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BY EMAIL

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

c/o

Me Philippe Lebel
Corporate Secretary and Executive Director,
Legal Affairs
Autorité des marchés financiers
Email: consultation-en-cours@lautorite.qc.ca

The Secretary
Ontario Securities Commission
Email: comments@osc.gov.on.ca

Dear Sirs/Mesdames:

Re: CSA Consultation Paper 25-403 *Activist Short Selling*

We are writing in response to CSA Consultation Paper 25-403 *Activist Short Selling* (the "**Consultation Paper**"). We commend the Canadian Securities Administrators (the "**CSA**") for its thoughtful consideration of the complex and controversial issue of activist short selling. In particular, we recognize the extensive research that CSA Staff have conducted and appreciate the CSA's commitment to ensuring that any potential changes to Canadian securities laws are accompanied by a thorough analysis of available empirical data as opposed to conjecture and anecdotal evidence.

Short selling continues to be misunderstood by many market participants who view it as a nefarious investment strategy because a short seller only profits if the value of an issuer's securities declines. As the Consultation Paper explains, short selling is a legitimate investment strategy that provides many benefits to our capital markets. So-called "short and distort" campaigns in which short sellers deliberately disseminate false or misleading information in order to drive down the market price of an issuer's securities are unquestionably problematic. However, we are not aware of any empirical evidence to suggest that such abusive campaigns are prevalent in Canada or that the Canadian regulatory framework is more conducive to abusive campaigns than the regulatory frameworks in other jurisdictions. Although the Canadian regime can potentially be improved by certain tailored and incremental modifications, implementing significant changes to address the spectre of abusive behaviour that may not be occurring with any regularity would be an overreaction that could have a significant chilling effect on legitimate short selling activities to the detriment of the Canadian capital markets.

I. ***Short Selling is Vital to a Healthy Capital Market***

As the Consultation Paper notes, short selling is an important and legitimate investment strategy that improves price accuracy and increases liquidity; as such, any additional regulation must be carefully considered to avoid discouraging legitimate short selling campaigns. Short selling provides incentives for sophisticated investors to gather and analyze information that will help them to assess an issuer's prospects for success. Although anyone can buy an issuer's securities in the market, without short selling, one would already have to be an owner of an issuer's securities in order to sell the securities in the market. Generally, existing security holders are not incentivized to discover problems with, or significant undisclosed risks to, an issuer's prospects, corporate governance or accounting practices, as doing so would result in a net decrease in the value of their assets (i.e. the securities themselves). Short selling increases the overall expected return of gathering and analyzing information about an issuer. An increase in the expected return on this work increases the amount of work that an investor will do, driving more accurate predictions of how the issuer will fare, which in turn is likely to result in more accurate share prices. Short selling also provides liquidity to the market by increasing the number of potential sellers, increasing trading volumes and reducing bid-ask spreads.

Short selling has also helped to identify market bubbles, which typically involve overly-optimistic investors irrationally following trends rather than analyzing them critically. Once a bubble begins to form with respect to an issuer, rational traders often exit the market and will therefore no longer have an influence on the price of the issuer's securities. This leaves only the most bullish investors holding the issuer's securities, which causes a feedback loop that propels the price of the securities higher for no objective reason. Short selling helps to address this imbalance and moderate bubbles before they grow unduly large.

Finally, short selling can contribute to the discovery of outright fraud. The most famous Canadian example occurred in 2011, when Muddy Waters, LLC ("**Muddy Waters**") accused Toronto Stock Exchange-listed Sino-Forest Corporation ("**Sino-Forest**") of being a Ponzi scheme riddled with fraud,

theft and undisclosed related party transactions.[1] Following the publication of Muddy Waters' report, Sino-Forest shares fell 82%. Six years later, the Ontario Securities Commission (the "**OSC**") concluded that Sino-Forest engaged in deceitful or dishonest conduct related to its standing timber assets and revenue that it knew constituted fraud contrary to subsection 126.1(b) of the *Securities Act* (Ontario)[2] and contrary to the public interest.[3] Muddy Waters' work, rewarded only through short selling profits, was instrumental in shedding light on these deleterious business practices and sharing this vital information with the investing public.

