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A New Path Forward is Needed to Improve Market Efficiency and Reduce Systemic Risk

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A New Path Forward is Needed to Improve Market Efficiency and Reduce Systemic Risk

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GLOSSARY

Access Person	a person other than a Participant who is a subscriber or user under UMIR
AFS	Australian Financial Services
Allen Committee	Toronto Stock Exchange Committee on Corporate Disclosure
AMF	Autorité des marchés financiers
ASC	Alberta Securities Commission
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commissions Act 2001* (Cth)
ASIC SS Instrument	ASIC Corporations (Short Selling) Instrument 2018/745
AB Act	*Securities Act* (Alberta)
ASC	Alberta Securities Commission
ASC Staff	staff of the ASC
ASX	Australian Securities Exchange
ATS	Alternative Trading System
Australian Corporations Act	*Corporations Act 2001* (Cth)
BC Act	*Securities Act* (British Columbia)
BC Staff	staff of the BCSC
BCSC	British Columbia Securities Commission
Cboe	Cboe Global Markets, Inc.
CCP	central counterparty
CDS	CDS Clearing and Depository Services Inc.
CDNX	Canadian Venture Exchange
CDSX	CDS system in which eligible securities are cleared and deposited
CESR	Committee of European Securities Regulators
CHESS	Clearing House Electronic Subregister System
Clearing House	TSE Clearing House Ltd.
CNQ	Canadian Trading and Quotation System
CNS	CDS' Continuous Net Settlement service
CNS/BNS	overnight batch net settlement process in CDSX
CSA	Canadian Securities Administrators
CSD	central securities depository
CSE	Canadian Securities Exchange
CSPR	Consolidated Short Position Report
CSTA	Canadian Securities Traders Association, Inc.
Danish FSA	Danish Financial Supervisory Authority
DMR	IIROC's Dealer Member Rules
DRS	Direct Registration System
DTC	The Depository Trust Company
EC	European Commission
EC Report	Report to the European Parliament and The Council on the evaluation of the effectiveness of the EU Short Selling Regulation, dated December 13, 2013
EFT	extended failed trade
EFTR	extended failed trade report which must be filed with IIROC
ESMA	European Securities and Markets Authority
ESMA 2013 Report	Technical advice on the evaluation of the EU Short Selling Regulation on June 3, 2013
ESMA 2017 Report	Technical advice on the evaluation of certain elements of the EU Short Selling Regulation, dated December 21, 2017
ETB list	easy to borrow list

ETF	exchange-traded fund
EU	European Union
EU Short Selling Regulation	Regulation (EU) No. 236/2012
Exchange Act	United States *Securities Exchange Act of 1934*
Failed Trade Study	IIROC's *Statistical Study of Failed Trades on Canadian Marketplaces*
FINRA	Financial Industry Regulatory Authority
FPL Program	fully-paid securities lending program
FSA	United Kingdom's Financial Services Authority
ICbCFS	Industry and Commercial Bank of China Financial Services LLC
IDA	Investment Dealers Association of Canada
IIAC	Investment Industry Association of Canada
IIROC	Investment Industry Regulatory Organization of Canada
IIROC Studies	Failed Trade Study and Trends Study
IOSCO	International Organization of Securities Commissions
IOSCO Four Principles	four principles outlined in IOSCO's *Regulation of Short Selling* report in 2009
MWCB	market-wide circuit breaker
NASDAQ	National Association of Securities Dealers Automated Quotation System
NI 23-101	National Instrument 23-101 – *Trading Rules*
NI 23-101CP	Companion Policy to National Instrument 23-101 – *Trading Rules*
NI 24-101	National Instrument 24-101 – *Institutional Trade Matching and Settlement*
NSCC	National Securities Clearing Corporation
NYSE	New York Stock Exchange
OSA	*Securities Act* (Ontario)
OSC	Ontario Securities Commission
OSC Staff	staff of the OSC
Participant	a registered investment dealer who is a member of IIROC
Policy 2.2	policies in connection with UMIR 2.2
Pre-Borrow Security	IIROC designation that imposes pre-borrow requirements on shorting a particular security
Regulation SHO	Regulation SHO
RS	Market Regulation Services Inc.
SEC	US Securities and Exchange Commission
SHO Study	SHO Pilot Project Study
Short Position Report	short position report which must be filed with IIROC
Short Sale Ineligible Security	IIROC designation that prohibits short sales of a particular security
SLAPP	strategic lawsuits against public participation
SME order	short-marking exempt order
SRO	self-regulatory organization
SSCB	single stock circuit breaker
SSTSSR	Short Sale Trading Statistics Summary Report
T	trade date
T2S	TARGET2-Securities
TFT	trade-for-trade
Trends Study	IIROC's *Recent Trends in Trading Activity, Short Sales and Failed Trades for the Period May 1, 2007 to April 30, 2010*
TSE	Toronto Stock Exchange, prior to April 2002
TSX	Toronto Stock Exchange, following April 2002
UMIR	Universal Market Integrity Rules
US	United States of America

1. INTRODUCTION[1]

In the past few years within the capital markets community, few topics of such narrow scope as short selling have led to such diametrically opposed views. The benefits and importance of short selling[2] are beyond dispute. Short selling is critical to the vibrancy of our capital markets – short selling improves liquidity and enhances or facilitates price discovery and market efficiency, and it can also prevent or mitigate market bubbles. However, short selling can also lead to disorderly markets broadly or for a single issuer, through (i) "overshooting" on the downside, which could raise issues of systemic risk[3] or lead to insolvency for companies targeted by short sellers, or (ii) the disruption of trade settlement, particularly where regulatory requirements do not strictly require that shares be borrowed prior to entering into a short sale. Short selling may also be combined with the public disclosure of misleading information[4] and thereby assist in market manipulation or abuse.

In times when there has been a significant drop in stock market prices, particularly where there is a concern regarding systemic risk, Canadian securities regulators, consistent with their mandates,[5] focus on short selling. Each time, they seek to enhance regulations in order to address systemic risk. And each time, once the crisis passes, they seem to revert to ignoring the topic. However, in our current environment, it is not systemic risk that has brought this topic to the forefront; rather, it is the increase in short campaigns or so-called "short activism".[6]

In reviewing data from Activist Insight,[7] it is clear that Canada has seen a general increase in short campaigns since 2015, while generally other jurisdictions have seen a decrease. The statistics are surprising – with more short campaigns in Canada during the four-year period from 2015 to 2018 than probably any other jurisdiction, other than the United States (the "**US**"). To their credit, Canadian regulators have begun to focus on this issue, particularly in respect of so-called "short and distort" campaigns.[8] With Canada becoming a haven for those who wish to pursue short campaigns, and with short selling being an important part of our capital markets, we would suggest that regulators need to review short selling in general. This has led us to analyze the short selling landscape in Canada, along with certain other jurisdictions, and to consider, among other things, whether regulatory changes are required in Canada to enhance market efficiency and integrity, and to lessen systemic risk.

This paper begins with a review of the current Canadian regulations governing short selling, including an outline of the share settlement process in Canada. Next, this paper reviews the legislative and regulatory history of short selling, including relevant commentary that was considered

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[1] At the outset, we should note that the views expressed in this paper are those of the authors and under no circumstances should they be considered to be the views of McMillan LLP, the partners of McMillan LLP who merely reviewed and commented on the paper, or that of McMillan LLP's clients.

[2] A short sale may be viewed simply as the sale of securities the seller does not own at the time of the sale. Generally, it is a transaction in which a market participant sells borrowed securities in anticipation of a price decline; the seller is then required to return an equal number of shares at some point in the future. Shorting, or the economic benefits thereof, may also be undertaken with derivative instruments. In this paper, we focus on short selling effected by the sale of securities.

[3] By systemic risk, we mean the risk of a significant disruption in one or more of the core functions of the financial system caused by the initial failure of one or more firms or a segment of the financial system.

[4] Referred to as "short and distort" schemes or campaigns. See Section 5.1.

[5] For example, the mandate of the Ontario Securities Commission is to "provide protection to investors from unfair, improper or fraudulent practices, to foster fair and efficient capital markets and confidence in capital markets, and to contribute to the stability of the financial system and the reduction of systemic risk: see Ontario Securities Commission, "About" (last visited 10 September 2019), online: *Ontario Securities Commission* <www.osc.gov.on.ca/en/About_about_index.htm>.

[6] We will not be using the term "short activism" to refer to public campaigns launched by persons who believe shares are overpriced and state so after shorting them. Instead, we will use the term "short campaign". Activism means to advance an argument or campaign for the purpose of effecting change in an organization and a short campaign is not focused on such change.

[7] See Section 5.1.

[8] Barbara Shecter "Ontario regulator on the lookout for 'short and distort' campaigns that aim to drive down stock prices" (20 December 2017), online: *Financial Post* <business.financialpost.com/news/fp-street/we-have-to-find-the-right-case-osc-committed-to-scrutinizing-short-selling-but-warns-bar-is-high-for-enforcement-action> [Shecter, *Ontario regulator on the lookout*].

in connection with proposed regulatory changes. Following that, this paper undertakes a comparative analysis of the different approaches taken to short selling in the US, Australia and the European Union (the "**EU**") in order to better understand the strengths and evaluate the effectiveness of the Canadian regime. In light of the current increase in short campaigns, this paper then reviews short campaigns by examining pre-emptive and defensive measures against them, including relevant jurisprudence. Next, this paper considers the issue of "naked" short selling,[9] so as to better understand how such activity can be undertaken and evaluate whether it increases systemic risk in Canada. Additionally, this paper examines empirical studies in respect of short selling and failed trades conducted by the Investment Industry Regulatory Organization of Canada ("**IIROC**") and considers the conclusions of those studies concerning Canadian capital markets. Based on the foregoing, this paper then considers what regulatory changes may assist in enhancing the short selling regime to address issues of market efficiency and integrity, and reducing system risk, which is consistent with the mandate of the Ontario Securities Commission (the "**OSC**").

It should go without saying that banning short selling would be unacceptable and would have dire effects on the capital markets and, accordingly, the Canadian economy. While we see a need for regulators to better address systemic risk in relation to the current short selling regime, there is no doubt that additional restrictions on short selling, even for the purpose of reducing systemic risk, must be carefully thought through and drafted so as not to curtail liquidity, which is a critical issue in the relatively small Canadian capital markets. Keeping these factors in mind, this paper concludes by outlining recommendations for changes that we believe are necessary to improve investor confidence and market efficiency while appropriately reducing systemic risk. Our hope is that the recommendations set out in this paper will, at the very least, ignite a healthy debate on the regulatory regime governing short selling in Canada and will eventually lead to much needed reform.

[9] See section 6.1.

2. CANADIAN REGULATIONS ON SHORT SELLING

IIROC's Universal Market Integrity Rules ("**UMIR**"), which apply to registered investment dealers that are members of IIROC ("**Participants**") and other persons such as "Access Persons" (as defined in UMIR, "**Access Persons**"),[10] largely govern short selling in Canada. Additionally, provincial and territorial securities legislation, which applies more broadly to all persons and companies operating within the Canadian market, contains regulations related to short selling.[11] Furthermore, the rules, policies and procedures of CDS Clearing and Depository Services Inc. ("**CDS**"), provincial and territorial securities regulators and the Canadian stock exchanges may be applicable to market participants engaging in short selling.

The regulations dealing with short selling are primarily related to three areas:

(1) designation and identification of short sales;
(2) reporting short positions; and
(3) restrictions on short sales.

In addition to UMIR, the settlement of short sales is subject to the rules, policies and procedures of CDS.

2.1 Designation and Identification of Short Sales

2.1.1 Ontario Securities Legislation

The declaration of short sales is generally required under securities laws in every jurisdiction in Canada.[12] Section 48 of the *Securities Act* (Ontario)[13] (the "**OSA**") requires that, when entering into a short sale, the short seller must declare to the registered dealer effecting the trade that he, she or it does not own the security being sold.[14] However, the OSA is silent on the definition of the word "own" for the purposes of section 48.

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[10] "Participant" is defined as: (a) a dealer registered in accordance with securities legislation of any jurisdiction and who is: (i) a member of an exchange, (ii) a user of a quotation and trade reporting system (a "**QTRS**"), or (iii) a subscriber of an alternative trading system (an "**ATS**"); or (b) a person who has been granted trading access to a marketplace and who performs the functions of a derivatives market maker. "Access Person" is defined as a person other than a Participant who is: (a) a subscriber; or (b) a user: see *Definitions*, Universal Market Integrity Rule 1.1, online: *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/industry/rulebook/Documents/UMIR0101_en.pdf> [*UMIR 1.1*]. The term "subscriber" means, for an ATS, a person or company that has entered into a contractual agreement with the ATS to access the ATS for the purpose of effecting trades or submitting, disseminating or displaying orders on the ATS, and the person or company's representatives. "User" means, for a recognized QTRS, a person or company that quotes orders or reports trades on the recognized QTRS, and the person or company's representatives: see also *Marketplace Operation,* OSC NI 21-101 (as consolidated 1 February 2017), online (pdf): *Ontario Securities Commission* <www.osc.gov.on.ca/documents/en/Securities-Category2/ni_20170201_21-101_unofficial-consolidation-forms-cp.pdf>.

[11] In addition, section 130(1) of the *Canada Business Corporations Act*, RSC 1985, c C-44 prohibits an insider of a public company from knowingly short selling, directly or indirectly, securities of the company.

[12] See legislation requiring declaration of short position for all provinces: Ontario (*Securities Act*, RSO 1990, c S-5, s 48); Alberta (*Securities Act*, RSA 2000, c S-4, s 103); British Columbia (*Securities Act*, RSBC 1996, c 418, s 56); Manitoba (*Securities Act*, RSM 1988, c S50, s 78); New Brunswick (*Securities Act*, SNB 2004, c S-5.5, s 67); Newfoundland and Labrador (*Securities Act*, RSN 1990, c S-13, s 49); Northwest Territories (*Securities Act*, SNWT 2008, c 10, s 161); Nunavut (*Securities Act*, SNu 2008, c 12, s 161); Nova Scotia (*Securities Act*, RSNS 1989, c 418, s 54); Prince Edward Island (*Securities Act*, SPEI 2007, c 17, s 161); Québec (*Securities Act*, CQLR, c V-1.1, s 194); Saskatchewan (*The Securities Act*, SS 1988-89, c S-42.2, s 54); Yukon (*Securities Act*, SY 2007, c 16, s 161). In this paper, we focus only on securities legislation in Ontario and do not discuss similar legislation in the other provinces or territories of Canada, unless directly applicable to jurisprudence being reviewed.

[13] *Securities Act*, RSO 1990, c S-5 [*OSA*].

[14] Section 48 of the *OSA* provides that "any person or company who places an order for the sale of the security through an agent acting for him, her or it that is registered dealer and who (a) at the time of placing the order, does not own the security; or (b) if acting as agent, knows the principal does not own the security, shall, at the time of placing the order to sell, declare to the agent that he, she or it or the principal […] does not own the security".

