

Playing the Short Game: Activist Short Sellers May Soon Face Greater Regulation

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In mid-to-late January 2021, GameStop Corp. saw its American stock price increase by approximately 1600%. This surge occurred, in part, as an attack against hedge funds, including some which attempted to profit by taking a short position in GameStop and making public statements intended to decrease the stock price. Contrary to the short sellers' plans, amateur traders coordinating online bought stock in GameStop en masse. Due to the substantial increase in GameStop's stock price, Melvin Capital and other corporate short sellers who were relying on a decrease in GameStop's stock price incurred substantial losses.

While this is far from the first instance of a "short squeeze," this unprecedented online coalition of amateur traders brought issues surrounding short sellers into sharp focus.

It is timely then, that on December 3, 2020, the Canadian Securities Administrators (CSA) published CSA Consultation Paper 25-403: *Activist Short Selling* (the Consultation Paper), soliciting public and stakeholder input regarding concerns about activist short selling and its potential impact on Canadian capital markets.

Key Takeaways

- The CSA's increased scrutiny of activist short selling is justified, particularly given the escalating use of social media as a means for disseminating negative information designed to artificially decrease share prices of targeted issuers for personal gain.
- While Canadian securities legislation contains general prohibitions on market manipulation, making misleading statements and fraud, which may be used by regulators to combat unwanted activist short selling activity, the CSA is considering regulatory intervention to specifically target such activity.
- New regulatory or remedial provisions could improve investor protection and market efficiency while still allowing for legitimate and appropriate short selling behaviour to continue unimpeded.

What is Activist Short Selling?

The term "activist short selling" is used to describe instances where investors take a short position in a security and then make a public statement with the intention of causing the security's price to fall

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(sometimes referred to as a “short report”). If the value of the security declines, the short seller realizes a profit.

Advocates of activist short selling suggest that the practice contributes to market efficiency and price discovery by identifying and correcting artificially inflated positions. Critics, however, focus on the inherent harm caused to the public market by deliberate attempts to destroy shareholder value for personal gain. These concerns are compounded by what many believe is an insufficient regulatory framework in Canada to deter and protect against short seller misconduct. There is, additionally, the question of whether the activist trading recently seen in the United States will see “copycat” cases in Canada.

CSA’s Findings on Activist Short Selling in Canada

The CSA conducted empirical analysis of activist short selling activities in Canada between January 2010 and September 2020. The findings are summarized as follows:

- in this period, a total of 73 Canadian issuers have been the target of 116 activist short selling campaigns;
- the most active years were 2015 (19 campaigns), 2016 (21 campaigns) and 2018 (22 campaigns). As of September 2020, there were 12 campaigns that year;
- compared to the United States, where there is an average of 21 US targets annually for every 1,000 US listed issuers, Canada has never had more than five Canadian targets for every 1,000 Canadian listed issuers;
- short sellers gravitate toward the securities of issuers and sectors where there is a perceived overvaluation (for example, 2018 saw 35% of new campaigns target the cannabis industry);
- campaigns tend to be focused on larger issuers. The median and average market capitalization of targets were \$867 million and \$4.5 billion, respectively;
- activist short selling campaigns tend to be successful. About 75% of targets experienced a negative price impact on the day of the first-campaign announcement and up to one month following;
- fraud is the most common allegation made by activist short sellers. Of all 116 campaigns, 40% involved allegations of fraud directed at the issuer, with the most common type of fraud allegation being a stock promotion (or “pump and dump”) scheme;
- approximately 73% of target issuers pursued some type of response to the activist short selling campaign. Common responses included either changing or replacing top executives, hiring a new auditor or independent investigator, halting the issuer’s stock from trading, pursuing a lawsuit against the activist short seller or announcing a capital market transaction; and
- following activist short selling campaigns, about 29% of targeted issuers experienced a “negative outcome” aside from a fall in the issuer’s share price. The most common “negative outcome” was a class action lawsuit.

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The Regulatory Framework, Enforcement and Remedies

Canadian securities legislation contains general prohibitions on market manipulation, making misleading statements and fraud, which may be used by regulators to combat much of the activist short selling activity that is considered undesirable by regulators.

However, the evidentiary threshold necessary to impose liability under such legislation, which requires finding a real market impact caused by the misleading/untrue statement, is seen as an obstacle to effective prosecution, including because of new complexities caused by the growing use of social media as a means for activist short sellers to broadcast their message.

Additionally, there is no mechanism under Canadian securities law for issuers or investors to directly seek damages against activist short sellers for statements made in the context of short selling campaigns. Although issuers and/or investors may commence civil proceedings, procedural delay and a lack of precedent-setting case law makes this a less effective and less certain mechanism for redress.

Given these concerns, the CSA is considering regulatory intervention that specifically targets activist short selling. The recent trend of individual investors banding together to seek their own redress against short sellers increases the potential need for intervention by the CSA.

Consultation Questions

The CSA hopes to gain an understanding of stakeholders' perceptions on activist short selling to determine the general sentiment surrounding increased regulation. The CSA asks:

- if, how and why Canadian issuers may be reluctant or limited in their ability to respond to negative activist short selling campaigns;
- whether the existing disclosure regime for short selling activities is adequate, and if more rigorous requirements could address the enumerated concerns surrounding activist short selling;
- whether the existing enforcement and remedial mechanisms adequately deter misconduct on the part of activist short sellers while protecting Canadian issuers and their investors; and
- what are examples of concerning activist short selling behaviour that is not captured by existing securities law prohibitions.

Looking Ahead

To strengthen Canada's regulatory framework, which is relatively lenient by international standards, the

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Consultation Paper cites suggestions for more stringent reporting and disclosure obligations to be placed on activist short sellers, as well as the development of a statutory scheme that provides a private right of action for those that have been harmed by problematic activist activity. A ten-day minimum hold period for short positions and increased transparency with respect to the identities of short sellers are two further policy changes that could address such behaviour.

Should regulators heed calls for more stringent regulation, it can be expected that incidents of problematic activist short selling will decline. This could be a positive development for capital markets, potentially resulting in improved investor protection, market efficiency and increased protection for upstanding Canadian issuers, who would be less likely to be negatively impacted by improper activist conduct, while still allowing for honest and appropriate short selling activity to continue unimpeded.

While it is unclear what outcome the Consultation Paper will bring, it can be expected that the conduct of activist short sellers will continue to be a focus of the CSA going forward.

Comments on the Consultation Paper should be submitted by March 3, 2021. We encourage all interested parties to participate in this opportunity to contribute to developing the regulatory regime governing activist short selling in Canada.

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