II. The Overarching Regulatory Regime Appropriately Regulates Activist Short Selling

A. Abusive activist short selling is already prohibited in Canada.

Although short selling is not inherently problematic, a short seller that intentionally disseminates false or misleading information about an issuer can cause significant and lasting harm to the target issuer, the issuer's security holders and the capital markets generally. Issuers are prejudiced by this conduct since it unfairly tarnishes their reputation and can have a calamitous effect on their market capitalization. Security holders that are induced to sell on the basis of misinformation suffer a loss equal to the difference between the "true" value of the issuer's securities and the artificially low price at which they sell multiplied by the number of securities sold. Finally, "short and distort" campaigns have a negative impact on the capital markets as whole, as market participants lose confidence in their fairness and integrity if unscrupulous short sellers deliberately spread false and misleading information and realize a profit at the expense of an issuer and its security holders.

There is no question that the CSA has a responsibility to combat abusive short selling. However, we submit that CSA members already have the requisite tools at their disposal in order to do so. As noted in the Consultation Paper, securities laws in most Canadian jurisdictions prohibit a person or company from: (a) directly or indirectly engaging or participating in any act, practice or course of conduct relating to securities that the person knows or reasonably ought to know results in or contributes to a misleading appearance of trading activity in, or an artificial price for, a security; (b) perpetrating a fraud on any person or company; and (c) making a statement that the person or company knows or reasonably ought to know, in a material respect and at the time and in 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 would reasonably be expected to have a significant effect on the market price or value of a security.[4] In addition, securities regulators have

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1 Muddy Waters, "Muddy Waters Initiating Coverage on TRE.TO, OTC:SNOFF – Strong Sell" (June 2, 2011), online: <https://www.muddywatersresearch.com/research/tre/initiating-coverage-treto/>.

2 RSO 1990, c S.5 (the "**Ontario Act**").

3 *Re Sino-Forest Corporation*, 2017 ONSEC 27 at para 1493.

4 Ontario Act, *supra* note 2, ss 126.1 and 126.2; *Securities Act* (Québec), CQLR c V-1.1, ss 196, 197 and 199.1; *Securities Act* (Alberta), RSA 2000, c S-4, ss 93 and 221.1; *Securities Act* (British Columbia), RSBC 1996, c 418 (the

broad powers to sanction conduct that is prejudicial to the public interest even in circumstances in which there has been no breach of the applicable act, but where a party's conduct is abusive of investors or the capital markets or is inconsistent with the animating principles underlying a particular requirement.[5] Accordingly, an activist's attempt to depress an issuer's stock price by knowingly spreading material misinformation is already prohibited conduct capable of redress by the CSA.

We recognize that the relatively few cases in the short selling context have proven challenging for securities regulators to prosecute. However, this is not because of material deficiencies with the rules themselves, but rather because of the inherent difficulty in distinguishing benign conduct from deleterious conduct. One of the challenges that Staff must overcome is to prove that the statement is, in fact, untrue. We note that it took six years for the truth of Muddy Waters' assertions regarding Sino-Forest to be established. Another challenge is that, in most CSA jurisdictions, the untrue statement must be reasonably expected to have a significant effect on the market price of the issuer's securities. However, as discussed in Section II.C. below, we do not believe that the solution to this latter challenge is to eliminate the market impact component of the prohibition; doing so would have a variety of adverse consequences, not the least of which would be to hold market participants to a higher standard when making statements about a public company than the standards to which the company itself is held.