In *R v. Kentish*,[15] the Ontario County Court attempted to interpret ownership for the purpose of section 79(a) of the OSA, the predecessor provision to section 48 of the OSA.[16] The case considered whether the holder of an unexercised option to purchase a security would be considered to "own" the security for the purpose of covering a short sale, such that the seller would not need to declare non-ownership of the security. The court stated that the concept of ownership was a question of "mixed fact and law" and that, in any particular case, its meaning would "depend upon the context in which it is used".[17] The court found that the object and intention of section 79 was to ensure that a short sale was made on the "uptick"[18] and that shares in a short sale could not "be sold in such a way as artificially to drive down the price of shares enabling the short sellers to cover short sales by purchasing in the market at the lower price".[19]

The court in *Kentish* ruled that holding an unexercised option to purchase shares could be considered ownership of the underlying shares. As a result, the failure to disclose that a seller merely held an option at the time of placing the sale did not necessarily amount to a breach of section 79 of the OSA. In *Kentish*, the court reasoned that because the short seller was not obliged to enter the market (since he could deliver the shares by exercising his option), he was "not involved in artificially driving down the price of a share".[20] However, in light of the fact that the option holder did in fact enter the market to cover his short sale and there was a question as to whether he held a valid option, there has been some debate as to the correctness of this decision.[21]

The concept of ownership for the purpose of declaring short sales was subsequently revisited in a decision by the OSC. In *Robinson*,[22] staff of the OSC ("**OSC Staff**") alleged that two individuals contravened section 48 of the OSA by conducting undeclared short sales. OSC Staff claimed that the respondents executed short sales involving 2,000,000 shares of Typhon Industries Limited ("**Typhon**") without declaring they did not own the shares. The respondents owned 500,000 shares of Typhon and had an absolute and unconditional right to an additional 500,000 shares upon the exercise of warrants held by the respondents.[23] The respondents were also entitled to an additional 1,200,000 shares as a result of another transaction[24] (the "**Canterra Transaction**") that was paid for on the day of the short sale. The respondents argued that the sales were not technically "short sales" but "covered shorts" that were not reportable as short sales based on the then-owned shares and the ones they were entitled to.[25] The issue turned on whether the warrants and entitlements

[15] *R v Kentish* (1979), 23 OR (2d) 746, 1979 CarswellOnt 923 [*Kentish* cited to CarswellOnt].
[16] Section 79(a) of the *Securities Act*, RSO 1970, c 426 provided: "[a]ny person or company who places an order for the sale of a security through an agent acting for him that is registered for trading in securities and, (a) at the time of placing the order, does not own the security; or (b) if acting as agent, knows his principal does not own the security, shall, at the time of placing the order to sell, declare to his agent that he or his principal […] does not own the security".
[17] *Kentish, supra* note 15 at para 44.
[18] *Kentish, supra* note 15 at para 53. Entering a short sale order on an "uptick", which at the time was required, means that, in broad terms, a short sale cannot be made at less than the price of the security in the previous transaction of that security. This is commonly referred to as the "tick test" or an "uptick rule".
[19] *Kentish, supra* note 15 at para 51.
[20] *Kentish, supra* note 15 at para 54.
[21] Borden Ladner Gervais LLP, *Securities Law and Practice*, 3rd ed, (Toronto: Thomson Reuters Canada, 1988, loose-leaf). Trading in Securities and Derivatives Generally: Declaration of Short Sales Section 48, §13.10.1, online: *WestlawNext Canada* (accessed 2 September 2019).
[22] *Re Robinson* (1996), 19 OSCB 2643, 1996 CarswellOnt 5458 [*Robinson* cited to CarswellOnt]. This case had multiple breaches of the OSA, including the entering of undeclared short sales contrary to section 48 of the OSA, and also involved non-compliance of section 11.27 of the TSE General By-law.
[23] *Ibid* at para 259.
[24] Typhon purchased a 50% interest in a corporation known as Diversified Store Fixtures, Inc. from Canterra Industries Limited. The consideration for the purchase included 600,000 shares of Typhon and an option to acquire 600,000 more shares. The agreement stated that the share certificate and option were to be issued on the closing date, and one of the respondents was the purchaser in this transaction: see *ibid*.
[25] *Ibid*.

were sufficient such that the respondents "owned" the 1,700,000 shares for the purpose of section 48 of the OSA.[26]

In considering the context to be applied to the concept of ownership for the purpose of section 48 of the OSA, the OSC focused on the purpose of the legislative section:

> The purpose behind section 48 of the [OSA] is essentially two-fold. First, section 48 requires a person to inform his or her broker that the person is selling short so the broker can make necessary arrangements for settlement of the transaction. In this connection, a broker might refuse to accept an order for a short sale where it appears that there will be no stock available to borrow to settle the trade. Second, in the case of an exchange trade, section 48 [of the OSA] requires a person to inform his or her broker of a short sale so the broker can be in a position to comply with the [Toronto Stock Exchange]'s short selling rules.[27]

The OSC concluded that the respondents had not exercised the warrants to the 500,000 shares when they placed their orders to sell, and moreover, there was no evidence that they exercised the warrants in time to deliver the securities on or before the settlement date.[28] Therefore, the OSC concluded that the respondents did not own these shares for the purpose of section 48 of the OSA. Further, the OSC concluded that the respondents did not own the 1,200,000 additional shares that were the subject of the Canterra Transaction at the time of the short sale because the shares would be delivered to the respondents only if and when the transaction closed.[29] Accordingly, the OSC found the respondents to have made undeclared short sales in violation of section 48 of the OSA.

Prior to undertaking its analysis, the OSC examined the definition of ownership under subsection 11.27(5) of the then-applicable Toronto Stock Exchange (the "**TSE**" or, following April 2002, the "**TSX**") General By-law[30] in its consideration of the definition of "own" under section 48 of the OSA. The OSC found that while the TSE's definition "may be reflective of the meaning that should be attributed to the word "own" for the purpose of section 48 of the [OSA]", it was "not necessarily definitive".[31] Nevertheless, it is clear from the reasoning that was adopted by the OSC that the TSE's short selling rule served as a guiding light.

In 2002, UMIR was adopted as the standard set of trading rules applicable to the TSX and replaced the then-applicable rules and policies of the exchange, including the TSE General By-law.[32] The

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[26] *Ibid* at para 260.
[27] *Ibid* at para 264.
[28] *Ibid* at para 265.
[29] *Ibid* at para 266.
[30] Subsection 11.27(5) of the TSE General By-law provided that a person is deemed to own a security for the purpose of the TSE's short selling rule if, "(a) he, directly through his agent, has title to it; (b) he has purchased or has entered into an unconditional contract, binding on both parties, to purchase it but has not yet received it; (c) he owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange or has issued irrevocable instructions to convert or exchange such security; (d) he has a written option to purchase or acquire it and has exercised such option; (e) he has rights or warrants to subscribe to it and has exercised such rights or warrants; (f) he is making a sale of the security for an arbitrage account, or an option market-maker account, provided he knows or has reasonable grounds to believe that an offer enabling him to cover such sale is then available to him and he intends to accept such offer immediately; or (g) he is making a sale of the security and he owns another security by virtue of which he is currently entitled to acquire an equivalent number of securities of the same class as the securities sold; provided such sale or the purchase which such sale offsets, is effected for the purpose of profiting from a current difference between the price of the security sold and the security owned": see *ibid* at para 261.
[31] *Robinson, supra* note 22 at para 262.
[32] The TSX and the Investment Dealers Association of Canada jointly established Market Regulation Services Inc., the predecessor to IIROC, as a new independent securities trading regulatory body in 2002. Market Regulation Services Inc., in its role as a regulation services provider, began administering UMIR upon its implementation on April 1, 2002: see *Regulation Services Notice 2002-051 – Transfer of Functions,* Toronto Stock Exchange, (28 February 2002) at 1, online (pdf): *TMX Group Limited* <apps.tmx.com/en/pdf/notices/28Feb-RSTransferofFunctions-051.pdf>.

meaning of "own" that was set out in the TSE General By-law is substantially similar to the concept of "own" in UMIR (see Section 2.1.2.1).

2.1.2 UMIR

Similar to the disclosure required under section 48 of the OSA, a Participant or Access Person is prohibited from entering into a short sale, unless the sale is designated as a short sale or a "short-marking exempt order" (an "**SME order**") under UMIR.[33]

2.1.2.1 Short Sale

A short sale is defined in UMIR as the following:

> a sale of a security, other than a derivative instrument, which the seller does not own either directly or through an agent or trustee and, for this purpose, a seller shall be considered to own a security if the seller, directly or through an agent or trustee:
>
> > (a) has purchased or has entered into an unconditional contract to purchase the security, but has not yet received delivery of the security;
> >
> > (b) owns another security that is convertible or exchangeable into that security and has tendered such other security for conversion or exchange or has issued irrevocable instructions to convert or exchange such other security;
> >
> > (c) has an option to purchase the security and has exercised the option;
> >
> > (d) has a right or warrant to subscribe for the security and has exercised the right or warrant; or
> >
> > (e) has entered into a contract to purchase a security that trades on a when issued basis and such contract is binding on both parties and subject only to the condition of issuance or distribution of the security,
>
> but a seller shall be considered not to own a security if:
>
> > (f) the seller has borrowed the security to be delivered on the settlement of the trade and the seller is not otherwise considered to own the security in accordance with this definition;
> >
> > (g) the security held by the seller is subject to any restriction on sale imposed by applicable securities legislation or by an [e]xchange or [recognized quotation and trade reporting system] as a condition of the listing or quoting of the security; or
> >
> > (h) the settlement date or issuance date pursuant to:
> >
> > > (i) an unconditional contract to purchase,

[33] See *Prohibition on the Entry of Orders*, Universal Market Integrity Rule 3.2, online: *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/industry/rulebook/Documents/UMIR0302_en.pdf> [*UMIR 3.2*]. See also *Designations and Identifiers*, Universal Market Integrity Rule 6.2, online: *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/industry/rulebook/Documents/UMIR0602_en.pdf> [*UMIR 6.2*].

(ii) a tender of a security for conversion or exchange,

(iii) an exercise of an option, or

(iv) an exercise of a right or warrant

would, in the ordinary course, be after the date for settlement of the sale.[34]

All short sales must be marked as a short sale at the time the order is placed, unless the short sale qualifies as an SME order and is marked with the SME order designation.[35]

2.1.2.2 Short Marking Exempt Order Designation

The SME order designation is used to identify orders for the purchase or sale of a security from certain types of accounts. In particular, the designation is meant to isolate the trading activity of accounts that are actively buying and selling a particular security while maintaining a "directionally neutral"[36] position, such as arbitragers, market makers and high-frequency traders.[37] All orders from such accounts, whether in respect of a purchase or sale, are marked with an SME order designation, providing a mechanism for IIROC to separately monitor "directional" [38] and "directionally neutral" short trading activities.[39] The SME order designation effectively allows IIROC to focus on monitoring short sale activity from "directional" accounts,[40] which take a true short position in a particular security with the aim of realizing gains from a decrease in the price of such security.

UMIR initially set out four types of accounts from which orders must be marked with the SME order designation:[41] (i) arbitrage accounts, (ii) accounts of persons with Marketplace Trading Obligations, (iii) "high-frequency" trading accounts, and (iv) principal accounts used exclusively for "facilitation" purposes. An arbitrage account is an account in which the holder makes a usual practice of buying and selling either securities in different markets to take advantage of differences in prices available in each market, or securities that are or may become convertible or exchangeable into other securities to take advantage of the price difference between them.[42] An account of a person with Marketplace Trading Obligations[43] is a market maker account used to provide a certain level of liquidity in respect of a security for which that person has obligations. The SME order designation is also applicable to orders from a client, non-client or principal account for which the order generation and entry are fully automated and which, in the ordinary course, does not have more than a nominal

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[34] *UMIR 1.1 supra* note 10. See definition of "Short Sale".
[35] *UMIR 3.2 supra* note 33 at (1) and (2).
[36] An account is "directionally neutral" when the account generally only has a nominal position (long or short) at the end of a trading day in any particular security: see *Rules Notice – Request for Comments – Updated Guidance on "Short Sale" and "Short-Marking Exempt" Order Designations,* IIROC Notice 15-0155 (16 July 2015) at 3, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2015/157fe498-61a3-4af1-8db5-185b828aa3ab_en.pdf> [*IIROC Notice 15-0155*].
[37] *Ibid.*
[38] A "directional" position refers to an investment strategy that aims to realize gains from the increase or decrease of the price of a particular security, with a long or a short position, respectively: see Akhilesh Ganti, "Directional Trading" (28 February 2018), online: *Investopedia* <www.investopedia.com/terms/d/directionaltrading.asp>.
[39] *IIROC Notice 15-0155 supra* note 36 at 3.
[40] *Ibid.*
[41] *Rules Notice – Notice of Approval – Amendment to the Short-marking Exempt Order Definition*, IIROC Notice 16-0028 (11 February 2016) at 5, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2016/e2d02ba0-8e7d-4ddd-b1fb-258c43fcebaa_en.pdf > [*IIROC Notice 16-0028*].
[42] See *UMIR 1.1 supra* note 10 for definition of an "arbitrage account".
[43] "Marketplace Trading Obligations" means "obligations imposed by: (a) Marketplace Rules on a member or user or a person employed by a member or user to guarantee: (i) a two-sided market for a particular security on a continuous or reasonably continuous basis, or (ii) the execution of orders for the purchase or sale of a particular security which are less than a minimum number of units of the security as designated by the marketplace; or (b) a contract between a marketplace and a member, user or subscriber to guarantee the execution of orders for the purchase or sale of a particular security which are less than a minimum number of units of the security as stipulated by the terms of the contract provided such number is less than one standard trading unit and the orders for the member, user or subscriber are automatically generated by the trading system of the marketplace": see *ibid.*

position (whether long or short) in the particular security at the end of each trading day.[44] The persons in this category are generally referred to as "high-frequency traders".[45] Finally, the designation is applicable to orders from a principal account that has acquired a position during a trading day in a particular security in a transaction with a client that is unwound during the balance of the trading day such that, in the ordinary course, the account does not have more than a nominal position – whether short or long – in a particular security at the end of each trading day.[46]

In 2016, UMIR was amended[47] to broaden the definition of an SME order to include an order for an Exempt Exchange-traded Fund[48] or one of its underlying securities for the principal account of a Participant that: (i) has Marketplace Trading Obligations[49] for the Exchange-traded Fund ("**ETF**") security; or (ii) has entered into an agreement with the ETF issuer to maintain a continuous distribution of the ETF, and the account used for this purpose at the end of each trading day has no more than a "minimal exposed risk".[50] IIROC has stated that the expansion of the SME order definition simplifies and promotes uniform SME order-marking standards for ETF market makers engaging in similar activities (to other short-marking exempt eligible accounts), assists in preserving the integrity of short selling data used and published by IIROC, and avoids unnecessary administrative burden to the ETF market-making function.[51]

2.2 Reporting Requirements

2.2.1 Short Positions and Trade

UMIR 10.10 requires each Participant and Access Person to prepare and file a short position report with IIROC[52] twice monthly (the "**Short Position Report**"),[53] reporting the aggregate short position

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[44] IIROC wrote "as a general guideline, IIROC would accept that an account with automated order generation and entry or a principal facilitation account would satisfy the requirements necessary to designate orders as "short-marking exempt" if the account is to be "directionally neutral" on the price of securities traded. IIROC would accept this to be the case if on approximately 90% of the trading days in the previous month, the aggregate net position of the account in respect of any security at the end of the trading day, whether short or long, did not exceed 5% of the volume of that security traded by the account on that trading day": see *Rules Notice Guidance – Updated Guidance on "Short Sale" and "Short-Marking Exempt" Order Designations,* IIROC Notice 16-0029 (11 February 2016) at 7–8, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2016/82ac4923-e4ec-486c-8a86-540fea08a63f_en.pdf > [*IIROC Notice 16-0029*].

[45] "High-frequency trader" is not defined in UMIR. "However, IIROC would expect that a "high-frequency trader" would have direct electronic access to more than one marketplace to execute fully automated trading strategies that seek to benefit from liquidity imbalances or other short-term pricing inefficiencies and the trading strategy is generally directionally neutral or closed out by the end of each trading day": see *IIROC Notice 15-0155 supra* note 36 at footnote 5.

[46] See *IIROC Notice 16-0029 supra* note 44 at 4–5. For principal accounts which are used exclusively for "facilitation" purposes, there is no requirement that order generation and entry be automated but IIROC would expect that the account be "directionally neutral" such that on 90% of the trading days in the previous month, the aggregate net short position of the account in respect of any security at the end of the trading day, whether short or long, did not exceed 5% of the volume of that security traded by the account on that trading day: see *IIROC Notice 15-0155 supra* note 36 at 7–8.

[47] *IIROC Notice 16-0028 supra* note 41.

[48] An "Exempt Exchange-traded Fund" is "a mutual fund for the purposes of applicable securities legislation, the units of which: (a) are a listed security or a quoted security; and (b) are in continuous distribution in accordance with applicable securities legislation but does not include a mutual fund that has been designated by the [an exchange, a recognized QTRS, and the regulation services provider] to be excluded from this definition": see *UMIR 1.1 supra* note 10.

[49] See fn 43 for the definition of 'Marketplace Trading Obligations'.

[50] An account with a "minimal exposed risk" is "fully hedged" by holding, for example, over a period of time, a position in a security to attempt to fully offset risk assumed on a prior purchase or sale or to be assumed on a subsequent purchase or sale of that security or a related security: see *IIROC Notice 16-0028 supra* note 41 at footnote 2.

[51] *Ibid* at 1–2.

