

## Outlook 2021: Regulating Market Manipulation – Challenges and Change

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The regulation of market manipulation, and activist short selling in particular, has been at the forefront of recent efforts to modernize the Canadian securities landscape. In late 2020, the Canadian Securities Administrators (CSA) released a consultation paper to solicit the public's views about activist short selling and its potential impact on Canadian capital markets. Shortly after that, in early 2021, the Ontario Capital Markets Modernization Taskforce (the Taskforce) released a report in support of regulatory reform which included recommendations for increased regulation of short selling.<sup>1</sup> The CSA and the Taskforce were both focused on finding a balance between fostering efficient and innovative capital markets while still ensuring investor protection. Recognizing the need to achieve this goal, the Government of Ontario published draft legislation for the new *Capital Markets Act* (the Draft CMA).<sup>2</sup> The Draft CMA was released for comment on October 12, 2021, and addresses the CSA's considerations in its consultation paper, the responses received, and the numerous recommendations put forward by the Taskforce.

Ultimately, the increased scrutiny of market manipulation is justified given the proliferation of social media as a means for disseminating negative information designed to artificially decrease the share price of targeted issuers for personal gain. Canadian securities legislation includes general prohibitions that regulators may use to combat unwanted activist short selling activity, including prohibitions against market manipulation, making misleading statements, and fraud. However, the CSA is considering (and the Taskforce has recommended) 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 (sometimes referred to as a “short report”). If the value of the security declines, the short seller realizes a profit.

The CSA conducted an empirical analysis between January 2010 and September 2020 regarding short selling activity. The findings are summarized as follows:<sup>3</sup>

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- 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), and there were 12 campaigns in 2020 as of September of that year;
- contrasted with the United States, where there is an average of 21 US targets annually for every 1,000 US listed issuers, Canada 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).

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.<sup>4</sup>

## The Current Regulatory Framework, Enforcement, and Remedies

The debate about whether the actions of short sellers are, in fact, beneficial or abusive to the market highlights one of the key questions to be answered by securities regulators: how can regulators effectively manage and prosecute those who act with the intent of manipulating stock prices? Concerns relating to the inherent harm caused by deliberate attempts to destroy shareholder value for personal gain are compounded by what many believe is an insufficient regulatory framework in Canada to deter and protect against such misconduct.

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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 regulators consider undesirable.<sup>5</sup>

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. It is often too difficult to show a “misleading appearance of trading activity” and/or an “artificial price” because proving that would require (i) a determination of the “real” supply and demand for the stock, and (ii) a finding that this “real” market activity was distorted by the investor in question. Therefore, despite the express prohibition, market participants are rarely held accountable under these provisions.

It is also unclear what type of evidence would be required to demonstrate an attempt to create an “artificial” stock price, as opposed to actions that are the result of a free and fair market. Given the number of short selling campaigns that successfully drove down stock prices over the last decade (approximately 70 according to the CSA), investors need better guidance to ensure that market activity does not cross the line into manipulation.

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 uncertain mechanism for redress.

## Regulatory Reform

Technological advancements, including the proliferation of social media and online broker activity, have had a significant impact on the fairness, volatility, and transparency of the capital markets. The CSA identified that the rise in use of social media may contribute to market manipulation, and there is increasing concern that Canadian legislation addressing market manipulation is less effective than those in other jurisdictions.<sup>6</sup> It is therefore not surprising that regulators are considering reform to reduce the ease with which market manipulation occurs.

For example, the CSA has proposed enforcing more stringent reporting and disclosure obligations on activist short sellers as well as a minimum hold period for short positions. The Taskforce recommended specific prohibitions from making misleading or untrue statements about public companies, which would prevent institutional short sellers from being able to “short and distort” stocks. This recommendation would allow the Ontario Securities Commission to take enforcement action against any person or entity who makes statements: (i) known to be misleading or untrue (or the truth of which is recklessly disregarded); and

(ii) which would be expected to affect the market price or value of the securities, or influence investment decision-making of a reasonable investor. The evidence would not need to demonstrate that the market was actually distorted, just that there was an intention to impact the market or influence the “reasonable investor’s” decision-making. The Draft CMA incorporates the Taskforce’s recommendations in this regard and has the potential to significantly alter the regulatory framework for market manipulation.

Along similar lines, the British Columbia Securities Commission recently proposed new enforcement tools to combat market manipulation schemes and misrepresentations on social media.<sup>7</sup> These pending changes follow recent amendments to British Columbia securities laws which remove the requirement to establish that a misrepresentation had an actual impact on the share price in cases of alleged market manipulation, thereby removing the need to prove “real” vs. “artificial” market activity.

## Looking Forward

Many stakeholders agree that regulatory and legislative changes are necessary to inhibit those who seek to artificially manipulate stock prices for their own profit. It is apparent that any changes to the current regulation of market manipulation should: (i) address the impugned activity itself to ensure that activist trading, no matter its form, occurs in a manner that is not abusive or unfair to other market stakeholders; and (ii) permit effective enforcement of securities law to ensure that those who intend to manipulate the market can be prosecuted for their misconduct. Such reform, if done correctly, will give Canada a competitive edge by ensuring investor protection while maintaining active and efficient capital markets.

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<sup>1</sup> “CSA Consultation Paper 25-403: Activist Short Selling,” *Canadian Securities Administrators*, December 3, 2020, online: <<https://www.osc.ca/en/securities-law/instruments-rules-policies/2/25-403/csa-consultation-paper-25-403-activist-short-selling>>; “Final Report,” *Capital Markets Modernization Taskforce*, January 2021, online: <<https://files.ontario.ca/books/mof-capital-markets-modernization-taskforce-final-report-en-2021-01-22-v2.pdf>>.

<sup>2</sup> “Capital Markets Act – Consultation Draft,” *Ontario’s Regulatory Registry*, October 12, 2021, online: <<https://www.ontariocanada.com/registry/view.do?postingId=38527&language=en>>.

<sup>3</sup> “CSA Consultation Paper 25-403: Activist Short Selling,” *Canadian Securities Administrators*, December 3, 2020, online: <<https://www.osc.ca/en/securities-law/instruments-rules-policies/2/25-403/csa-consultation-paper-25-403-activist-short-selling>>; “Canadian securities regulators seek comment on activist short selling,” *Canadian Securities Administrators*, December 3, 2020, online: <<https://www.securities-administrators.ca/news/canadian-securities-regulators-seek-comment-on-activist-short-selling/>>.

<sup>4</sup> “Playing The Short Game: Activist Short Sellers May Soon Face Greater Regulation,” *Cassels Brock & Blackwell LLP*, February 8, 2021, online: <<https://cassels.com/insights/playing-the-short-game-activist-short-sellers-may-soon-face-greater-regulation/>>.

<sup>5</sup> *Securities Act*, RSO 1990, c. S.5, sections 126.1 and 126.2; *Securities Act*, RSA 2000, c. S.4, sections 92(4.1) and 93(1); *Securities Act*, RSBC 1996, c. 418, sections 57 and 168.1.

<sup>6</sup> “Short Selling,” *European Securities and Markets Authority*, March 14, 2012, online: <<https://www.esma.europa.eu/regulation/trading/short-selling>>.

<sup>7</sup> “BCSC eyes new rules to address manipulation of stocks on social media,” *Financial Post*, February 8, 2021, online: <<https://financialpost.com/news/fp-street/bcsc-eyes-new-rules-to-address-manipulation-of-stocks-on-social-media>>.

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