COMMENT LETTER ON OSC/SRO STAFF NOTICE 23-329 – SHORT SELLING IN CANADA

This personal comment letter, including the 5 suggestions for "levelling the playfield" contained in the Summary, are based upon regulatory and public interest principles rather than on strict technical or legal arguments.

For the purposes of this comment letter, I have reworded the current UMIR definition of "short sale" with the goal of not changing the definition but limiting it to common shares and including current regulatory restrictions on where and how the short seller may borrow or obtain access to shares for the purpose of covering the short sale. This rewording is being done both for simplicity's sake and in order to more easily understand examples of the gaps in the current regulation and reporting of short sales.

The definition of "short sale" that I use in this comment letter is as follows:

"The sale of a common share, which the seller does not own, either directly or indirectly, through an agent or a trustee, provided that the seller has a reasonable expectation that he or she can borrow to cover the short position and purchase the shares subsequently at a lower price. Such shares cannot be borrowed from cash accounts or registered accounts (RRSP, RRIF, TFSA) so that short sellers are limited to borrowing from firms' margin or inventory accounts. There is a further proviso that no borrowing may be done of shares which are subject to a statutory hold, control block restrictions, or classified as being on an "if, as and when issued" basis (restricted shares)".

I have also defined the word "transparency" to mean that:

- not only should short sales follow the basic principle of securities regulation (which in plain English means) that all market participants (brokers, funds, public companies, investors) are to have equal access to the same material information at the same time so as to prevent any person realizing a profit or avoiding a loss based on an unfair trade advantage that that person has by virtue of information that only he or she is aware of; and

- the trading of common shares based on the above principle of this "same time access to equal knowledge among all market participants" must not only exist but it must be seen to both exist and be enforced.

Lastly, I will address the issue of at what point does short selling (which I agree is a legitimate trading practice since it is the opposite side of the same coin to normal purchases or "going long" a stock) become abusive? This will include examples of some of the possible abuses which can occur in the current regulatory regime and how can these and other abuses be cured by extending existing reporting and transparency requirements so that the requirements for going long or shorting a stock are more balanced than is currently the case.

I believe that the following is an accurate, plain English description of how a short sale occurs under the current regulatory scheme. A person wishing to short sell shares will phone a market participant such as a brokerage firm and tell them that he/she wishes to short 25,000 shares of XYZ. The market participant/broker will then ask where the short seller intends to obtain access to share s which will are available to cover the sale from any firm's existing clients' margin accounts or any firm's inventory. Once the market participant/broker is satisfied that shares are available to borrow and they are not restricted shares, the broker will mark the short sell order or "ticket" with the appropriate "notation" as to what type of short sale it is and enter the order into the system.

The problem that exists is that the trade in the preceding paragraph is almost totally lacking in transparency. For example, the two major trading information sources that are available to the general investing public, the TMX website and Stockwatch, do not reflect any individual trade that is a short sale. In fact the TMX website is completely silent on labelling any trade to be a short sale and the trade markers in Stockwatch which deal with well over 20 different types of trades has the following buried in a footnote:

"Short History

Short history data is currently limited to Canadian stock

1. Enter the symbol you require.
2. Exchange is shown automatically.
3. **Note: Report Dates are periodical not prescheduled." (emphasis is mine)**

Effectively the only public disclosure of shorts is a report that is published a bi-weekly and is so lacking in information so as to be effectively useless to most public market participants. The most useful information that is given is what the short position in a stock (in terms of number of securities) was as of 2 weeks previously. It is analagous to someone going through the futile exercise of buying a 2 week old newspaper to determine what current events are.

More importantly this means that the only other people who know that there is an active short seller is the brokerage house that is doing the short sales and if the short seller uses more than one brokerage houses for selling and/or borrowing, then only the short seller knows the extent of what he or she is doing in the market. One has to question this complete lack of transparency – why does the elaborate exercise of ensuring that a short seller has access to borrowing shares to cover his/her short and marking the sales ticket as a short sale end with that same information not being extended to the public on any website like the TMX or Stockwatch? This practice contravenes the underlying principle of securities regulation referred to above (equal access to the same material information at the same time among all market participants). One would expect that the first rebuttal to this statement is that a short seller executing a small program of short selling would not have any material effect on the stock's market price overall and that is true.

There are, however, other considerations. The fact that there is no requirement for **ever** requiring that this information be disseminated to all market participants in any meaningful and timely manner by identifying a particular sale to be a short sale in real time. In fact, all the other markers in Stockwatch are delayed only 15 minutes. The question is what is the CSA's and SRO's policy justification for exempting short sellers from the majority of public reporting requirement? This void in the current regulatory regime allows a short seller to short stocks as long and as often as he/she personally determines without any public reporting or disclosure requirements (the bi-weekly publications referred to above being completely lacking in substance and timeliness and therefore incapable of being classified as any form of timely and meaningful disclosure).