[52] Short Interest Reports used to be provided to stock exchanges. IIROC announced on March 22, 2018, in *IIROC Notice 18-0062* that, starting November 30, 2018, participants would cease reporting to the stock exchanges and the Short Position Reports must be filed directly with IIROC, pursuant to the new guidelines: see *Rules Notice – Technical – Short Position Calculating and Reporting*, IIROC Notice 18-0062 (22 March 2018), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2018/90444c68-d1db-443a-b53a-660d0cdeaf96_en.pdf> [*IIROC Notice 18-0062*].

[53] The short position is calculated as of the 15th day and the last day of each month and the Short Position Report must be filed within two trading days following the calculation date: see *Rules Notice – Guidance Note – Guidance on Short Position Calculation and Reporting*, *IIROC Notice 17-0241* (15 December 2017) at 2, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2017/85c557c2-c63e-4071-9211-2f03539c1e2f_en.pdf> [*IIROC Notice 17-0241*].

of each individual account in respect of each listed and quoted security. The reporting party must calculate the short position from each account separately.[54] IIROC then aggregates the data provided in the Short Position Reports to publicly report short positions on a per security basis.

IIROC publishes the following two reports with respect to short interests: (i) the Consolidated Short Position Report (the "**CSPR**") and (ii) the Short Sale Trading Statistics Summary Report (the "**SSTSSR**"). The CSPR provides, on a per security basis, the aggregate short position as of the reporting date and the net change in the short position from the previous reporting date of all listed and quoted securities. The SSTSSR provides information with respect to short selling in proportion to total trading activity for the given time period and displays the following for each listed and quoted security: (i) the number of short sale trades and such number as a percentage of the total number of trades; (ii) the volume of short sale trades and such number as a percentage of total traded volume; and (iii) the value of short sale trades and such number as a percentage of total traded value.

Neither the CSPR nor the SSTSSR include any information about individual Participant accounts, client accounts or individual trades. Both reports contain aggregated gross short positions and gross trades, not net positions or trades.[55] Both reports are prepared and published semi-monthly by IIROC, typically a few days after Participants file the Short Position Reports with IIROC. The key difference between the CSPR and the SSTSSR is that the former contains position information and the latter contains trade information. The information in one report does not, and is not expected to, reconcile information in the other. The two reports differ in the way that data is collected. The CSPR is prepared based on the short positions submitted to IIROC by Participants and Access Persons through the Short Position Reports. In contrast, the SSTSSR is prepared based on the trades marked "short sale" supplied to IIROC by each marketplace. A short sale that is designated as an SME order does not appear on either report; as such, only trades that are designated solely as a "short sale" will be included in the data made public by IIROC.

2.2.2 Extended Failed Trade Reports

Under UMIR 7.10, Participants and Access Persons are required to report all extended failed trades ("**EFTs**") to IIROC through an extended failed trade report (an "**Extended Failed Trade Report**" or "**EFTR**").[56] With regard to a short sale, the Participant or Access Person that entered the order on a marketplace must notify IIROC if, within 10 trading days following the settlement date contemplated on the execution of a failed trade, the account failed to (i) make available securities in such number and form or (ii) make arrangements to borrow securities in such number and form, in either case as to permit the settlement of the trade on the contemplated settlement date, and the account has not made available such securities or has not made arrangements for the borrowing of such securities.[57] The Participant or Access Person, as the case may be, must also provide notice to IIROC once the account makes the relevant securities available or arranges to borrow the securities.[58]

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[54] *Ibid.*

[55] The CSPR provides net change in the number of shares sold short measured against the prior report of each listed or quoted security. However, this data does not provide insight into net short positions.

[56] The requirement to file an EFTR with respect to trades executed on a marketplace that were to settle through the CNS (defined in Section 2.4.5.2) facility of CDS became effective on June 1, 2011. The requirement to file an EFTR with respect to trades executed on a marketplace that were to settle through the TFT (defined in Section 2.4.5.2) facility of CDS became effective on April 15, 2013: see *Rules Notice – Technical UMIR – Implementation Date for Reporting 'Trade-for-Trade' Extended Failed Trades*, IIROC Notice 13-0014 (14 January 2013), online (pdf): <*Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2013/63c078e6-6424-40aa-af27-1a9cd639e702_en.pdf> [*IIROC Notice 13-0014*].

[57] *Extended Failed Trades,* Universal Market Integrity Rule 7.10 at (1), online: *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/industry/rulebook/Documents/UMIR0710_en.pdf>

[58] *Ibid* at (2).

IIROC has stated that these reports assist the organization in evaluating whether a trade has failed to settle for an "improper" reason, such as an undeclared or naked short sale.[59]

The presence of a large number of failed trades may be a consideration for IIROC in deciding to place restrictions on the short selling of relevant securities. IIROC may impose pre-borrowing requirements for short trades in specific securities by requiring that a short sale may not be executed without the Participant or Access Person having made arrangements to borrow the securities necessary to settle the resulting trade (see Section 2.5.2). Note that such pre-borrowing requirements are imposed on a Participant or Access Person, acting as principal, in respect of a specific security where there has been an EFTR in respect of that security, or, in certain circumstances, on a client where such client of a Participant or Access Person has executed a trade that led to an EFTR in respect of any securities (see Section 2.5.2).

Additionally, IIROC may designate a security or class of securities as being a "Short Sale Ineligible Security".[60] As a result, these securities cannot be shorted (see Section 2.5.3). IIROC may make such a designation for one or more trading days if there is an unusual number or pattern of failed trades, and the number or pattern of failed trades is related to short selling and it is in the interest of maintaining fair and orderly capital markets.[61] We understand that, to date, IIROC has not designated any security as being short sale ineligible.

In effect, repeated EFTs in an individually listed or quoted security may cause IIROC to temporarily designate a certain security as a "Pre-Borrow Security" or, in the extreme, a "Short Sale Ineligible Security" to rectify a surge of failed trades.[62]

2.3 Margin Requirements

Short sales may only be made from margin accounts. IIROC's Dealer Member Rules ("**DMR**") prescribes margin requirements for both dealer members of IIROC and their customers with respect to short positions.[63] The margin is used for collateral on the short sale with respect to the initial trade and to provide sufficient collateral following the trade as the sale is being made without the short seller being in possession of the sold securities.

The amount of margin required is dependent on the market value of the securities sold short. DMR 100.2(f)[64] sets out the initial margin requirements for short sales of most securities listed on a Canadian or US stock exchange. The minimum credit required for securities selling at: (i)$2.00 or

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[59] *Rules Notice – Notice of Approval – Provisions Respecting Short Sales and Failed Trades,* IIROC Notice 08-0143 (15 October 2008) at 14, online (pdf): Investment Industry Regulatory Organization of Canada <www.iiroc.ca/Documents/2008/2ABBC107-41D7-4B8D-95D4-C15B07BA25EC_en.pdf> [*IIROC Notice 08-0143*].
[60] *Ibid* at 10.
[61] *UMIR 1.1, supra* note 10 at Policy 1.1 Part 4.
[62] *Rules Notice – Notice of Approval – Provisions Respecting Regulation of Short Sales and Failed Trades,* IIROC Notice 12-0078 (2 March 2012) at 11, online (pdf): *Investment Industry Regulatory Organization of Canada* <docs.iiroc.ca/DisplayDocument.aspx?DocumentID=7026F16880C345EAA63555B8802DBBAF&Language=en> [*IIROC Notice 12-0078*].
[63] Margin is also required for long positions, i.e., purchases, made from a margin account.
[64] Effective June 1, 2020, IIROC will repeal the existing DMR and implement the Dealer Member Plain Language Rule Book (the "**PLR Rule Book**"). Rule 5310 of the PLR Rule Book sets out the basic margin requirement for short positions. The minimum margin required for securities with a market value of: (a) $2.00 or more per share and qualifying for inclusion on the List of Securities Eligible for Reduced Margin published by IIROC is 25% for dealer member positions, and 30% for client positions; (b) $2.00 or more per share, other than positions in (a), is 50%; (c) $1.75 per share to $1.99 per share is 60%; (d) $1.50 per share to $1.74 per share is 80%; (e) $0.25 per share to $1.49 per share is 100%; and (f) below $0.25 per share is $0.25 per share: see *Rules Notice – Notice of Approval/Implementation – IIROC Dealer Member Plain Language Rule Book Implementation,* IIROC Notice 19-0144 (22 August 2019) at 1, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/documents/2019/20d0e74a-6c98-4762-bbee-0221608986c3_en.pdf>. See also *Rules Notice – Notice of Approval/Implementation– Implementation of IIROC Dealer Member Plain Language Rule Book*, IIROC Notice 19-0144 (22 August 2019) at Appendix 2, IIROC Rules (Clean) Rule 5310, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/documents/2019/4849f324-cca1-476d-aa99-d6eb3a67f3e4_en.pdf>.

higher is 150% of the market value of the share, (ii) $1.50 to $1.99 is $3 per share, (iii) $0.25 to $1.49 is 200% of the market value of the share, and (iv) below $0.25 is the market value of the share plus $0.25 per share.[65] Maintenance margin is required when the amount of the margin provided falls below the requisite percentage or amount, for example as a result of the market price of the shares short sold increasing, calculated at least daily.

Certain securities are eligible for reduced margin, including those set out in the IIROC's List of Securities Eligible for Reduced Margin, which IIROC produces quarterly.[66] For such eligible securities, the margin required from dealer members is 25% of the market value of the securities short sold,[67] and from their customers is 30% of the market value of the securities short sold.[68]

The margin requirements ensure that there is capital to purchase shares to return to the lender if the short sale must be closed out. A broker will pay interest on the cash margin provided but not on the proceeds of sale and, in practice, this interest is just deducted from the amount paid by the customer to borrow the securities.

2.4 Settlement Regime

2.4.1 CSA Instruments

A number of Canadian Securities Administrators ("**CSA**") instruments and policies regulate trading and settlement. Pursuant to National Instrument 24-101 – *Institutional Trade Matching and Settlement* ("**NI 24-101**"), a registered dealer cannot execute a trade unless the dealer has established, maintains and enforces policies and procedures designed to facilitate the settlement of the trade[69] "on a date that is no later than the standard settlement date for the type of security traded prescribed by [a self-regulatory organization] or the marketplace on which the trade would be executed."[70]

NI 24-101 does not set out a specific standard settlement period[71] and instead allows the self-regulatory organization (the "**SRO**") or marketplace to determine what is appropriate.[72] As such, the settlement rules in Canada have been established by IIROC.

2.4.2 IIROC Dealer Member Rules

IIROC mandates a settlement cycle of two business days following the day the trade was executed, or T+2, for all trades of equity securities, unless alternative terms of settlement are agreed upon in

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[65] In calculating the margin required when such amount is set out as a percentage of market value, up to 100% of the market value is comprised of the proceeds from the short sale of the security, with the remaining amount of the margin requirement to be provided by the short seller.
[66] See *Margin Requirements* Investment Industry Regulatory Organization of Canada Dealer Member Rule 100 at Rule 100.12(a)(i), online (pdf): Investment Industry Regulatory Organization of Canada <www.iiroc.ca/Rulebook/MemberRules/Rule00100_en.pdf> [*DMR 100*].
[67] *Ibid* at 100.12(a).
[68] *Ibid* at 100.2(f)(vi).
[69] *Institutional Trade Matching and Settlements*, OSC NI 24-101 (as consolidated 5 September 2017) at s 3.1(1), online (pdf): <www.osc.gov.on.ca/documents/en/Securities-Category2/csa_20180130_24-101_ni-trade-matching.pdf> [*NI 24-101*].
[70] *Ibid* at s 7.1(1).
[71] However, note that a number of provisions of NI 24-101 are aligned with the settlement cycle currently in place. As such, when Canada moved from a T+3 settlement to a T+2 settlement on September 5, 2017, amendments to NI 24-101, among other CSA instruments, came into effect to facilitate such change: see *Amendments to National Instrument 24-101 Institutional Trade Matching and Settlement and Changes to Companion Policy 24-101CP to National Instrument 24-101 Institutional Trade Matching and Settlement*, (2017) 40 OSCB 3941 (27 April 2017), online (pdf): *Ontario Securities Commission* <www.osc.gov.on.ca/documents/en/Securities-Category2/csa_20170427_24-101_trade-matching.pdf>.
[72] *NI 24-101, supra* note 69 at s 7.1(1).

writing at the time the trade is entered into.[73] Under IIROC rules, dealer members must not accept an order from a customer pursuant to an arrangement whereby the payment of securities purchased or the delivery of securities sold is to be made to or by the customer's settlement agent, unless the dealer member has followed certain procedures designed to facilitate the affirmation and settlement of the trade.[74]

2.4.3 Exchanges

Subject to certain limited exceptions, Canadian exchanges require that trades be settled on T+2.[75]

2.4.4 CDS

The Canadian Depository for Securities Limited acts as Canada's depository and a clearing and settlement agency for eligible securities. It is owned by TMX Group Inc. and provides its services for Canadian equity, fixed income and money markets through CDS, its wholly owned subsidiary.[76]

CDS moved to a T+2 settlement cycle on September 7, 2017.[77] CDS's settlement process is described in more detail in Section 2.4.5.

2.4.5 CDS Settlement Services

2.4.5.1 Eligibility

CDS has set out standards for eligibility as a participant in its settlement services.[78] At minimum, the participant must be a regulated entity and, if applicable, a member in good standing of an SRO.[79] For the purposes of fulfilling their obligations to CDS and to other participants, all participants must be able to demonstrate certain basic abilities, including having financial ability, sufficient personnel and operational capabilities.[80]

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[73] Pursuant to DMR 800, "[a]ll transactions are to be consummated upon the following regular delivery terms unless at the time each individual transaction takes place alternative terms are agreed upon and confirmed in writing: […] (c) [i]n the case of Government of Canada Bonds and Government of Canada Guaranteed Bonds having an unexpired term to maturity of longer than three years (where such a bond is traded at a premium the earliest call date shall be treated as the maturity date) and all provincial, municipal, corporation and other bonds or debentures, stock, or other certificates or indebtedness including (subject to clause (f)) mortgage-backed securities, regular delivery shall involve the stopping of accrued interest, where applicable, on the second clearing day after the transaction takes place": see *Trading and Delivery,* Investment Industry Regulatory Organization of Canada Dealer Member Rule 800 at Rule 800.27, online: *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Rulebook/MemberRules/Rule00800_en.pdf.>.
[74] *Ibid* at Rule 800.31(a).
[75] Rules 5-103(1) of the TSX Rule Book provides that "[TSX] trades in securities shall settle on the second Settlement Day after the trade date, unless otherwise provided by the [TSX] or the parties to the trade by mutual agreement.": see *Clearing and Settlement of Trades in Securities*, Toronto Stock Exchange Rule 5, online: *TSX.com* <www.tsx.com/resource/en/1464> [*TSX Rule 5*]. Rule C.3.03 of the TSX Venture Exchange (the "**TSXV**") Rule Book provides that "[o]n all trades in securities executed on the [TSXV], except those specifically designated as cash trades, delivery and payment shall be made through [The Canadian Depository for Securities Limited and/or any other securities clearing corporation to be designated by or acceptable to the TSXV] unless authorized by the [TSXV].": see also *Clearing and Settlement of Trades of Securities,* Toronto Stock Exchange Venture Exchange Rule C 3, online: *TSX.com* <www.tsx.com/resource/en/1465> [*TSXV Rule C3*]. Similarly, Rule 5-103(1) of the Canadian Securities Exchange Trading Rules mandates a settlement cycle of two days, unless otherwise provided by the [e]xchange or mutually agreed by the parties: see also *Clearing and Settlement of Trades*, Canadian Securities Exchange Trading Rules and Regulations Rule 5, online: *CSE* <webfiles.thecse.com/resource/CSE_RULE_5_-_Clearing_and_Settlement_of_Trades.pdf>.
[76] Committee on Payment and Settlement Systems, "Red Book – Payment, clearing and settlement systems in Canada", (September 2011) at138, online (pdf): *Bank of International Settlements* <www.bis.org/cpmi/publ/d97_ca.pdf> [*Red Book*].
[77] TMX Group, Press Release, "CDS Moves to T+2 Settlement" (11 September 2017) at 15, online: *CDS* <www.cds.ca/newsroom?id=161>.
[78] *CDS Financial Risk Model Version 11.0* (October 2018) at 15, online (pdf): *TMX CDS – The Canadian Depository for Securities Limited* <cds.ca/resource/en/56> [*CDS Financial Risk Model*].
[79] *Ibid.*
[80] *Ibid.*

2.4.5.2 Types of Settlement

Eligible debt and equity securities are cleared and deposited through CDSX, a CDS system.[81] Two types of trade settlement are provided by CDS in CDSX: (i) trade-for-trade ("**TFT**") settlement and (ii) central counterparty ("**CCP**") settlement.[82]

In CCP settlement, through a legal mechanism called novation, CDS becomes the CCP one day prior to the scheduled settlement date.[83] A trade between two parties is novated to become two trades, with CDS acting as a counterparty to each. For example, a trade between seller A and buyer B becomes two separate trades – the first with A as the seller and CDS as the buyer, and the second with CDS as the seller and B as the buyer.[84] CDS's Continuous Net Settlement ("**CNS**") service offers CCP settlement.[85] Conversely, TFT settlement does not provide for novation before settlement, so each of the original counterparties of the trade remain the counterparties.[86] The TFT trade is settled through CDSX, but CDS does not assume the role of buyer or seller.