As the Consultation Paper notes, activist short sellers' conduct occurs on a spectrum. It is a rare circumstance in which a short selling campaign clearly does or does not contain misleading, market-moving information. Accordingly, the CSA is charged with the important task of carefully reviewing and assessing whether a short seller has crossed a line based on the unique facts and circumstances of each particular campaign. Although this is a difficult exercise, lowering the bar to make it easier to identify whether a line has been crossed is not, in our view, an appropriate regulatory approach. Rather, CSA Staff should continue to bring well-prepared cases in the appropriate circumstances in the right forum using the statutory tools that are currently available to them.

B. There is scant evidence to suggest that abusive activist short selling is prevalent in Canada.

The debate regarding activist short selling in Canada has too frequently been based upon anecdotal evidence and conjecture rather than an analysis of available empirical data. The methodical approach in the Consultation Paper supports the conclusion that activist short selling campaigns are not particularly prevalent in Canada.[6] As the Consultation Paper notes, there were more than a dozen

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"**BC Act**"), ss 57 and 168.1; *Securities Act* (Manitoba), CCSM, c S50, ss 112.3 and 136; *The Securities Act, 1988* (Saskatchewan), SS 1988-98, c S-42.2, ss 55.1 and 55.11.

5 *Re Canadian Tire Corp* (1987), 10 OSCB 857 at para 130; *Re Seto*, [2003] ASCD No 270 at paras 40 to 43; *Re Patheon Inc* (2009), 32 OSCB 6445 at para 114; *Re Donald*, 2012 ONSEC 26 at paras 304 to 308; *Re Catalyst Capital Group Inc*, 2016 ONSEC 14 at para 24.

6 We recognize that the CSA's research was limited to data gathered by Activist Insight, a third party data provider that only tracks campaigns by prominent activist short sellers. We believe that this is appropriate, as it will be rare for a less prominent activist short seller to materially affect the market price of an issuer's securities or impact the

activist campaigns in a single year just three times since 2010. Moreover, the data in the Consultation Paper states that the proportion of Canadian issuers targeted by activist campaigns is significantly lower than the proportion of U.S. issuers targeted by activist campaigns. To some extent, this is a reflection of the differences between the Canadian and U.S. markets generally; the average U.S. public company is larger and its securities are more liquid than the average Canadian public company, which would make the U.S. company more attractive to an activist short seller assuming that all else was equal. If the unique nature of the Canadian market serves as a natural deterrent against activist short selling campaigns, the importance of <u>not</u> over-regulating the practice becomes even more pronounced, as such over-regulation could reduce or eliminate the numerous benefits that short selling provides to our capital markets and the competitiveness of Canada's capital markets.

The fact that activist short selling is a relatively infrequent occurrence does not mean that it should be ignored or that abusive activist short selling campaigns should not be addressed. However, the frequency of abusive campaigns – or the ostensible lack thereof – ought to be relevant to an assessment of whether the Canadian regulatory landscape should be fundamentally altered in a manner that could have far-reaching, negative consequences.

C. Market impact assessments and materiality thresholds are necessary to prosecute misleading or untrue statements.

Most provincial securities legislation prohibits a person or company from making a statement that the person or company knows or reasonably ought to know is materially misleading or untrue and which would reasonably be expected to have a significant effect on the market price or value of a security. However, most of these hurdles have been eliminated in British Columbia following recent amendments to the BC Act that came into force in 2020. Specifically, a person engaged in "promotional activities", which is defined to include any activity that encourages or reasonably could be expected to encourage a person to trade a security, cannot make a statement or provide information that a reasonable investor would consider important in determining whether to trade a security if the statement or information is false or misleading or omits a fact necessary to make the statement or information not false or misleading.[7] Notably absent is any requirement for the statement or information to be <u>materially</u> misleading or untrue or for the statement or information to be expected to have a significant market impact. Also missing is a requirement that the person making the statement or providing the information know that the statement is false or misleading, as well as a due diligence defense for persons that have conducted reasonable investigations regarding the truth or falsity of the statement or information in question.

