the accounting rules.

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?

Absolutely!!! The playing field is so tilted in the favor of the activist short sellers that even the best companies in Canada are exposed to activist short sellers. In 2019 and 2020 the activist short sellers took their campaigns to the Canadian media and attacked the Canadian banks, not recognizing the incredible regulatory bodies that monitor the Canadian banks and that make sure the banks are operated conservatively.

Canadian executives are so constrained by the disclosure rules imposed on them by the regulators that they cannot counter the activist short sellers' campaigns. The activist short sellers answer to nobody in Canada. Absolutely nobody. While the Canadian executives have to answer to--the regulators, the shareholders and the Board of Directors, just to name a few. Every word out of a public executive's mouth has to be vetted and monitored. And because they know insider information and they know about some of the details of the companies accounting that may not be standard they cannot say anything to defend themselves or the company. Their hands are tied.

I would recommend that activist short sellers be given strict restrictions with respect to their ability to promote their cause to the public. They should not be allowed to go on TV with their story and they should not be allowed to promote their thoughts to the newspaper. With respect to American activist short sellers there is absolutely no reason they should be attacking Canadian companies in the media. If they want to short our stocks, they should short our stocks. There is absolutely no reason to run a vicious public campaign that destroys jobs and share values and companies for their own personal gain. Canadians do not have to sit back and be victimized by American short sellers. It does not provide one benefit to Canadian investors.

The activist short seller has to play on a level playing field to the corporations they attack. They must be forced to have complete transparency, just the same way Canadian corporations must be transparent. In a recent short and distort campaign the activist short seller was asked on numerous times to disclose his short position and he refused. The rules must dictate that the activist short sellers disclose their position.

Obviously, the Canadian regulators cannot impose separate rules for Canadians and Americans. But the rules should be based on stopping the extreme activities carried about by American short sellers and of course the Canadian short sellers will be more than happy to abide by the same rules (I have never seen a Canadian short seller carry out a campaign like the American short sellers' campaigns)

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?

Badger Daylighting was attacked by an activist short seller and they approached the Alberta Securities Commission to prevent the activists from spreading their damaging words throughout the market. They tried to get a cease trading order against the short sellers but they were turned down.

It appears that other targets in Canada have approached the regulators about activist short sellers with absolutely no success. This is because the activist short seller has already alerted the regulator to the "companies' issues" well before they started their campaign. They have disclosed numerous false facts (accounting interpretations that they believe to be wrong among other issues they determine to be wrong) to the regulators and have immediately placed the regulator in the position to investigate the company in question. It doesn't matter that the facts are incorrect, they line up so many accusations, and the accusations may have a small bit truth attached to them that the regulatory commission still feels the responsibility to act. The issues are often immaterial but the regulatory bodies cannot determine that early on. By the time the company wants to reach out to the regulator they are in a defensive position and they are trying to defend themselves against the false accusations. In any large public corporation, there are always certain parts of the company that can be questioned and there are always employees that are not perfect. Its easy for the short sellers to uncover. Unfortunately, the regulators do not have the depth of management to investigate the activist short seller's accusations and to meet with the company and determine if there is a material issue that needs to be addressed. Materiality is one of the cornerstones of accounting. But materiality is never assessed by the authorities and is never considered by the activist short sellers.

Too many great Canadian companies and outstanding Canadian executives have been damaged by activist short sellers based on either immaterial issues or subjective issues. The regulators must impose changes to stop this from happening in the future.

CONCLUSION

Canadian regulators should define Activist Short Selling and once it has been defined the regulators should prohibit Activist Short Selling in Canada.

The novel, *Selling America Short*, written by Richard C Sauer*, should be must reading for every executive working at a Canadian Regulatory body. The latter part of the book outlines the activists short selling strategy. The methods and campaigns used ten plus years ago in the United States during the mortgage-backed security crisis are the exact same methods used by the same people in Canada. **Their playbook has not changed.** **They are not protecting investors.** They are just trying to profit off other people's vulnerabilities.

Richard Sauer has been, among other things, an Assistant Director with the U.S. Securities and Exchange Commission, a partner in an international law firm, and an analyst with a Northern California Hedge Fund. Sauer's articles on legal and financial topics have appeared in numerous publications including the New York Times, the Wall Street journal and Barron's. He holds a doctorate in law from Harvard Law School.

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