Before a trade is settled by CCP settlement, CNS performs a netting and marking process.[87] CDSX nets and novates a participant's eligible trades in a particular security to either a single "to-deliver" position or "to-receive" position between the participant and CDS.[88] Unsettled trades are maintained by CDSX as outstanding CNS positions.[89] Eligible trades are netted daily by participant, security, currency, clearing organization and value date (settlement date).[90] Once netted, the positions become "value-dated CNS positions". Upon the value date being reached for the relevant value-dated CNS positions, such positions are netted with outstanding CNS positions – e.g., the total of all value-dated CNS positions that have reached the relevant value date but have not yet settled.[91]

Trades are mandated to settle on T+2. If a trade targeted to settle by CNS fails to settle due to the seller's failure to deliver the relevant securities to CDS, the unsettled quantities of shares are maintained by CDSX as CNS outstanding positions, with the seller having an outstanding CNS to-deliver position and CDS having an outstanding CNS to-receive position.[92] Consequently, CDS may not be able to deliver securities to all participants with to-receive positions, which results in CDS having a CNS outstanding to-deliver position and the buyer having a CNS outstanding to-receive position.

The priority of settlement of trades settling in CNS may result in CNS outstanding to-receive positions being carried forward in time. The outstanding shares delivered by the seller with a CNS outstanding to-deliver position may be used to settle a CNS outstanding to-receive position with a higher priority, such as a position with a buy-in (see Section 2.4.7), resulting in all or part of the shares comprising

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[81] CDSX settlement operates as a delivery versus payment mechanism whereby transactions are "settled with securities ownership moving on a gross real-time basis while the net funds positions are settled at the end of the day": see *Red Book*, *supra* note 76 at 139. Securities may also be cleared in a batch settlement process which occurs daily.
[82] *CDS Financial Risk Model*, *supra* note 78 at 10.
[83] *Ibid* at 28.
[84] *Ibid.*
[85] *Ibid* at 10.
[86] *Ibid.*
[87] *Ibid.*
[88] *Ibid* at 28.
[89] A seller would have an outstanding "to-deliver" position and a buyer would have an outstanding "to-receive" position: see *Trade and Settlement Procedures* (4 September 2018) at 61, online (pdf): *TMX CDS – The Canadian Depository for Securities Limited* <cds.ca/resource/en/67> [*CDS Handbook*].
[90] *Ibid.*
[91] *Ibid.*
[92] *Ibid.*

the CNS outstanding to-receive position being rolled over. Once a trade has reached the value date and is confirmed, it becomes "available for settlement".[93]

2.4.5.3 Settlement Processes

Trades are settled through CDS's CDSX system via one of three distinct processes: (i) overnight batch settlement ("**CNS/BNS**"), (ii) real-time TFT settlement, or (iii) real-time CNS settlement.[94] Therefore, there are three types of settlement processes to settle the following two types of trade settlements: TFT and CCP (or CNS trades through CNS settlement). TFT trades are settled in either the CNS/BNS settlement process or the real-time TFT settlement process.[95] CNS trades are settled in either the CNS/BNS settlement process or the real-time CNS settlement process.[96]

Whether trades are settled through the overnight batch net settlement process or the real-time TFT or CNS processes depends on when trades become available for settlement.[97] Trades that are available to be settled by the time the CNS/BNS process is initiated are processed through the batch settlement process.[98] Trades and outstanding positions that do not settle through batch settlement and trades that become available for settlement after the batch process begins are settled through the real-time TFT or real-time CNS settlement processes, as applicable.[99]

2.4.5.3.1 CNS/BNS Settlement

The CNS/BNS method processes trades that are targeted to settle by the TFT and CNS settlement processes together.[100] The CNS trades are processed by the CNS component and the TFT trades are processed by the BNS component.[101] The combined process is aimed at reducing a participant's requirements for security positions, funds, collateral, cap and credit, and allowing CNS and TFT activities to be netted against each other, while still ensuring the relevant risk controls imposed by CDS are satisfied.[102] The process is scheduled to execute at approximately 4:00 a.m. ET every trading day and stops at approximately 6:00 a.m. ET.[103]

First, the CNS/BNS system extracts all trades available for settlement that are targeted to settle in CNS and for TFT settlement.[104] For each participant, account and security, the system takes the sum of new CNS trades, the outstanding CNS positions, TFT confirmed trades and the participant's ledger position in the security to calculate a provisional net security position.[105] Funds amounts from CNS and TFT trades are netted to calculate a provisional net funds position.[106] To determine the positions, provisional changes to a participant's securities and funds positions are made based on the participant's net obligations. The positions reflect the balances that would result if the participant's entire obligations were settled. As such, shortages of securities or funds result in a negative position.

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[93] *CDS Financial Risk Model*, *supra* note 78 at 10.
[94] *Ibid.*
[95] *Ibid.*
[96] *Ibid.*
[97] *Ibid.*
[98] *Ibid.*
[99] *Ibid.*
[100] *Ibid.*
[101] *Principles for Financial Market Infrastructures ("PFMI") Disclosure* (31 December 2017) at 15, online (pdf): *TMX CDS – The Canadian Depository for Securities Limited* <cds.ca/resource/en/247> [*CDS PFMI*].
[102] *Ibid.*
[103] *Ibid* at 15-16.
[104] *Ibid* at 15.
[105] *Ibid.*
[106] *Ibid.*

Participants must have sufficient securities and/or funds for settlement to occur.[107] As a result, all provisionally negative positions must be eliminated.[108] The system finds all such negative provisional security positions and removes transactions to eliminate the negative positions. In other words, trades are excluded until the provisional security positions are positive. Note that while partial exclusions of CNS positions are possible, for TFT trades the entire trade must be removed.[109]

Once all negative positions are eliminated, the system creates a new outstanding CNS position.[110] Non-excluded TFT netted trades are executed as settled, and excluded trades are updated to have a pending status.[111] CNS settlement transactions are created for fully or partially settled outstanding CNS positions.[112]

The settlement priority is an important factor in the determination of which positions or trades are removed during the exclusion process, with higher priority CNS positions and TFT trades being excluded last, as exclusion means the trades will not settle. The settlement priority for the CNS/BNS settlement process is as follows:[113] (i) domestic US dollar TFT trades flagged as mandatory cash[114], (ii) domestic Canadian dollar TFT trades flagged as mandatory cash, (iii) domestic US dollar TFT settlement, (iv) domestic Canadian dollar TFT settlement, (v) domestic US dollar CNS to-receive positions with buy-ins[115], (vi) domestic Canadian dollar CNS to-receive positions with buy-ins, (vii) domestic US dollar CNS outstanding positions and (viii) domestic Canadian dollar CNS outstanding positions.

After execution of the CNS/BNS process based on the above settlement priorities, pending TFT trades are reconsidered for settlement in the real-time TFT settlement process, and outstanding CNS positions are reconsidered for settlement in the real-time CNS settlement process.[116]

2.4.5.3.2 Real-time TFT Settlement

The TFT process attempts to settle a transaction when both parties have agreed to the details and the transaction is available to be settled.[117] If, among other things, a participant's funds, securities or collateral positions make it such that settlement cannot be satisfied, CDSX puts the transaction into pending status and re-attempts settlement later when a change to the participant's funds, securities or collateral positions occurs.[118]

The real-time TFT settlement process runs continuously between approximately 12:30 a.m. ET to 4:00 a.m. ET and stops to allow the CNS/BNS process to execute, then resumes to run between approximately 7:00 a.m. ET to 7:30 p.m. ET.[119]

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[107] *Ibid* at 17.
[108] *Ibid* at 16.
[109] *CDS Handbook, supra* note 89 at 65.
[110] The new outstanding CNS position may only be up to the maximum of the net of the starting CNS position and the new CNS trades: see *CDS Financial Risk Model, supra* note 78 at 11.
[111] *Ibid.*
[112] *Ibid.*
[113] *CDS Handbook, supra* note 89 at 65.
[114] Mandatory cash trades are a designated trade type on the CDSX system. They are cash trades which are defaulted to settle by TFT: see *ibid* at 22.
[115] See Section 2.4.7.
[116] *CDS PFMI, supra* note 101 at 16.
[117] *Ibid.*
[118] *Ibid.*
[119] *Ibid.*

2.4.5.3.3 Real-time CNS Settlement

Outstanding CNS positions remaining after the CNS/BNS process is executed are carried forward into the real-time CNS settlement process, which runs through the business day from approximately 7:00 a.m. ET to 4:00 p.m. ET.[120]

Generally, the settlement priority for the real-time settlement process is the same as the priority for CNS trades under the CNS/BNS settlement process, as follows: (i) domestic US dollar CNS to-receive positions with buy-ins, (ii) domestic Canadian dollar to-receive positions with buy-ins, (iii) domestic US dollar CNS outstanding positions and (iv) domestic Canadian dollar CNS outstanding positions.[121]

The real-time CNS process compares the current ledger positions and a participant's CNS outstanding positions, and settles – partially or fully – a trade, where possible.[122] For settlement execution in the real-time CNS process, in addition to the participant eligibility and security eligibility requirement, the outstanding to-deliver position must not be on hold.[123]

For a trade to settle, the following must occur: (i) the seller must have sufficient securities in their account to complete full or partial delivery, (ii) the buyer must have sufficient funds available and (iii) both parties must have sufficient aggregate collateral value after settlement to cover the resulting funds obligation.[124] If these requirements are satisfied, CDSX settles the trade by (i) subtracting the securities from the seller's account and adding those securities to the buyer's account, (ii) subtracting the funds from the buyer's account and adding those funds to the seller's account, and (iii) updating both parties' aggregate collateral value.[125]

The priorities of the settlement processes may result in trades not settling within the standard T+2 settlement cycle.

2.4.6 Failed Trades – CDS Fees and Reporting

While UMIR imposes consequences for extended failed trades, such as the obligation to file an Extended Failed Trade Report (discussed in Section 2.2.2) and in limited circumstances, pre-borrowing requirements (discussed in Section 2.5.2), CDS also imposes consequences for failed trades. CDS charges a fee of $1,000 per day for failure to deliver securities to settle an outstanding CNS settlement position prior to the start of the payment exchange.[126]

CDS provides a daily report to the OSC with respect to each security where there has been a failure to settle outstanding "to-deliver" CNS obligations. For each security on an aggregate basis, the report

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[120] Due to the timing of the real-time CNS settlement process, only outstanding positions from the early morning CNS/BNS settlement process are eligible to be settled via the real-time CNS settlement process on that business day: see *ibid.*
[121] *CDS Handbook, supra* note 89 at 65.
[122] Changes to a participant's ledger position may occur in the time between the completion of the CNS/BNS settlement process and the execution of the real-time CNS settlement process (e.g., a participant's position may change through the settlement of a TFT trade): see *CDS Financial Risk Model*, *supra* note 78 at 11.
[123] *CDS Handbook, supra* note 89 at 66.
[124] Aggregate collateral value is "the estimated calculated value of the collateral that could be realized if the [CDS] participant failed to pay their payment obligation": see *Ibid.* This requirement ensures that a negative (Canadian dollar denominated) funds balance in a participant's account is collateralized: see CDS, *CDS Financial Risk Model*, *supra* note 78 at 22.
[125] *Ibid* at 12.
[126] *2019 Price Schedule* (1 January 2019), online (pdf): *TMX – CDS The Canadian Depository for Securities Limited* <www.cds.ca/resource/en/275/>.

includes the number of participant ledgers with fail "to-deliver" positions at both the beginning and the end of the business day.[127]

2.4.7 CDS Buy-in Requirements

While UMIR does not impose buy-in requirements for failed trades, CDS and Canadian stock exchanges have buy-in processes that allow enforcement of the seller's settlement obligations for failed trades.[128] CDS participants with to-receive CNS positions may effectively force settlement through the CNS buy-in function. Similarly, stock exchange members that fail to deliver securities: (i) in respect of a trade made on the exchange, (ii) to settle a securities loan or (iii) pursuant to any other obligation to deliver securities are in default of the exchange trade contract. As a result, at the discretion of the exchange, the trade may be closed out through the exchange's buy-in process.[129] For securities listed and traded on a Canadian stock exchange, CDS coordinates the submission of buy-in related trades and acts as the clearing organization.[130]

To initiate the buy-in process,[131] a buyer, who should have received the securities, enters an intent to buy-in, and a seller, who should have delivered such securities, is provided with a notice of intent.[132] The seller may request an extension, which the buyer may respond to.

If the buyer wishes to proceed with the buy-in after it is set up and prior to the execution date, the buyer changes the status of the buy-in from "intent" to "execute" to force execution.[133] Depending on when the buy-in was first entered, the execution date is either two or three trading days following the buy-in date.[134] On the execution date, CDS submits the replacement trade to the relevant Canadian exchange in the case of a domestic buy-in,[135] or instructs the buyer to execute a buy-in in the case of securities not listed or traded on a Canadian exchange. For domestic buy-ins, if the buy-in notice[136] is delivered by CDS to the exchange and the participating organization that is in default prior to 12 p.m. ET,[137] the exchange will execute the buy-in at approximately 3:00 p.m. ET[138] and close out the trade.[139] The buy-in is washed and purged from the CNS process upon the replacement trade being filled. Settlement priority among buyers with buy-ins is determined by the time the intent

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[127] *Submission from the Canadian Depository for Securities Limited to Investment Industry Regulatory Organization of Canada* (26 May 2011), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2011/32b33a3d-ef98-4345-a23b-19760f605282_en.pdf>.

[128] *CDS Handbook, supra* note 89 at Part 8. *TSX Rule 5, supra* note 75 at Rule 5-301. *TSXV Rule C3, supra* note 75 at Rule C.3.00.

[129] *TSX Rule 5, supra* note 75 at Rule 5–301.

[130] *CDS Handbook, supra* note 89 at 103.

[131] Unless cited otherwise, the description of the process has been largely extracted from the *CDS Handbook* Section 8: Buying in Outstanding CNS Positions: see *CDS Handbook, supra* note 89 at 73–106.

[132] At the time the buy-in is accepted on the CDS system, the quantity of the buy-in is the quantity intended minus the 'serviced quantity', which is the number of securities delivered to the buyer after the buy-in was initiated, minus the "unserviced quantity", which is any amount of the buy-ins that CNS attempted to deliver but the buyer was unable to accept.

[133] If the buyer does not update the status to execution, the buy-in is automatically cancelled. The buyer may change the status from "intent" to "execute" (i) from 5:00 p.m. to 7:30 p.m. ET the evening before the execution date or (ii) from 7:30 a.m. to 12:30 p.m. ET the morning of the execution date.

[134] If the buy-in is entered between 4:00 p.m. and 4:45 p.m. ET, the execution day is the second business day following the buy-in date. If the buy-in is entered between 4:45 p.m. and 7:30 p.m. ET, the execution day is the third business day following the buy-in date.

[135] Pursuant to the *TSX Rule Book* and the *TSXV Rule Book*, the buy-in notice must be delivered to the TSX or TSXV, as applicable, as well as the dealer in default prior to 12:00 p.m. ET on the day that the buy-in is to be executed and the trade closed out. The *TSXV Rule Book* specifies that for buy-ins in respect of a failed trade, the buy-in notice may only be delivered by CDS. The *TSX Rule Book* is silent on who may deliver such a buy-in notice.

[136] CDS provides a list of securities that TSX participating organizations have failed to make delivery to the TSX on a daily basis.