More recently, the Capital Markets Modernization Taskforce (the "**Taskforce**") published its final report in which it recommended a new prohibition that would allow the OSC to take enforcement against any person that makes or attempts to make statements about a public company that are known to be, or for

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investment decisions of an issuer's security holders. In this regard, we agree with the points made by the Alberta Securities Commission in *Re Cohodes*, 2018 ABASC 161 that a short seller's opinions must command a certain level of respect among market participants to be impactful, and that a less prominent activist may only impact the market of a small, thinly-traded issuer in certain circumstances (see paras 82 to 83).

[7] BC Act, *supra* note 4, s 50(3)(a).

which there is a reckless disregard for whether the statements are, misleading or untrue, and when those statements would be expected either to affect the market price or value of the securities of the public company or influence the investment decision-making of a reasonable investor. As in the BC Act, as amended, no materiality threshold appears to be contemplated and the market impact assessment is one of two alternative prongs that could ground liability. Although the Taskforce's report notes that the new prohibition is not intended to capture analysts that may omit facts without an intention to mislead or reputable activist short sellers, it is not clear how the Taskforce is proposing to thread that particular needle or if the Taskforce's recommendation is proposing different standards of disclosure and liability for different market participants.

In our view, both the amendments to the BC Act and the Taskforce's recommendation are overreactions to a perceived problem based on anecdotal evidence. The elimination of a market impact assessment and a materiality threshold can be expected to have a significant chilling effect on legitimate short selling activities given that these (and other) market participants do not have access to issuer information beyond what the issuer itself publicly discloses, and are therefore forced to form opinions and draw conclusions from their own work and investigation. Any benefits that could be derived from such overly-broad prohibitions do not outweigh the costs.

In addition, if the Taskforce's recommendation is implemented in Ontario, Canada will have three distinct regimes with which market participants will have to comply. This is antithetical to the spirit of harmonization to which the CSA has continually expressed its commitment. As the CSA recently stated, "[i]t is fundamental to keep in mind that a highly harmonized securities regulatory system ensures the best possible outcomes for the Canadian capital markets and adhering to this foundational principle is critical to ensure our regulatory system remains efficient and responsive."[8] In light of the research conducted by the CSA in connection with the Consultation Paper, the BC Act should be amended to revert to the previous iteration of the prohibition on misleading or untrue statements and the OSC and the Ontario Ministry of Finance should not implement the Taskforce's recommendation. These steps would promote harmonization with other Canadian jurisdictions, thereby decreasing the risk of forum shopping and minimizing fragmentation with respect to investors' rights and obligations throughout the country.

D. Alignment with the U.S. regime would help to minimize regulatory friction.

The CSA's research and analysis with respect to activist short selling, and any proposed reforms resulting from that, should be informed by carefully considering the regulatory approach in the U.S., including any potential changes that may be implemented in the near future. Consistent with the objective and benefits of fostering harmonization of securities regulation across Canadian jurisdictions, as outlined above, it is equally important to maintain the competitiveness of Canada's capital markets having regard to other global markets, especially the U.S. Where appropriate, alignment with U.S. securities laws serves to minimize unnecessary regulatory friction and fragmentation and reduce regulatory burden, particularly where the activity is not unique to the Canadian market. The importance of maintaining alignment, where appropriate, between Canadian rules and those of other advanced

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[8] CSA, "Open Letter from the CSA in Response to the Capital Markets Modernization Taskforce final report" (February 12, 2021), online: <https://www.securities-administrators.ca/aboutcsa.aspx?id=2018>.

capital markets is consistent with the objectives of the Taskforce and the CSA, and a principle that should not be overlooked.