There are a number of situations, some of which are mentioned below, which can arise given the current state of the law, which results in the companies affected by the short seller(s) generally have no clear understanding of why their respective stock prices are being negatively affected:

1. Short selling can lead to a significant reduction in the price of a stock to a point whereby the company's assets and valuation are not reflected in the share price. In order to survive, a company may well have to undertake a financing at a greatly reduced stock price with significant dilution to its existing shareholders.
2. The reduction in price may result in another company recognizing an artificially low share price as an opportunity to launch a take-over bid in order to acquire the target's underlying assets at a fire sale price.

3. A company may approach a brokerage firm to take part in a financing and the institutional and retail sales departments will recommend that clients (with cash, registered and margin accounts) purchase the stock. Additionally, the firm may take some stock into its own inventory account. At some point in time - generally after the 4 month statutory hold period for a private placement and earlier if pursuant to a prospectus offering, the underwriter/agent may be approached to lend the stock to a short seller. Whether it is an RR within the firm or from outside the firm who is executing the short sale for a client, the firm is now in a conflict position having recommended purchase of the stock to its clients and then lending stock from those same clients' margin accounts or its own inventory as that action can reasonably be expected to result in a decrease in the stock price, especially with junior companies.
4. The situation in 3 above can also be exacerbated by the fact that most financings will contain a ROFR so if the ROFR is exercised, the company enters into a dangerous loop whereby the brokerage firm will again do part or all of the financing and in effect "replenish" the short seller's borrowing ability to further affect the company's share price despite the fact that the firm may at one time have had the company on a gray or restricted list.
5. A further issue that arises indirectly from "replenishment" on a financing is that word may leak out that a company is interviewing brokerage firms to do an offering of equity securities or a security convertible into equity. The problem that arises is that once word of that gets out, which does not necessarily mean "insider trading" or "tipping", someone could short the underlying stock and cover by purchasing stock on the offering because in both the case of a prospectus offering or a private placement, the stock is almost always offered at a lower than market price so the financial gains (although not risk free) are obvious. Borrowing from the American experience, entities/investors who are short the stock offered should be prohibited from purchasing that stock in the offering.

The three commonalities in the above examples are that: (1) the short seller never has to disclose their short selling activity nor his/her identity; (2) in all of the above scenarios the only market participants who benefit are the short seller who has the best odds of realizing the most significant financial benefit with the brokerage firms profiting by lending the stock at not insignificant interest rates and the rest of the participants will suffer losses: and (3) lastly, the deleterious effects of these examples in the current regulatory structure will be amplified when the short selling turns **"abusive"**.

Therefore, the next question to answer is "What is the test for determining when a short seller's behaviour can be classified as "abusive"? I believe that you have to have a specific test for abusiveness, rather than relying on the only existing provision in law which is the catch all of "deceptive" or "manipulative" trading because it is too generic and too subjective to properly address the problems created by short selling and to ensure that transparency governs the short selling process.

There are two general types of tests for determining when short selling becomes abusive; one is subjective and the other is objective.

The **subjective test** for abusive short selling would be the point in time where the short selling ceases to be a legitimate trading tool for someone who doubts the value of a company and the price of its stock and instead the short selling becomes **intentionally** used solely as a tool for maximizing trading profit. The problem with a subjective test is that it is dependent on proving the short seller's state of mind and determining the time when the intention changed based solely on the trades the short seller carried out. In most cases the burden will be very difficult to establish.

The **objective test** on the other hand would occur when the short selling activity is **deemed** to have reached a specific and measurable point where the possibility of abusiveness becomes a potential threat to the **orderly function and "transparency"** of the market. This is the preferred test because of two factors:

- there is a stated and objective level known to all market participants that triggers this test; and
- the actual thresholds and reporting requirements already exist in current securities legislation but in other fact situations.

I had said earlier in this comment letter that short selling was the opposite side of the same coin as acquiring (or going long) shares in the market in the ordinary course.

If you examine the regulation of share acquisitions, CSA members have long had in place deeming provisions which recognize that acquiring shares of a company (directly, indirectly or in concert) reach a point where the purchase of shares is or is deemed not to be in the ordinary course and disclosure is required of both the activity and intent of the purchaser(s) to ensure orderly trading and transparency.

For example, the insider trading reporting requirements are very specific and are triggered when acquisitions reach the 10% level. An "insider" is deemed by law to have special knowledge of the market and is required to very quickly report acquisitions and dispositions that maintain his/her position at or over 10% of the stock in question. Not only are the times for filing insider reports reasonably short but the whole SEDI and SEDAR systems has been established to ensure that there is a central public repository of this information and the information associated with take-over bids as discussed below. There are also further disclosure requirements such as in management information circulars where a specific disclosure is directed to 10% holders.

A similar requirement for timely and specific disclosure of acquisitions was introduced many years ago under the so called "creeping take-over bid" provisions. Even in its earliest iterations, these rules required that when an acquiror reached 10% (under a slightly different calculation the "insider" threshold), a number of clear and certain reporting obligations were immediately imposed: cease further acquisitions for a period in order to issue a press release and file a report fully identifying the acquiror (and those acting with him/her), the common shares owned and the acquiror(s)' future intentions with respect to the stock. Once that is done, the additional requirements to notify the market by reporting further acquisitions at various stages are immediately imposed and at 20% the take-over bid threshold is attained and the pre-bid integration rules as to pricing a take-over bid become effective. Failure to adhere to these requirements is subject to regulatory intervention and penalty, a fact made clear as long ago as the Canadian Tire case.