[137] If the buy-in notice is delivered to the exchange after 12:00 p.m., the buy-in is considered to be effected and will be executed on the next trading day: see *TSX Rule 5, supra* note 75 at Rule 5-301(5).

[138] *TSX Rule 5, supra* note 75 at Rule 5-301(7). *TSXV Rule C3, supra* note 75 at Rule C.3.05(4).

[139] After CDS provides a list of securities where buy-in notices have been issued, the exchange posts the buy-in list online. Dealers that are capable of immediately delivering the securities may submit buy-in orders. The cut-off time for accepting buy-in orders is 3:00 p.m. ET. The exchange then allocates the buy-in volume on an equal by-dealer basis and manually enters the trades, which are then cleared and settled by CDS on a same-day basis.

to buy in was entered. The buy-in is first executed against the seller with the oldest identified outstanding position who was among those originally provided with the buy-in notice.

Buyers may arrange for multiple execution dates for a buy-in via the repeat buy-in process, which duplicates the original buy-in with a new execution date. For the seller, each repeat buy-in is a new intent on which the buyer may choose to force execution.

The dealer that is in default is responsible to the purchaser for the costs incurred as a result of the failure to deliver, including any lost benefit or entitlement.[140] The buy-in price is based on the price of the last sale price of a standard trading unit before 3:00 p.m. ET, plus a premium.[141]

2.5 Restrictions on Short Sales

UMIR imposes a general restriction that prohibits manipulative and deceptive activities when entering into any trade, including a short sale. Specifically, UMIR rules and policies require that, for a short sale, there be a "reasonable expectation" of settling the trade by the settlement date – i.e., the delivery of the securities. Further to this general restriction, IIROC can also impose requirements to pre-borrow before short selling in respect of designated securities ("**Pre-Borrow Securities**") or prohibit the short selling of a particular security outright ("**Short Sale Ineligible Securities**").

2.5.1 Manipulative and Deceptive Activities

There is a risk that a Participant or one of its clients may aim to use short selling as a means to drive down the price of a company's securities in a manipulative or deceptive manner, such as in short and distort campaigns and "bear raids".[142] Pursuant to UMIR 2.2, a Participant shall not enter an order to execute a trade on a marketplace if the Participant knows or ought reasonably to know that the order will create or could reasonably be expected to create a false or misleading appearance of trading activity or interest in the purchase and sale of a security, or an artificial ask, bid or sale price for the security or a related security. To determine whether the price of a security is considered artificial, IIROC will consider and evaluate whether the price is justified by real demand or supply in the security, the recent liquidity of the security and whether any person has a motivation to establish an artificial price, among other things.[143]

To provide guidance on manipulative and deceptive activity that would contribute to or result in misleading trading activity or an artificial price, IIROC has set out policies that accompany UMIR 2.2 ("**Policy 2.2**").[144] Under Part 2 of Policy 2.2, making an order for the sale of a security without having the "reasonable expectation" of settling the trade is an attempt to create an artificial price or misleading trading activity in a security.[145] While the definition of "reasonable expectation" is not defined in UMIR or Policy 2.2, Market Regulation Services Inc. ("**RS**"),[146] a predecessor organization to IIROC, stated that the "reasonable expectation" requirement under Policy 2.2 does not require a

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[140] *TSX Rule 5*, *supra* note 75 at Rule 5-301(4). *TSXV Rule C3, supra* note 75 at Rule C.3.05(4).
[141] Toronto Stock Exchange, "TSX Buy-ins" (last visited 17 September 2019), online: *TMXmoney.com* <www.tmxmoney.com/en/research/buy_ins.html>.
[142] A "bear raid" is when a trader or group of traders attempts to force down the price of a stock – in a concerted attack – to cover a short position. This activity is usually accompanied by abusive tactics and manipulative behaviour: see Cory Mitchell, "Bear Raid" (21 August 2019), online: *Investopedia* <www.investopedia.com/terms/b/bearraid.asp>.
[143] *Manipulative and Deceptive Activities*, Universal Market Integrity Rule 2.2 at 3, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/industry/rulebook/Documents/UMIR0202_en.pdf > [*UMIR 2.2*].
[144] *Ibid* at 1.
[145] *Ibid* at 2.
[146] IIROC was established from the merger of the Investment Dealers Association of Canada and RS on June 1, 2008.

Participant to make a "positive affirmation"[147] that the security can be located and delivered by the settlement date before the trade, nor does it require that the seller have borrowed the securities before the trade.[148] Rather, the provision requires that the seller "not make the sale knowing that the securities can not be borrowed", and that the seller take "reasonable steps" to attempt to borrow the securities to make delivery by the settlement date (see Section 3.2.3).[149] IIROC has provided a similar explanation of the "reasonable expectation" standard[150] and has further stated that once a Participant is "aware of difficulties in obtaining particular securities", the Participant would no longer have a "reasonable expectation" of being able to settle a resulting trade and would not be able to enter further short sale orders.[151]

While UMIR 2.2 is only applicable to Participants and Access Persons, section 126.1(1) of the OSA applies more broadly and prohibits any person or company from directly or indirectly participating in any conduct that they know, or reasonably ought to know, results in or contributes to a misleading appearance of trading activity in or an artificial price for a security, derivative or underlying interest of a derivative, or that perpetrates fraud on any person or company. This allows the OSC to also pursue actions against persons who are not Participants or Access Persons who have engaged in conduct that would likely run afoul of UMIR 2.2. Subsection 3.1(1) of National Instrument 23-101 – *Trading Rules* ("**NI 23-101**") also provides similar prohibitions on manipulative and deceptive activities,[152] including fraud. However, subsection 3.1(1) of NI 23-101 does not apply to any person or company that is governed by the rules of an SRO or by relevant Ontario securities legislation.[153] Participants and Access Persons are governed by IIROC, so UMIR applies to them in lieu of NI 23-101.[154]

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[147] See *Request for Comments – Provisions Respecting Manipulative and Deceptive Activities*, RS Market Integrity Notice No. 2004-017 (13 August 2004) at 4, online (pdf): *Market Regulations Services Inc.* <www.iiroc.ca/Documents/2004/B3FD1E6E-FCCA-4954-A1A4-56ED62D82D6D_en.pdf> [*Market Integrity Notice 2004-017*]. Neither RS nor IIROC has clarified the meaning of "positive affirmation". Rule 3370 (now repealed) of the National Association of Securities Dealers ("**NASD**") had provided that no short sale can be made unless the broker-dealer, or person associated with the broker-dealer making the short sale, makes an affirmative determination that the broker-dealer will receive delivery of the security from the person making the short sale or the broker-dealer can borrow the security on behalf of that person by the settlement date: see *Member Regulation Notice: Positive Affirmation Rule*, MR0282 (13 April 2004), online (pdf): Investment Dealers Association of Canada <www.iiroc.ca/RuleBook/MRNotices/2004/MR0282_en.pdf>. In *Market Integrity Notice 2004-017* at 25, when a commentator asked RS whether Policy 2.2 (h) is similar to NASD 3370 (affirmative determination), RS responded "[Policy 2.2 (h)] does not require a 'positive affirmation' before the trade". NASD 3370 has been repealed but is consistent with the "locate" requirement under Rule 203 of Regulation SHO in the US (discussed in Section 4.2).

[148] See *Market Integrity Notice 2004-017, supra* note 147 at 25.

[149] *Ibid.*

[150] "[…] The provision does not require that the dealer make a "positive affirmation" that it has the ability to settle the trade but merely have a "reasonable expectation" at the time of the entry of the order. Essentially, a Participant may enter a short sale of a security until such time as the Participant knows, or should reasonably have known, that it can no longer borrow the securities to effect settlement […]": see *Rules Notice –Request for Comments – Provisions Respecting Regulation of Short Sales and Failed Trades, IIROC Notice 11-0075* (25 February 2011) at footnote 51, online (pdf): *Investment Industry Regulatory Organization of Canada* <docs.iiroc.ca/DisplayDocument.aspx?DocumentID=14604580516B48F88A0BCFA629781242&Language=en> [*IIROC Notice 11-0075*].

[151] *IIROC Notice 12-0078*, *supra* note 62 at 10. RS also stated that "[h]aving made a short sale of a security that has failed to settle because of an inability to borrow the security, a person should not undertake further short sales of that security without knowing where the securities to complete the additional shares will be obtained" (*Market Integrity Notice 2004-017, supra* note 147 at 25).

[152] See *Trading Rules*, OSC NI 23-101 (as consolidated 10 April 2017), online (pdf): *Ontario Securities Commission* <www.osc.gov.on.ca/documents/en/ni_20170410_23-101_unofficial-consolidatation-cp.pdf>. Subsection 3.1(1) of NI 23-101 provides that "[a] person or company must not … engage in, or participate in any transaction … or method of trading relating to a trade in or acquisition of a security or any act, practice, or course of conduct, if the person or company knows or ought reasonably to know that the transaction or method of trading or act, practice or course of conduct (a) results in or contributes to a misleading appearance of trading activity in, or an artificial price for, a security … or (b) perpetrates a fraud on any person or company".

[153] Ontario is exempt from Part 3 of NI 23-101 and the provisions of s. 126(1) of the OSA apply instead. Subsection 3.1(2) of NI 23-101 provides that "[i]n […] Ontario […] instead of subsection (1), the provisions of […] the *Securities Act* (Ontario) […] relating to manipulation and fraud apply". This exemption also applies to Alberta, British Columbia, Québec and Saskatchewan.

[154] See *Trading in a Marketplace*, Universal Market Integrity Rule 7.1, online: *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/industry/rulebook/Documents/UMIR0701_en.pdf > and *UMIR 2.2, supra* note 143. These rules would apply to Participants and Access Persons.

While section 126.1(1) of the OSA is silent as to the types of activities that would contribute to or result in an artificial price for a security, guidance may be found under the companion policy to NI 23-101 ("**NI 23-101CP**").[155] Under NI 23-101CP, staff of the CSA provides guidance as to what constitutes manipulative and deceptive activities in the context of short selling in discussing section 3.1 of NI 23-101, which corresponds with section 126.1(1) of the OSA. Subsection 3.1(3)(f) of NI 23-101CP provides that entering orders to sell securities without the "ability and intention" to deliver the securities necessary to properly settle the transaction is sufficient conduct to result in, contribute to or create a misleading appearance in trading activity in, or an artificial price for, the given security. RS has stated that the test for conducting short sales under the "reasonable expectation" standard is comparable to that required under subsection 3.1(3)(f) of NI 23-101CP.[156]

In summary, under securities legislation, a person or company may not enter a short sale without having the intention to settle the trade. Under UMIR, a Participant or Access Person may not enter into a short sale on behalf of a client without having the "reasonable expectation" that the trade will be settled. Entering into a short sale without the intention or expectation of delivering the securities to settle the trade creates a misleading price and trade activity, and would be seen as a manipulative and deceptive practice in Canada.

2.5.2 "Pre-Borrow Securities"

IIROC has the ability to designate a security as a "Pre-Borrow Security".[157] If this designation is made, a Participant or Access Person must make arrangements to borrow the securities prior to the entry of a short sale order. In determining whether to make such a designation, IIROC will consider the following:[158] (i) if there has been an increase in the number, value or volume of failed trades (as further discussed in Section 2.4.6) in the particular security by more than one Participant; (ii) whether the number or pattern of failed trades is related to short selling; and (iii) whether the designation helps to maintain a fair and orderly market. Without prior designation by IIROC, pre-borrow requirements are also automatically imposed[159] on a person making a short sale who has previously executed trades that failed to settle on the settlement date and in respect of which an Extended Failed Trade Report has been made (as further discussed in Section 2.2.2), unless the Participant, acting as agent for such person (whether a client or non-client), is satisfied after reasonable inquiry that the reason for any prior failed trade was not the result of the person's intentional or negligent act. In addition, a Participant or Access Person, acting as a principal, has pre-borrow obligations with respect to a short sale for a *particular* security if it had previously filed a failed trade report under UMIR 7.10 in respect of that security unless IIROC has consented to the entry of such order.[160] IIROC very rarely provides such consent. It should be noted that, to our knowledge, IIROC has never made

[155] Section 1.1 of NI 23-101CP provides that "[t]he purpose of this Companion Policy is to state the views of the Canadian securities regulatory authorities on various matters related to [NI 23-101], including: (a) a discussion of the general approach taken by the Canadian securities regulatory authorities in, and the general regulatory purpose for, [NI 23-101]; and (b) the interpretation of various terms and provisions in [NI 23-101]": see *Trading Rules Companion Policy, OSC NI23-101CP* (as consolidated 10 April 2017) at s 1.1, online (pdf): *Ontario Securities Commission* <www.osc.gov.on.ca/documents/en/ni_20170410_23-101_unofficial-consolidatation-cp.pdf>.
[156] *Market Integrity Notice 2004-017, supra* note 147 at 25–26.
[157] "Pre-Borrow Security" means a security that has been designated by a market regulator to be a security in respect to which an order that, on execution would be a short sale, may not be entered on a marketplace unless the Participant or Access Person has made arrangements to borrow the securities that would be necessary to settle the trade prior to the entry of the order: see *UMIR 1.1 supra* note 10.
[158] *IIROC Notice 12-0078, supra* note 62 at 13.
[159] *Entry of Orders to a Marketplace*, Universal Market Integrity Rule 6.1, online: *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/industry/rulebook/Documents/UMIR0601_en.pdf>.
[160] *Ibid* at (4)(b).

a "Pre-Borrow Security" designation and does not monitor short trades where there has been an automatic imposition of pre-borrow requirements.[161]

2.5.3 "Short Sale Ineligible Securities"

Under UMIR, a Participant or Access Person is also prohibited from entering into a short sale if the listed security is determined to be a "Short Sale Ineligible Security"[162] by IIROC.[163] IIROC has stated that a key purpose of a "Short Sale Ineligible Security" designation is to provide "flexibility to respond to evolving developments" in the trading of that particular security.[164] IIROC has also stated that this designation should be a rare occurrence, and should only be considered a "backstop" in case further enforcement is required.[165] An example given by IIROC of when this designation may be used is during a "bear raid".[166] We understand that IIROC will only apply the designation if it believes trading in the security would present systemic risk. To our knowledge, IIROC has never designated a security as a "Short Sale Ineligible Security".

[161] On November 2, 1995, the TSE imposed pre-borrow requirements on the Non-Voting Exchangeable Shares of Softkey Software Products Inc. due to the size of the short interest and the tight loan situation in the shares. *Notice to Members – Restriction on Short Sales Softkey Software Products Inc.,* TSE Notice 95-320 (1995), print: *Toronto Stock Exchange*.

[162] "Short Sale Ineligible Security" means a security or a class of securities that has been designated by a market regulator to be a security in respect of which an order that, on execution would be a short sale, may not be entered on a marketplace for a particular trading day or trading days: see *UMIR 1.1, supra* note 10.

[163] The "Short Sale Ineligible Security" designation would prohibit both sale orders that would have been marked as a short sale or SME order: see *UMIR 3.2, supra* note 33.

[164] *Request for Comments – Transparency of Short Selling and Failed Trades,* CSA/IIROC Joint Notice 23-312 (2 March 2012) at 8, online (pdf): *Ontario Securities Commission* <www.osc.gov.on.ca/documents/en/Securities-Category2/csa_20120302_23-312_rfc-trans-short-selling.pdf> [*CSA/IIROC Joint Notice 23-312*].

[165] *IIROC Notice 08-0143*, supra note 59 at 11.

[166] For definition of a "bear raid", please refer to footnote 142.

3. CANADIAN REGULATORY HISTORY ON SHORT SELLING

3.1 Early Efforts to Regulate Short Sales

Current Canadian regulations governing short sales have developed from earlier incremental interventions, primarily through the rules imposed by Canadian exchanges. Short sales were banned in the United Kingdom in the 18th century and in some states in the US in the late 19th century, and later by the US Securities and Exchange Commission ("**SEC**") in the 1930s. In contrast, short sales attracted limited attention from Canadian legislators, exchanges and regulators during the same time period. Key provisions in UMIR find their origin in the TSE's earlier by-laws and have been more influenced by domestic experience than by international movements to regulate or restrict short sales.