III. ***Changes to the Regulatory Regime should be Tailored and Incremental***

Although we believe that the overarching securities regulatory regime suitably regulates activist short selling, certain tailored and incremental modifications may be appropriate in order to address instances of abuse without constraining legitimate short selling activity. As noted above, it is critical that the bar for what constitutes illegitimate conduct not be lowered to make it easier to prosecute short selling, as this would have a significant chilling effect on legitimate short selling campaigns specifically and free speech generally. Rather, the bar for what constitutes illegitimate conduct should be maintained while allowing victims of abusive short selling campaigns to pursue their own remedies. In addition, the potential adoption of a modified uptick rule by the Investment Industry Regulatory Organization of Canada ("**IIROC**") and the creation of a requirement for a short seller to update its position in circumstances in which the short seller has voluntarily disclosed a short position are additional measures that could be analyzed and considered in an effort to enhance market integrity and investor confidence.

Each of the options noted below requires further analysis and consultation, including having regard to a more robust consideration of the approaches adopted in other advanced capital markets in addition to those noted in the Consultation Paper.

A. The CSA could consider enabling victims of abusive short selling campaigns to pursue remedies.

The CSA may wish to consider creating a private right of action that provides recourse for targets of "short and distort" campaigns. As the Consultation Paper notes, there is no securities law mechanism for issuers or investors to seek damages against activist short sellers for statements made in the context of a campaign. There is also no recognized common law cause of action for abusive short selling. As such, issuers or investors would likely be required to fit their claim within one or more of the torts of defamation, unlawful means conspiracy, unjust enrichment or intentional interference with economic relations. However, each of these causes of action presents its own challenges. With respect to defamation, certain jurisdictions have enacted legislation in response to concerns about companies using a defamation lawsuit as a tool to silence legitimate criticism.[9] In Ontario, if the court is satisfied that the criticism expressed by the defendant relates to a matter of public interest, the court will summarily dismiss a defamation claim.[10] An unlawful means conspiracy claim necessarily requires an

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[9] In Ontario, the *Protection of Public Participation Act, 2015*, SO 2015, c 23 amended the *Courts of Justice Act*, RSO 1990, c C43 (the "**CJA**") to allow the defendant of a defamation claim to bring a motion to dismiss the claim on the basis that the impugned speech should be protected in the interest of the public.

[10] Pursuant to section 137.1(4) of the CJA, in order for the claim to proceed, it must be the case that: (a) there are grounds to believe that the claim has substantial merit and that the defendant has no valid defence; and (b) the harm

agreement between two or more parties and would therefore be unavailable if an activist short seller were acting alone. An unjust enrichment claim would require a plaintiff to establish that the short seller obtained an enrichment or benefit and that the plaintiff suffered a corresponding loss or deprivation, which can be challenging given the many inputs that go into the market price of an issuer's securities. Finally, the tort of intentional interference with economic relations is nuanced and requires a plaintiff to demonstrate that the defendant intended to injure the plaintiff's economic interests through unlawful means directed at a third party, which can be difficult to establish. Accordingly, an issuer targeted by an abusive short selling campaign, as well as the issuer's security holders that are induced to sell their securities on the basis of misinformation, do not have any clear recourse and are often forced to wait and see whether CSA Staff will commence regulatory proceedings.[11]

The CSA could consider a new provision that creates statutory civil liability for a statement about a public company that is made by a person or company that knows or reasonably ought to know, in a material respect and at the time and in 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 would reasonably be expected to have a significant effect on the market price or value of its securities. The provision should provide appropriate defenses, including for a person or company that can demonstrate that it conducted a reasonable investigation and had no reasonable grounds to believe that the statement was misleading or untrue. It is important to emphasize that such a provision should not meaningfully alter the existing prohibition on making misleading or untrue statements in most CSA jurisdictions. Accordingly, we do not believe that it would have significant unintended consequences for analysts, legitimate short sellers or other market participants, all of whom are already subject to this prohibition. Although civil proceedings have not been widely used by issuers or investors in relation to allegations of problematic conduct historically, providing issuers and investors with such an option may itself deter unscrupulous short sellers from deliberately disseminating misleading information given the enhanced risk of litigation. We do not believe that legitimate activist short sellers would have an issue with such a provision to the extent that it helps to reduce the number of bad actors in the Canadian capital markets and lend additional credibility to activist short selling.