The indisputable conclusion from the immediately preceding paragraphs is that Canadian securities regulators have long ago introduced disclosure and reporting requirements to the **"acquisition side of the coin"** that are intended to ensure that the most basic principle of securities regulation - that all market participants must have timely access to the same information" in order to ensure that the entire regulatory system allows no one to have a trading advantage over another market participant and that the entire system must be and must be seen to be transparent.

The thornier question is why have Canadian securities regulators been so reticent to regulate short selling as they do acquisitions (given that short selling is the "opposite side of the same coin" as acquisitions) as short selling, especially abusive short selling, can cause an equal amount of damage as undisclosed acquisitions to all other market participants. Notwithstanding this, the nature, extent and extremely limited reporting requirements applicable to short selling and available to the general investing public are anything but transparent. In effect, short selling (both as a normal market tool and in its abusive form) is in essence unregulated. There appear to be only two regulatory requirements:

-the provision within UMIR which requires that short sales effected by the broker are marked as such but that information is never made easily accessible to the other market participants even though the means to do so exist on the TMX, Stockwatch or SEDAR websites.

-the bi-weekly short sales report is another example of the complete lack of transparency given its limited content and the fact that it is two weeks old – another issue that can be cured by the tools already in place. **In this way you change the current regulatory status quo whereby only the short sellers and the firms lending stock are the only ones who profit by short selling and they profit at the expense of all other market participants.**

When you consider sale side issues that do not apply to short selling (I have set out but two examples below), it is entirely fair to say that the existing regulatory requirements are profoundly lacking as well as being an exception to other reporting requirements within the current regulatory regime.

- insider reporting sales rules require timely disclosure and transparency; and
- sales from "control blocks" (and we all know a control block is a question of fact not just a 20% threshold) require advance notice in a specified form and content being given to the market including identification of the seller and the selling broker to ensure transparency.

Not only are short sellers exempt from any other form of transparent regulation, they can do the following without restriction or meaningful reporting:

- short an unlimited number of shares at any price they want without ever having to identify to other market participants their identity, their broker's identity, the quantity and prices the shares are shorted at and the shares bought to cover;
- they can further hide their identity and trades by using the "#1 Anonymous" designation;
- an equally egregious issue is the fact that the uptick rule does not apply to short sellers. Although I am not an expert in trading by any means, the professional traders I have talked to refer to the lack of an uptick rule as the equivalent of a written invitation to short sellers to artificially depress the price of a stock to only benefit themselves;
- As I said above, the above factors benefit only the short seller and the brokerage firms lending stock to the short sellers for a profit at the expense of all the other market participants whereas on the buy side, factors such as insider reporting, the Early Warning System and pre-bid integration rules create a level playing field for all market participants.

I think it inevitable that someone is going to respond to this comment letter with the "one size fits all" argument that selling is completely different from buying and so the rules that apply to buying such as insider trading and the Early Warning System where thresholds start at 10% shouldn't apply. Even if that person could dance their way around the complete lack of transparency and the current de minus regulation associated with short selling, the fact is that if a someone shorts 10% of a company's stock, they have to **acquire that 10%** in order to cover the short position and that, together with transparency, is why short selling should be treated in exactly the same manner as the acquisition buy side of the same coin.

SUMMARY

The fundamental nature of abusive short selling is probably best defined as a situation where short selling becomes so excessive that it artificially depresses a stock's price by forcing it to a level that would otherwise not exist absent the short seller.

I can think of no regulatory rationale that would justify why the current Canadian securities regulatory authorities have accorded all short sellers such a large and almost unrestricted "safe harbour" to in effect do whatever they want and in a manner that is totally opaque, not transparent, to the general investing public and the publicly listed companies whose shares they own. This is further exacerbated by the fact that the current tools to solve the issue (insider trading and Early Warning System requirements) and a reporting infrastructure (SEDI and SEDAR) currently exist and have functioned successfully on the acquisition side for decades.

To reduce the contents of this letter to its essence, achieve transparency in short selling and close the safe harbour which now benefits only short sellers and the brokerage firms profiting by lending stock to them by:

1. immediately implementing the same thresholds for abusive short selling that currently exist for acquisitions;
2. extend the marking of all short sale orders under UMIR so that they are reflected in real time on public websites such as the TMX and Stockwatch;
3. prohibit any short sellers from using "#1 Anonymous" on the trades referred to in 2 above to also ensure transparency;
4. reintroduce the uptick rule so as to apply to all short sales; and
5. prohibit any investor that is in a short position from purchasing securities in an offering of the same security or a security that is convertible into the same underlying security.

RESPECTFULLY SUBMITTED THIS 21ST DAY OF FEBRUARY, 2023.

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