3.1.1 Gambling in Stocks and the Bucket Shop Prohibitions

In Canada, gambling in respect of the sale of stock, among other fraudulent practices, was criminalized in 1888 in *An Act respecting Gaming in Stocks and Merchandise,*[167] which was added to the *Criminal Code* in 1892. However, anti-gambling provisions were capable of broader interpretation and provided as follows:

> Every one who, -
>
> (a) With the intent to make gain or profit by the rise or fall in price of any stock of any incorporated or unincorporated company or undertaking, either in Canada or elsewhere, or of any goods, wares or merchandise, and without the *bona fide* intention of acquiring any such shares, goods, wares or merchandise, or of selling the same, as the case may be, makes or signs, or authorizes to be made or signed, any contract or agreement, oral or written, purporting to be for the sale or purchase of any such shares of stock, goods, wares or merchandise; and every one who acts, aids or abets in the making or signing of any such contract or agreement; or –
>
> (b) With the intent to make gain or profit by the rise or fall in price of any stock of any incorporated or unincorporated company or undertaking, either in Canada or elsewhere, or of any goods, wares or merchandise, makes or signs, or authorizes to be made or signed, any contract or agreement, oral or written, purporting to be for the sale or purchase of any such shares of stock, goods, wares or merchandise, in respect of which no delivery of the thing sold or purchased is made or received, and without *bona fide* intention to make or receive such delivery; and everyone who acts, aids or abets in the making or signing of any such contract or agreement;
>
> [i]s guilty of a misdemeanour and liable to imprisonment for any term not exceeding five years, and to a fine not exceeding five hundred dollars …[168]

[167] See *An Act respecting Gaming in Stocks and Merchandise,* 1888, c 42. These provisions were brought into the *Criminal Code,* 1892, c 29 which came into force on July 1,1893. In contrast, in the US, certain states specifically banned short sales and academic commenters discussed short selling (selling what you do not yet own) with both suspicion and distaste.

[168] These provisions were added to the *Criminal Code*, where they remain today amended as part of the provisions prohibiting fraudulent and manipulative market practices. Discussion of criminal market manipulation is outside the scope of this paper.

These provisions were used sporadically to prosecute true "bucket shops", where notional sales or purchases of shares took place – usually made on margin – without an order being placed through an exchange to actually acquire the shares. These "sales" were viewed as a form of gambling, with buyers and sellers betting on whether the price of a particular stock went up or down. The purchaser was only required to pay – or entitled to receive – the difference on the rise or fall of the stock.[169] However, there is little indication that the bucket trading prohibitions were intended or were ever used to regulate short sales on established exchanges. Short sales and futures trading through exchanges are not bucket trades, and short selling has not been considered to be merely gambling in stocks. Moreover, a covered short sale – one where the shares sold have been borrowed by the seller – would not offend these provisions, because the arrangement to borrow securities for settlement would be evidence that the seller actually intended to deliver.

These provisions were also used by unscrupulous or impecunious customers as a defence to a broker's margin call on the grounds that the margin contract was void.[170] The Privy Council in *Forget v Ostingy*,[171] which was decided in 1895 – before the *An Act respecting Gaming in Stocks and Merchandise* was enacted – recognized the legitimacy of speculative trading, such as short sales, on a client's behalf, including on margin.

> To enter into such transactions with such an object is sometimes spoken of as "gambling on the Stock Exchange"; but it certainly does not follow that the transactions involve any gaming contract. A contract cannot properly be so described merely because it is entered into in furtherance of a speculation. It is a legitimate commercial transaction to buy a commodity in the expectation that it will rise in value and with the intention of realizing a profit by its resale. Such dealings are of every-day occurrence in commerce. The legal aspect of the case is the same whatever be the nature of the commodity, whether it be a cargo of wheat or the shares of a joint-stock company. Nor again, do such purchases and sales become gaming contracts because the person purchasing is not possessed of the money required to pay for his purchases, but obtains the requisite funds in a large measure by means of advances on the security of the stock or good he has purchased. This, also, is an every-day commercial transaction.[172]

Nevertheless, many viewed short sales with distaste and, on occasion, the practice received judicial rebuke, even by the Supreme Court.[173]

There were few cases involving the short sale of securities.[174] Rather, most of the decisions in which the judicial debate about the legitimacy of short sales occurred involved commodities sales made through recognized grain exchanges. The Supreme Court of Canada confirmed the legitimacy of

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[169] See for example, *Pearson v Carpenter & Son* (1904), 35 SCR 380, 1904 CarswellOnt 800 [*Pearson*]; *R v. Harkness* (1905), 6 OWR 219, 1905 CarswellOnt 412 (ONCA) [*Harkness*].

[170] See for example, *Beamish v Richardson* (1914), 49 SCR 595, 16 DLR 855 [*Beamish*], where the court held that futures contracts on the Winnipeg Grain Exchange were void for illegality. In his dissenting opinion, Duff J distinguished between legitimate market activities and the kinds of transactions that s 231 of the *Criminal Code* was intended to prohibit.

[171] [1895] AC 318, 1895 CarswellQue 19 (PC) [*Forget* cited to CarswellQue].

[172] *Ibid* at para 12.

[173] See for example, *Beamish, supra* note 170. In his dissenting opinion out of the Manitoba Court of Appeal, Chief Justice Howell went so far as to speculate that *Forget* would have been decided differently after the introduction of the anti-gambling provisions: *Beamish v Richardson* (1913), 13 DLR 400, 1913 CarswellMan 244 at paras 28-29 (ManCA). The Supreme Court of Canada agreed with him, and allowed an appeal in this decision, finding that the trades made by the defendant on the Winnipeg Grain Exchange as agent for the plaintiff were illegal (with Fitzpatrick CJC and Duff J dissenting). The Supreme Court in subsequent decisions in *Maloof v Bickell* (1919), 59 SCR 429, 50 DLR 590 and in *Prudential Exchange Co v Edwards*, [1939] SCR 135, 1 DLR 465 [*Prudential*] worked to reconcile *Beamish supra* note 170 with the earlier Privy Council decision in *Forget supra* note 171.

[174] See for example, *Harkness, supra* note 169, which was a prosecution of a true bucket shop where customers of the defendant "placed" orders for shares on margin accounts (of 1% or 2%), but that were never actually made on any exchange. No shares were ever delivered further to these transactions.

short sales in 1938 in *Prudential Exchange Co v Edwards.*[175] Although this was not a prosecution under the *Criminal Code* provisions, the Supreme Court made it clear that short sales did not fall within the scope of the stock gaming and wagering provisions. In this case, the defendant attempted to avoid his obligations on promissory notes held by his broker for his margin account. He claimed that the notes were unenforceable since he gave them in consideration of illegal commodity futures trades. Reviewing a series of impugned commodities futures sales, the court concluded that even though the seller never intended to make or receive physical delivery of the grain, it was plain that the transactions were not gaming nor wagering within the meaning of the *Criminal Code*. These were real transactions creating enforceable legal obligations. The *Criminal Code* provisions were clearly aimed at bucket shops, which were not legitimate brokers placing orders on recognized exchanges, but were merely book-makers who facilitated gaming and wagering on the rise and fall of the price of shares.[176] In *Edwards*, the Supreme Court noted that each order placed on behalf of the customer created an enforceable legal obligation to carry out the sale or purchase. Commodities purchased or sold came with an obligation to make actual payment, delivery or settlement through another equally binding and enforceable contract. Therefore, the client was obliged to settle its margin accounts with the broker for the trades made on his behalf. The bucket shop provisions remain in Part X of the *Criminal Code*[177] and form part of the offences related to fraud and the fraudulent manipulation of stock exchanges and insider trading.[178] None of these offences directly target short sales, although anyone who engages in short selling with an intent to defraud by using deceit, falsehood or fraudulent means and affects the public market price of securities could potentially violate the *Criminal Code*.[179]

3.1.2 Permissive Securities Regulation

In 1929, popular opinion in Canada and the US placed blame for the stock market crash on traders, particularly short sellers. In the two years immediately following, provincial ministers of finance met and concluded that stock exchanges should have rules that require the disclosure of whether a sale is a short sale. Following this, the Standard Mining Exchange prohibited brokers from shorting or trading against client accounts, but otherwise left short sales largely unrestricted and unregulated.[180]

Despite the consensus that short sales had precipitated or at least exacerbated the 1929 market crash, they remained largely unregulated in Canada. With the exception of a brief ban in May 1940, following the outbreak of the Second World War – and in sharp contrast with the approach taken by the US, which regulated stock exchanges in the *Securities Exchange Act of 1934* (the "**Exchange Act**") and banned short sales except in accordance with SEC rules – the only action taken by

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[175] See *Prudential, supra* note 173. See also in 1938, *Zacks v CA Gentles & Co.,* [1939] SCR 45, 1 DLR 545, where the Supreme Court also confirmed that brokers were entitled to do what is reasonable in their own interests and the interests of their client, if the client engaged in short sales fails to meet a margin call on his account.

[176] The preamble to *An Act respecting Gaming in Stocks and Merchandise,* 1888, c 42 provided: "Whereas gaming and wagering is on the rise and fall in value of stocks and merchandise are detrimental to commercial and public morality, and places affording facilities for such gaming and wagering, commonly called bucket shops, are being established; and it is expedient to prevent such gaming and wagering, to punish the persons engaged in them, and to prohibit and punish the opening and maintaining of such places therefor, and the frequenting thereof: Therefore her Majesty, by and with the advices and consent of the Senate and House of Commons of Canada enacts as follows […]".

[177] *Criminal Code*, RSC 1985, c C-46, s 383.

[178] *Criminal Code*, RSC 1985, c C-46, s 380, 382-384.

[179] *Criminal Codes,* RSC 1985, c C-46, s 380(2) provides: "Every one who, by deceit, falsehood or other fraudulent means, whether or not it is a false pretence within the meaning of this Act, with intent to defraud, affects the public market price of stocks, shares, merchandise or anything that is offered for sale to the public is guilty of an indictable offence and liable to imprisonment for a term not exceeding fourteen years." Other provisions, such as s 382 do not prohibit short sales, although it is conceivable that short sales (or a long sale) could form part of the alleged offence (e.g., market manipulation through wash-trades (s 382), insider trading and tipping (s 382.1(1) and (2)), or – still – gaming in stock (s. 383) and brokers selling for their own account (s 384)).

[180] See Christopher Armstrong, *Blue Skies and Boiler Rooms: Buying and Selling Securities in Canada 1870–1940* (Toronto: University of Toronto Press, 1997) at 298. See also for example, "Your Investments – Short selling" (7 December 1935) at 9, online: *Financial Post* <www.newspapers.com>, which notes that there are no rules on short sales on the TSE beyond prohibitions against brokers shorting against their clients' long purchase.

regulators or exchanges in Canada was the TSE's introduction of a sale price rule at some point in the 1930s.[181] By-Law 46 of the TSE provided the following:

> No 'short' selling of a security shall be made on this Exchange below the price at which the last sales of a board lot of the securities was effected on this Exchange.[182]

The sale price rule did not eliminate short sales, which regulators, especially the relatively new OSC, continued to see as a legitimate and useful form of trading.

However, the well-publicized 1946 failure of Beaulieu Yukon Mine Ltd. ("**Beaulieu Mine**"), which resulted in significant shareholder losses, was blamed on short selling. Once again, there were demands for reform and regulation of short sales by the public and commentators.[183] In response, the OSC investigated trading activity leading to Beaulieu Mine's stock price collapse and released its findings in a 1946 report (the "**Beaulieu Report**").[184]

The Beaulieu Report discussed short sales of Beaulieu Mine shares as well as allegations of stock manipulation by the promoter of the issuer. The OSC noted that there had been an artificial price for Beaulieu Mine shares that inevitably caught the attention of experienced traders, many of whom concluded based on disclosures and their own mining engineers that the price was artificially high. "To these speculators, Beaulieu was an inviting but legitimate target for a short sale."[185] The share price for Beaulieu Mine collapsed following a negative editorial by the *Northern Miner* on May 16, 1946, which led to major investors shorting the company's shares. The OSC observed that selling brokers had difficulty obtaining stock for delivery and used lieu slips – a certified cheque that the TSE Clearing Rules permitted members to deliver in lieu of shares[186] – instead of share certificates.

The Beaulieu Report made the following observations:

- Short selling is a legitimate method of trading on various exchanges and is subject to each particular exchange's rules, which differ. The TSE By-Laws do not require brokers to determine if an order to sell is in fact a short sale.[187]

- By-Law 46 was rarely observed, which was true in this case. "This, in our opinion, was due to the fact that the By-Laws and regulations are defective in not setting forth the necessary machinery to provide for an enforcement of their manifest intention".[188]

- Some of the short sales appear to have been naked shorts. The OSC did not single these trades out for criticism. Rather, the Beaulieu Report simply notes the facts that lead to the conclusion that these were naked shorts where selling brokers failed to deliver:

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[181] See Toronto Stock Exchange, By-law 55, *Short Selling*, s 1 (as it appeared on 14 January 1969), reprinted in *Toronto Stock Exchange: Act of Incorporation, By-Laws, and Rules* (Toronto: 1954) (loose-leaf 14 January 1969 supplement) at 54 –55 [*1969 TSE By-Laws*]. Prior to 1960, see Toronto Stock Exchange By-Law 46.
[182] See "When Will T.S.E Action Come on Short Selling" (November 23, 1946) at 4, online: *Financial Post* <www.newspapers.com> [Financial Post, "*TSE Short Selling*"], which reproduces then Rule 46.
[183] *Ibid*. See also, Christopher Armstrong, *Moose Pastures and Mergers: the Ontario Securities Commission and the Regulation of Share Markets in Canada 1940–1980* (Toronto: University of Toronto Press, 2002), at 114-117.
[184] Ontario Securities Commission, *Report on the Beaulieu Yellowknife Gold Mines Limited*, by TP O'Connor & JH Collins (no date) [unpublished, archived at University of Toronto Robarts Library] [*Beaulieu Report*].
[185] *Ibid* at 6.
[186] See the TSE Clearing Rules annexed to the TSE By-Laws, which are discussed in footnote 181.
[187] *Beaulieu Report, supra* note 184 at 10.
[188] *Ibid.*

> "We also find that short sellers were not compelled to make delivery within the time limits prescribed by the clearing house regulations, but they were unwittingly abetted in this by the buying broker, Prescott & Company. Prescott time and again allowed the selling broker to "leave off" a transaction from his clearing sheet and when he did force the selling broker to "put on" the accepted "lieu slips" and "lieu cheques" instead of certificates. This, of course, is permitted by the rules governing trading but certainly enables a short seller to maintain his position for an undue length of time. In such transactions, the buying broker is not obliged to allow either a "leave off" or to accept a "lieu slip" or a "lieu cheque". Machinery is provided for "buying in" a defaulting broker who can not or does not make delivery on the due date. In our opinion an adequate knowledge of and the application of the rules governing trading could have forced the short interests to cover their positions to their detriment prior to May 16".[189]

The Beaulieu Report made specific recommendations to regulate short sales, including rules that would:

(a) require brokers who accept a sell order to have the client declare whether the sale was long or short and to pass that information on to the floor trader ("**Recommendation 2**");

(b) clarify the rules for the loan post and impose strict time limits for the delivery of stock against either long or short sales with shares borrowed from the loan post to allow brokers to deliver on time ("**Recommendation 3**"); and

(c) amend the Clearing House Rules regarding the use of lieu slips to expressly provide that brokers can refuse to accept lieu slips ("**Recommendation 4**"). Recommendation 4, however, did not go as far as banning naked shorts, but merely allowed a broker to refuse to accept a cash settlement in lieu of the delivery of the share certificates.[190]

Recommendation 2 was reflected in the amended rules of the TSE in 1947 in By-Law 46. However, at the time, Recommendation 3 and Recommendation 4 were not fully adopted by the TSE, whether in its By-Laws or the TSE Clearing Rules.

The calls to ban or restrict short sales were not universal following the failure of Beaulieu Mine. *The Globe & Mail* published an opinion on October 30, 1946, which cautioned restraint and urged that "it would be a mistake to follow slavishly New York practices. If brokers have developed ways of getting over the insufficiency of time to make delivery for clients on the other side of the continent and are willing to sell on faith for clients in whom they have great confidence, that is a state of affairs which has as its chief merit that it gives the public what it wants, quick service".[191] The opinion published in *The Globe & Mail* suggesting that brokers faced difficulties in settling short sales because it was difficult for brokers to physically deliver share certificates from one side of the country to the other appears naive. The opinion's caution against regulating short sales was unresponsive to the concerns that short sales were speculative and could be used to manipulate the market generally, or to manipulate the shares of a specific company.