B. IIROC should evaluate adopting a modified uptick rule.

The U.S. Securities and Exchange Commission (the "**SEC**") introduced the "uptick rule" in 1938 and it remained in force until 2007. The uptick rule applied to all New York Stock Exchange-listed stocks and required short sales to take place on an uptick (i.e. at a price higher than the last reported transaction price). The purpose of the rule was to prevent successive short sales at progressively lower prices;

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that has been or is likely to be suffered by the claimant is sufficiently serious such that the public interest in allowing the proceeding to move forward outweighs the public interest of protecting free expression.

[11] In Ontario, it is possible for a private party to bring an application under section 127(1) of the Ontario Act; however, private parties do not have a right to do so (see e.g. *Re MI Developments Inc* (2009), 32 OSCB 126 at para 107 and *Re Catalyst Capital Group Inc*, 2016 ONSEC 14 at para 25). In order for a private party to be permitted to bring an application, it must satisfy certain criteria, including showing that the application relates to both past and future conduct regulated by securities law and that the application is not, at its core, enforcement in nature. This may be difficult for a private party to establish in a short selling context.

instead, traders could short securities only on a price uptick (or later, a zero-plus tick). Following its elimination in 2007, the SEC re-introduced a modified version of the uptick rule in 2011 that did not apply unless a circuit breaker had been triggered by a 10% price decline in a particular security in a trading day. Unlike the U.S., Canada no longer has an uptick rule following its repeal in 2012. Although IIROC noted in its 2011 consultations that its studies supported the premise that the uptick rule has no appreciable impact on pricing, IIROC neither sought nor received specific comments on the use of circuit breakers in Canada. We appreciate that views regarding the efficacy of the modified uptick rule are mixed. However, in light of the fact that the rule has been in effect in the U.S. for over a decade, we believe that there is now additional data that can help to inform IIROC's analysis regarding the potential pros and cons of adopting a similar version of the modified uptick rule in Canada, which analysis is recommended.

C. The CSA should consider requiring short sellers that voluntarily disclose their short positions to update such disclosure when the position is closed.

Short sellers are not, and should not be, obligated to disclose their short positions. In this regard, we agree with the conclusions of the studies cited in the Consultation Paper that such disclosure would have undesirable effects, and that short sellers would likely choose to remain below the applicable disclosure threshold in order to maintain privacy. However, in circumstances in which an activist short seller has publicly disclosed its short position in an issuer, it may be appropriate to require the short seller to disclose the fact that it has closed its position promptly after doing so. The fact that a short seller has ceased to have a financial incentive in an issuer's performance is itself information that would likely be relevant to other market participants' assessments of the truth or falsity of the short seller's allegations. Quite apart from a distinct statutory duty to update, in certain circumstances, one could argue that a failure to update would itself be materially misleading and contrary to existing securities laws.

IV. <u>Conclusion</u>

Short selling is an important component of healthy and robust capital markets. It improves price accuracy, provides liquidity, serves as an important hedging tool and helps to uncover fraud and mitigate price bubbles. Although activist short selling campaigns are not inherently problematic, any campaigns by any market participants that involve the spread of false and misleading information are detrimental to the target of the campaign, its security holders and the capital markets as a whole. While the limited CSA jurisprudence has demonstrated that short selling can be difficult for securities regulators to prosecute, this is not because of deficiencies with the rules themselves, but rather the challenge of distinguishing legitimate conduct from illegitimate conduct. Amending securities legislation to make it easier to prosecute short selling would have a significant chilling effect on appropriate short selling activities and would represent a disproportionate overreaction. Instead, the CSA should consider incremental yet meaningful modifications to the existing regime, such as statutory civil liability that can equip victims of abusive short selling campaigns to seek redress and avoid over-reliance on regulatory intervention. Any such reforms, however, should only be undertaken after further research, analysis and consultation with market participants.

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The following lawyers at our firm participated in the preparation of this comment letter and may be contacted directly should you have any questions regarding our submissions.

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