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[189] *Ibid.*
[190] *Ibid* at 11.
[191] See Wellington Jeffers, "Beaulieu's Case History Gives Inside Details of Promotion Which Much Attracted the Public; Ball of Reform Thrown to Stock Exchange", *The Globe and Mail* (30 October 1946), at 22.

In November 1947, the TSE amended By-Law 46 to adopt portions of the Beaulieu Report's specific recommendations, as follows:

> No short sale of a security shall be made on this Exchange below the price at which the last sale of a board lot of the security was effected on the Exchange.
>
> It shall be the duty of a member or member firm accepting any order for sale of a security from any person, broker or other member or member firm to ascertain from such person, broker or other member or member firm at the time of acceptance of the selling order whether such order is an order for a short sale or a long sale.
>
> A member or member firm accepting an order which the member or the person accepting it is informed or knows is for a short sale shall mark the order in writing as "short" or "s" and shall report it as such to his or its floor trader and it shall be the duty of such floor trader to see that the price restriction in paragraph 1 is observed.
>
> A member or member firm shall keep a record of all transactions known to be short sales and of the particulars of the execution thereof and shall retain his record for a period of at least one year.
>
> A sale against a valid and subsisting option to purchase is not a short sale within the meaning of this Regulation.[192]

The TSE By-Laws were amended in the 1960s, and the new rules continued to facilitate short sales. By-Law 46 (as amended in 1958) established a Loan Department, which was managed by the TSE Clearing House Ltd. (the "**Clearing House**"). Members of the TSE ("**Members**") were required to lend shares to and borrow shares from other Members through the Loan Department, which settled loans for Members (subject to its Clearing Rules).

The TSE introduced amendments to its By-Laws over the 1960s. Similar to the former By-Law 46, By-Law 55 required that:

(i) short sales be at a price equal to the last sale of a board lot of the security, or above the next preceding different price at which a sale of a board lot was made on the TSE (as amended on May 12, 1960), which is commonly referred to as the "tick test";

(ii) each broker ascertain at the time it accepted an order for a sale whether the sale was for a short sale or long sale (as amended on May 17, 1956);

(iii) all orders for a short sale be marked in writing as "short" or "s"; and

(iv) brokers keep a record of all short sales (and particulars) for at least a year.

By-Law 55 was amended on May 9, 1963, to exempt certain sales from the short sales rules, including "a sale for a *bona fide* arbitrage account provided the seller at the time of such sales knows, or by virtue of information currently received has reasonable grounds to believe, that such an offer enabling him to cover such sale is then available to him and intends to accept such offer immediately".[193]

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[192] "Publish Short Positions Toronto Stock Exchange", *Financial Post* (15 November 1947), at 8.
[193] *1969 TSE By-Laws supra* note 181 at 54–55.

By-Law 56 further required Members to make semi-monthly reports for the total short positions on their books for each security posted for trading on the TSE that were established by short sales on the exchange.

The TSE Clearing Rules further required Members to clear their trades daily, or within the time specified, or by over-the-counter delivery. If a Member was unable to deliver according to the delivery instructions on the ticket issued, the ticket had to be stamped "FAIL" and returned to the Clearing House. Members could put a previously failed item on for settlement the next day by returning the ticket to the Clearing House by 4:00 p.m., but there was no obligation to do so. The Clearing Rules also permitted Members to settle by delivery of a certified cheque (cash) if "[w]hen, on the settlement date, a member is unable to make delivery of an item, or any part thereof entered on the sheet he may issue a certified cheque *in lieu of delivery of the stock*. All cheques must have the delivery instruction ticket (properly altered if for partial delivery) attached"[194] [emphasis added]. Members who were short share certificates on any day could return an acknowledgment slip listing any stock short and the Clearing House would make inquiries to locate securities to cover the Member's position.[195] However, the TSE Clearing Rules provided that "no 'short slips' will be issued by the Clearing House" and Members were responsible to effect delivery or to take action the delivering Member deemed "necessary for his own protection should the receiving broker report a deficiency". The Clearing Rules thus provided a mechanism to facilitate naked shorts.

Despite the Beaulieu Report's specific comments on the use of lieu slips and the evidence of naked shorting, the TSE By-Laws did not specifically address the concerns raised by the OSC in Recommendation 4 of the Beaulieu Report. Instead, sanctions could be imposed for manipulative short sales under a number of other By-Laws; for example, for conduct unbecoming a member of the TSE under By-Law 11, section 3(c), as a sale or offer to sell securities "for the purpose or with the effect of unduly disturbing the normal position of the market, and creating an abnormal market condition in which market prices do not fairly reflect current values" or for making a fictitious sale or not conducting business openly and fairly, and in accordance with just and equitable principles of trade under By-Law 30, section 9.[196]

Thus, the following three main areas of regulation of short selling were established by the TSE: (i) the designation and identification of short sales; (ii) the periodic reporting of short positions; and (iii) the specific restrictions on short sales, primarily through the sale price restriction. In addition, exemptions from the short sale rules were created for transactions that appeared to not have a "directional position". These building blocks continued to evolve in the modern era of securities regulations and industry self-regulation through RS and, now, through IIROC.

3.2 Modern Securities Regulation

3.2.1 Kimber Report and the *Securities Act, 1966*

The 1965 Kimber Report[197] ushered in modern securities legislation. Short sales were not discussed in either the Kimber Report or in legislative debates in Ontario leading to the passage of Bill 66,

[194] Toronto Stock Exchange, Clearing Rules, s 6 as it appeared on 14 May 1959, reprinted in *Toronto Stock Exchange: Act of Incorporation, By-Laws, and Rules* (Toronto:1954) (loose-leaf 14 May 1969 supplement) at (iii).
[195] *Ibid* at s 7.
[196] Separate sanctions could be taken for failing to close out a trade or for improperly lending customer securities to close-out a contract: see 1*969 TSE By-Laws, supra* note 181 at 24 and 36–38A.
[197] J.R Kimber, *Report of the Attorney General's Committee on Securities Legislation in Ontario* (March, 1965), print. Toronto [*The Kimber Report*].

which became the *Securities Act, 1966*.[198] However, Section 78 of the *Securities Act, 1966*, provided as follows:

> Any person or company who places an order for the sale of a security through an agent acting for him that is registered for trading in securities and,
>
> (a) at the time of placing the order, does not own the security; or
>
> (b) if acting as agent, knows that his principal does not own the security,
>
> shall, at the time of placing the order to sell declare to his agent that he or his principal, as the case may be, does not own the security.[199]

The disclosure of short sales by all persons was – and remains – a requirement. As with the *Criminal Code* market manipulation provisions, however, the short sale disclosure rule was rarely the subject of regulatory enforcement.

3.2.2 TSE Rules Give Way to UMIR

The TSE Rules governing short sales remained largely intact, even though the By-Laws were rewritten at some point in the 1970s. By-Law 11.27 in the 1986 *TSE Manual* was largely consistent with former By-Law 55, with some provisions consolidated from other By-Laws so they appear in one place. Further changes to the *TSE Manual* followed the 1997 closure of the TSX trading floor. By-Law 11.27 became section 3.9 of the TSE Rules and Policies, but no substantive changes were made to the rules. The TSE Rules and Policies were restructured completely in 2000, when the TSE became a for-profit company.

In 2001, RS was established as a joint initiative of the TSE and the Investment Dealers Association of Canada (the "**IDA**"), and was recognized in 2002 as an SRO by the CSA. RS became the regulator for all exchanges and adopted UMIR on April 1, 2002,[200] with the short selling provisions included as section 3.1, at which time the TSE and Canadian Venture Exchange[201] ("**CDNX**") rules and policies governing market integrity were amended to delete or vary any provisions covered by UMIR.[202] Again, the rules themselves remain largely unchanged from former By-Law 55.

3.2.3 Introduction of Reasonable Expectation Standard

The cornerstone of IIROC's "regulation" of naked shorting was introduced in 2005 as an amendment to Policy 2.2, which imposed a requirement that anyone entering into a short sale could only do so with a reasonable expectation of their ability to settle the trade.

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[198] *Securities Act*, S.O. 1966, c 142.
[199] *Ibid* (see *Securities Act*, RSO 1995, c S-5, s 48).
[200] See *Universal Market Integrity Rules*, Market Integrity Notice 2002-003 (1 April 2002), print: *RS* [*2002 Universal Market Integrity Rules*].
[201] The Canadian Venture Exchange formed in 1999 as a result of a merger between the Vancouver Stock Exchange and the Alberta Stock Exchange, and in November 2002, with the business of the Winnipeg Stock Exchange and the small-cap portion of the equities market of the Montreal Stock Exchange. The CDNX was renamed the TSX Venture Exchange when the CDNX was purchased by the TMX Group Ltd. in 2001: see "Canadian Venture Exchange" *Glossary, Practical Law*, online: *Thomson Reuters* <Resource ID 6-570-1125>.
[202] *2002 Universal Market Integrity Rules*, *supra* note 200 at 2.

RS put out its proposed amendments to Policy 2.2 for comment in 2004.[203] At the time, RS explained its reasons for the amendments, as follows:

> The amendments propose to move the specific examples of prohibited activities from the Rules to the Policies to be consistent with the structure of the rules in UMIR. The amendments also propose to expand the list of specific examples to include a prohibition on entering orders without ability or the reasonable expectation of making settlement of the resulting trade. [NI 23-101] contain[s] comparable prohibitions for trading which is not subject to UMIR.[204]

Among the activities that could be deceptive or manipulative, the proposed amendments to Policy 2.2 listed two separate "reasonable expectation of settlement" requirements: Policy 2.2(g) applied to orders to purchase a security without the reasonable expectation to make payment required to settle any trade that would result from the execution of the order, and Policy 2.2(h) applied to orders to sell securities without the reasonable expectation of settling any trade that would result from the execution of the order.

Several commenters[205] addressed Policy 2.2(h), with two[206] asking for clarification of what would be required to meet "reasonable expectations" or delivery verification, and two others[207] expressing concern that a "reasonable expectation of settlement" on short sales was a requirement to pre-borrow securities. RS responded to clarify that:

> The test being suggested by RS is similar to that … required under clause (f) of section 3.1 of the Companion Policy to [NI 23-101]. It does not require a "positive affirmation" before the trade. The proposal under clause (h) does not limit the ability to make a *bona fide* short sale. It does not require that the vendor have borrowed the securities prior to the sale. The provision merely requires that the vendor not make a sale knowing that the securities cannot be borrowed and that the vendor take "reasonable steps" to attempt to borrow the securities to make delivery on closing. Having made a short sale of a security that has failed to settle because of an inability to borrow the security, a person should not undertake further short sales of that security without knowing where the securities to complete the additional sales will be obtained.[208]

The proposed amendments to Rule 2.2 were again put out for comment in August 2004, with no further comments received on the "reasonable expectation of settlement" requirement. The changes to Policy 2.2 came into effect on April 1, 2005.[209] While IIROC sees Rule 2.2 as sufficient to prohibiting naked shorting, it is clear that Rule 2.2 (and Policy 2.2) is not specifically aimed at short sales and it is clear that IIROC did not intend to impose a "reasonable expectation" test in order to limit or restrict short selling and address systemic risk, but rather to provide clarity with respect to prohibited, manipulative and deceptive trading.

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[203] *Request for Comments – Manipulative and Deceptive Activities,* Market Integrity Notice 2004-003 (30 January 2004), online (pdf): *Market Regulations Services Inc* <www.iiroc.ca/Documents/2004/CE832340-849F-432C-876D-ED50A29F719D_en.pdf> [*Market Integrity Notice 2004-003*]. See also *Market Integrity Notice 2004-017, supra* note 147.
[204] *Market Integrity Notice 2004-003, supra* note 203 at 3.
[205] See *Market Integrity Notice 2004-017, supra* note 147 (specifically, comments by CIBC World Markets, RBC Capital Markets, Merrill Lynch Canada Inc. and Raymond James Ltd.).
[206] *Ibid* (see comments by CIBC World Markets and RBC Capital Markets).
[207] *Ibid* (see comments by Raymond James Ltd. and Merrill Lynch Canada Inc.).
[208] *Ibid* at *25.*
[209] See *Notice of Amendment Approval – Provisions Respecting Manipulative and Deceptive Activities*, Market Integrity Notice 2005-011 (April 1, 2005) at 4, online (pdf): *Market Regulations Services Inc* <www.iiroc.ca/Documents/2005/F8339CA6-B1EA-4574-8663-16A855F86B1F_en.pdf#search=2005%2D011> [*Market Integrity Notice 2005 – 011*].

3.2.4 2008 Amendments to UMIR

In 2003, RS, which soon after became IIROC, began a strategic review of UMIR.[210] IIROC identified a number of market integrity risks addressed in UMIR, and the risk associated with short selling addressed in UMIR 3.1 was "inappropriate pricing".[211] Prompted in part by proposed regulatory changes in the US, staff began a general review of both the short sale and short position reporting requirements in UMIR and sought public comment from industry participants.[212] In addition, IIROC[213] noted that it participated in an informal working group with the CSA, IDA, CDS, TSX and the Bourse de Montréal to study issues related to failed trades and short sales, including "the role that short sales played in the occurrence of failed trades".[214]

3.2.4.1 Proposed Amendments

In September 2007, IIROC published for comment proposed amendments to UMIR (the "**2007 Proposed Amendments**") and its rationale for these changes. At this time, short sales were regulated in UMIR under three principal heads:

- sale price regulation rule (UMIR 3.1);
- disclosure through marking orders as "short" and requiring Participants to file aggregate Short Position Reports on a twice monthly basis (UMIR 10.10); and
- prohibitions on deceptive or manipulative trading practices (UMIR 2.2).[215]

In the introduction to the request for comments on the 2007 Proposed Amendments, IIROC noted that the public input it received from industry participants who supported the regulation of short sales generally also favoured regulations that were designed to prohibit market manipulation, rather than the imposition of price restrictions or adopting US pre-borrow requirements for all short sales.[216] Accordingly, IIROC proposed to make certain amendments to UMIR.

3.2.4.1.1 Repeal Rule 3.1 – Removal of the Sale Price Restrictions

IIROC proposed rescinding all sale price restrictions to parallel the SEC's elimination of the sale price rule in Rule 3.1.[217] IIROC supported this proposed amendment by referring to academic literature as well as empirical studies, particularly the SEC's Reg SHO Pilot Report (the "**SHO Study**"). The SHO Study looked at the impact of temporarily lifting sale price restrictions and reached two principal conclusions: first, sale price restrictions did not impact price stability in declining markets, and second,

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[210] *Background Chart for the Strategic Review of the Universal Market Integrity Rules*, Market Integrity Notice 2004-026 (October 4, 2004), online (pdf): *Market Regulations Services Inc* <www.iiroc.ca/Documents/2004/10CAF135-BFE9-430B-AE31-DED85D300510_en.pdf#search=2004%2D026> [*Market Integrity Notice 2004-026*].
[211] *Ibid* at 2.
[212] *Request for Comments – Provisions Respecting Short Sales,* Market Integrity Notice 2004-012 (32 April 2004) at 5, online (pdf): *Market Regulations Services Inc* <www.iiroc.ca/Documents/2004/0375D254-0309-49CE-839F-F7718955BE8A_en.pdf#search=2004%2D012> [*Market Integrity Notice 2004-012*].
[213] At this time, RS along with the IDA.
[214] *Request for Comments – Provisions Respecting Short Sales and Failed Trades,* Market Integrity Notice 2007-017 (7 September 2007) at 11, online (pdf): *Market Regulations Services Inc* <www.iiroc.ca/Documents/2007/B8DA6A67-D127-4705-8EE2-864A38DD2993_en.pdf#search=2007%2D017> [*Market Integrity Notice 2007-017*].
[215] Fraudulent manipulation of stock exchange transactions became a criminal offence prior to this: see s. 325 of the *Criminal Code*, RSC 1953–54, c C-51, s 325, (now s 381 *Criminal Code*, RSC 1985, c C-46, s 381, as amended SC 2004, c 3, s 4). The fraudulent manipulation of stock exchange transactions is also prohibited under provincial securities regulations.
[216] *Market Integrity Notice 2007-017*, *supra* note 214.
[217] *Ibid* at 14–15.

that a tick rule alone cannot prevent market manipulation.[218] Rather, the SHO Study concluded that while there was an increase in the volume of short selling of exchange-listed stocks and Nasdaq National Market stocks added to the SHO Study, it had no impact on the level of short interest in either market, and there was no clear impact on market liquidity or daily volatility.[219]

3.2.4.1.2 Short Sale Ineligible Security

The 2007 Proposed Amendments sought to give IIROC the power to designate a security as a "Short Sale Ineligible Security" in order to respond to developments in trading of a particular security or class of securities if IIROC concluded that the rates of failed trades became excessive.[220] The designation of a security as a Short Sale Ineligible Security was intended to function with existing rules, such as the market integrity rules in Policy 2.2, as well as the CSA's expectations set out in NI 24-101.[221] IIROC concluded that the 2005 amendments to Policy 2.2 requiring Participants to have a reasonable expectation of settling a trade – and hence, in their view, prohibiting naked shorting – "should preclude short selling in so-called death spiral situations".[222] Again, IIROC clearly viewed any risks posed by short selling, particularly naked shorting, as primarily a question of market conduct. It saw its additional discretion to designate securities as ineligible for short sales as a "backstop" intended to allow RS to respond to "systemic failures" to settle.[223] Exemptions would permit the sale of a Short Sale Ineligible Security in certain circumstances; for example, by market makers. In IIROC's view, this approach was preferable in Canada over the approach used in the US.[224]

3.2.4.1.3 Designation – Amend Rule 10.10 – Short Sale Price Exempt Marker

IIROC's focus on regulating short sales shifted to obtaining better trading data with a view to a targeted intervention to address suspected abusive trading. In 2004, it expressed concern that a lack of transparency in short position reporting could prevent price discovery. At that time, IIROC was of the view that "short positions represented future buying pressure combined with an indication of 'current market sentiment' with respect to a particular security".[225] Fundamentally, however, IIROC's surveillance did not distinguish between abusive short selling and any other form of abusive market conduct.

Short sales were required to be marked as either subject to the sale price restrictions or exempt from the sale price restrictions. The elimination of the tick test meant that it would no longer be necessary

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[218] IIROC was heavily influenced by the SEC's amendments (as of July 6, 2007) to remove all sale price restrictions as well as removing short exempt order marking requirements. The SHO Study temporarily lifted the tick test (including in Rule 10a-1 of the *Exchange Act* and various exchanges' rules) on 1,000 actively traded securities and after-hours trading of another 1,000 securities. RS looked to a report published by the SEC Office of Economic Analysis: see *Economic Analysis of the Short Sale Price Restriction under the Regulation SHO Pilot – A Study by the Staff of the Office of Economic Analysis* (12 February 2007), *U.S. Securities and Exchange Commission - Office of Economic Analysis*. IIROC noted that the SHO Study should be applied cautiously to the Canadian context given significant difference in market capitalization and liquidity for securities listed on United States and Canadian exchanges, as well as particular circumstances existing at the time the SHO Study was conducted: see *Market Integrity Notice 2007-017, supra* note 214 at 8–9, 15–16.
[219] See *Market Integrity Notice 2007-017, supra* note 214 at 6, 9. RS also took into account a further study by the SEC's Office of Economic Analysis on the reasons for "failures to deliver" in connection with trading in equity initial public offerings ("**IPO Study**"). RS noted that the IPO Study looked at short selling data from the SHO Study and other data from short sales, and concluded that there was no evidence that short selling was related to failures to deliver in connection with an IPO: see Amy K Edwards and Kathleen Weiss Hanley, "Short Selling and Failures to Deliver in Initial Public Offerings" (23 April 2007).
[220] *Market Integrity Notice 2007-017, supra* note 214 at 20.
[221] *IIROC Notice 08-0143, supra* note 59 at 28, 34–35.
[222] See *Market Integrity Notice 2007-017, supra* note 214 at 20.
[223] *Ibid* at 21.
[224] *Ibid* at 20–21.
[225] *Market Integrity Notice 2004-026, supra* note 210 at 11,

to mark short sale orders that were exempt from short sale price restrictions.[226] Despite the elimination of short sale price restrictions, and the exempt designation, all short sales would still be required to be marked as "short", as required under securities laws, in order to allow IIROC to monitor the effect of the elimination of the sale price restrictions and intervene. Citing academic literature and the SEC studies, IIROC predicted that the elimination of sale price restrictions would result in lower price volatility for "large-capitalization" securities and higher volatility for "small-capitalization" securities.[227] IIROC anticipated that while the repeal of sale price restrictions would have a minor effect on price volatility on the TSX, there could be increased volatility on the TSX Venture Exchange (the "**TSXV**") and Canadian Trading and Quotation System (the "**CNQ**"), which is now the Canadian Securities Exchange (the "**CSE**"). This, in turn, would result in a greater number of statistical trading alerts. IIROC proposed to undertake an empirical study of the impact of the repeal of the sale price restrictions and other changes in the 2007 Proposed Amendments.[228]

3.2.4.1.4 Short Position Reporting

When it was first introduced, Rule 10.10 required Participants and Access Persons to file a report of the aggregate short position of each account, the Short Position Report, twice a month. In addition, the TSX produced a twice monthly Consolidated Short Position Report, which is now the CSPR produced by IIROC, for IIROC. IIROC stated that its view was that preparing these reports "impose an administrative burden on Participants, Access Persons and the TSX", and that IIROC did not use Short Position Reports extensively "for any regulatory purpose as the information it contains is of limited regulatory utility".[229] IIROC expressed further concern that the CSPR did not provide a complete or meaningful picture of the short position in any security, and did not reflect short positions in securities held by US-based or foreign dealers, non-Participant dealers, or custodians or other institutions that are members of CDS or securities listed on the CNQ.[230]

IIROC proposed relieving Participants, Access Persons and the TSX of the administrative burdens connected with producing the CSPR, but only if IIROC's Board of Directors was satisfied that adequate information on short positions otherwise became available. An example of an alternative that was considered was retaining the CSPR but providing more meaningful information "by categorizing the short position as 'covered', 'hedged', 'naked' or 'closing out of a short position'. This alternative was dismissed in light of the expected "higher compliance cost".[231] RS envisaged that an appropriate alternative would be for third parties to provide separate reports from each marketplace.

3.2.4.1.5 Reporting – New Rule 7.11 – Extended Failed Trade Reporting

UMIR did not require Participants or Access Persons to report failed trades. IIROC noted that the relationship between failed trades and market integrity is a concern to regulators. It looked to the new definition of "failed trade" and the requirements in the new Rule 7.11 to give IIROC a reliable audit trail and sufficient information to evaluate whether trading activity complied with UMIR and other regulatory requirements. That said, IIROC clearly took – and maintains – the view that failed trades in Canada are not primarily the result of abusive short selling, but by and large were the result of what IIROC called administrative error, such as inadvertent delays related to taking possession of physical certificates for securities, the custodian lacking instructions and discrepancies related to the

[226] The 2007 Proposed Amendments included amendments to UMIR Rule 6.2 to this effect: see *Market Integrity Notice 2007-017*, *supra* note 214 at 27.
[227] *Ibid* at 15.
[228] *Ibid* at 16.
[229] *Ibid* at 25–26.
[230] *Ibid.*
[231] *Ibid* at 26.

price or number of securities. IIROC's own 25-dealer self-reporting study (the "**Failed Trade Study**") in Canadian marketplaces over a period of five business days[232] concluded that failed trades accounted for 0.27% of the total number of trades executed on the TSX, TSXV and CNQ in Canada; less than 6% of failed trades resulted from short sales; and approximately 96% of failed trades settled within 10 trading days after the expected settlement date – typically T+13 at the time for equity securities.[233] It is surprising that such a limited study formed the basis of definitive conclusions.[234]

Adding what is now Rule 7.10 to the 2007 Proposed Amendments required Participants and Access Persons to file an EFTR with IIROC or other market regulators if a trade remained unsettled for 10 trading days following the expected settlement date. IIROC concluded that requiring EFTRs at the account level – and for all trades – would allow it to examine if a trade failed to settle for an "improper reason", such as being executed as an undeclared short. A second "close-out" report would be required once the trade settled. IIROC explained that "[i]n this way, [IIROC] will be in a position to monitor trends in 'failed trades' including the steps which a Participant or Access Person may be taking to rectify the default".[235] IIROC proposed to use EFTRs to determine when to designate a security as a "Short Sale Ineligible Security".[236] Given IIROC's conclusion that 96% of trades that fail to settle on the settlement date do so within 10 trading days, it did not expect that there would be a significant volume or burden with the new obligation to file failed trade reports. Rather, it appears that IIROC selected 10 trading days as the trigger for an EFTR principally to avoid a large number of EFTRs because of these "administrative errors" although IIROC indicated in its response to comments that it would consider a shorter trigger period if it detected market integrity concerns.[237]

3.2.4.1.6 Intervention – Cancelling or Varying Trades – Rules 7.12 and 10.9

IIROC introduced a new provision in proposed Rule 7.12 to prevent parties to an executed trade from cancelling or varying the trade before settlement – e.g. to change the price, volume of shares sold or the settlement date – without first giving notice to IIROC and then following the procedures and facilities provided by the marketplace on which the trade was executed or the clearing agency through which the trade is to be cleared and settled. IIROC explained that this amendment "is to ensure that a trade variation or cancellation is not effected outside the normal processes of the marketplace and CDS", unless IIROC is notified and has the opportunity to review the change for "possible market integrity concerns" and to ensure that the trade is cancelled or varied for a legitimate reason and "not as part of a manipulative or deceptive manner of trading (including the establishment of a price that would permit other trading activity to then be conducted in nominal compliance with UMIR or other securities regulatory requirements)."[238] IIROC proposed requiring each Participant or Access Person that is party to a trade that is cancelled or varied after settlement by the clearing agency to give it notice of the cancellation or variation.[239]

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[232] See *General – Results of the Statistical Study of Failed Trades on Canadian Marketplaces.* Market Policy Notice 2007-003 (13 April 2007), online (pdf): *Market Regulation Services Inc.* <www.iiroc.ca/Documents/2007/64AAACCA-3D8D-41B6-A20F-F49AB7F4770D_en.pdf#search=2007%2D003>. See also *Market Integrity Notice 2007-017, supra* note 214 at 12–13.
[233] See *Market Integrity Notice 2007-017, supra* note 214 at 13–14, 23.
[234] We note that RBC DS Inc. noted: "We further feel that the RS' *Statistical Study of Failed Trades on Canadian Marketplaces* conducted in the summer of 2006 may not have provided an accurate correlation between short selling and failed trades": see Response letter from RBC Dominion Securities to Market Regulation Services Inc. (October 9, 2007) online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2007/2C8465B0-61B2-485D-B4BC-802964CD9FDE_en.pdf#search=RBC%20Write%3E%3D2007%2F10%2F9%20AND%20Write%3C%3D2007%2F12%2F12> [*RBC Dominion Securities Response Letter*].
[235] *Market Integrity Notice 2007-017, supra* note 214 at 23.
[236] *Ibid.*
[237] See discussion of the 2012 Proposed Amendments in Section 3.2.6. IIROC continues to monitor and review the occurrence and frequency of failed trades and whether it is accurate to say that most are explained by administrative errors.
[238] See *Market Integrity Notice 2007-017, supra* note 214 at 22.
[239] *Ibid* at 22–23.

In addition, IIROC proposed to give itself the specific power to cancel a "failed trade" in proposed amendments to Rule 10.9. IIROC again tied this proposed power to market integrity and the objective of ensuring that all trades executed on a marketplace are *bona fide* and settle in the ordinary course.[240] While IIROC expressed the view that a failed trade "may be indicative of improper behaviour if not cured within a reasonable period of time", it also noted that this provision was "aimed at the less than 2% of failed trades that are not resolved within 15 days after the expected 'settlement date'".[241] Even then, a failed trade would not be cancelled so long as IIROC was satisfied that there was a valid reason for continuing the default.

3.2.4.2 Industry Comments to the 2007 Proposed Amendments

IIROC solicited comments on the 2007 Proposed Amendments and sought specific comments on the repeal of Rule 3.1 and whether UMIR should adopt provisions comparable to those in the US governing short sales, such as mandatory locate requirements, documentation requirements for short and long sales, the maintenance of fail lists and close-out requirements for securities on a fail list.[242] IIROC received comments to the 2007 Proposed Amendments from a wide range of parties, including institutional investors, issuers and industry associations.

3.2.4.2.1 Repealing Sale Price Restrictions – Rule 3.1

While larger institutional traders, industry associations, the TSX Group and CNQ[243] favoured the repeal of share price restrictions, smaller dealers and issuers pointed to the traditional concerns that eliminating sale price restrictions would lead to market abuses and a risk of increased volatility for smaller, less-liquid issuers, and undermine investor confidence.[244] One commenter described the tick test as "the only hard barrier against predatory behaviour".[245] Several issuers[246] commented that the removal of sale price restrictions would threaten investors in low-volume issuers and put those issuers themselves at risk of market manipulation. Concern was expressed that the volatility and downward price pressure associated with minimally restrained short selling would harm shareholders by artificially reducing their returns and negatively impact small-capitalization issuers' ability to access capital.[247] Others[248] expressed concern that eliminating the tick test while allowing naked shorting, "piggybacking" on the SEC's analysis, "may be disastrous to Canadian markets"[249] and that allowing

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[240] *Ibid* at 24.
[241] *Ibid* at 24, 25.
[242] *Ibid* at 31–32.
[243] The CNQ, which was recognized as a stock exchange by the OSC in 2004, became the Canadian National Stock Exchange Markets Inc. in 2008, and is now the CSE operated by CNSX Inc.
[244] *IIROC Notice 08-0143*, *supra* note 59 at 30–32.
[245] Comment Letter from Absolute Software Corp. to Market Regulation Services Inc. (7 February 2008), at 2, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2008/A4C203F0-FDCF-46CA-9AEA-FBE37624EE11_en.pdf#search=Absolute%20Software> [*Absolute Software Comment Letter*].
[246] See *ibid.* See also Comment Letter from Globex Mining Enterprises Inc. to Market Regulation Services Inc. (31 January 2008), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2008/1A46B075-29B3-45AF-9E57-2616B16A8AC6_en.pdf#search=Globex%20Mining> [*Globex Mining Comment Letter*]. See also Comment Letter from Platinum Group Metals Ltd. to Market Regulation Services Inc. (25 February 2008), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2008/4EB2793A-572C-4989-B521-DB115DEC7FA0_en.pdf#search=Platinum%20Group%20Metals> [*Platinum Group Metals Comment Letter*].
[247] *IIROC Notice 08-0143*, *supra* note 59 at 30 – 32.
[248] See Comment Letter from David Patch to Market Regulation Services Inc. (12 September 2007), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2007/C4C92FCF-8C76-45F1-9D58-BE43DBBD13A1_en.pdf#search=David%20Patch> [*David Patch Comment Letter*]. See also Comment Letter from Sentry Select Capital Corp. to Market Regulation Services Inc. (14 February 2008), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2008/6A130424-BFC2-4124-B08D-FAC550CF0829_en.pdf#search=Sentry%20Select> [*Sentry Select Capital Comment Letter*].
[249] See *David Patch Comment Letter, supra* note 248. See also *IIROC Notice 08-0143, supra* note 59 at 31.

unfettered short selling by hedge funds and arbitrageurs "would promote bear raids against many Canadians' long-term savings".[250]

IIROC dismissed these and other less critical comments and concerns about allowing unrestricted short selling. First, it noted that the objectives of short sellers and sellers owning the securities are the same – to maximize their proceeds of sale. Anyone – that is, regardless of whether they are selling short or long – entering an order with the intention of effecting an artificial price engages in manipulative behaviour prohibited under UMIR and would be detected by IIROC's alert systems.[251] Repealing the sale price restrictions would not affect UMIR's existing "anti-manipulation" provisions and continued short making would allow IIROC to continue to monitor the effect of short selling activity.[252] IIROC proposed to undertake an "Impact Study" to test the effects of the repeal of the short sale restrictions and looked to other rules to preclude manipulative behaviour, "whether it is abusive short selling or "upticking" for the purpose of establishing an artificial price".[253]

There was a significant industry hesitation to endorse the new "Short Sale Ineligible Security" designation and commenters sought greater clarity on the criteria IIROC proposed to use in determining whether to make a security ineligible for a short sale. IIROC noted that the "Short Sale Ineligible Security" designation should be a subjective determination based on the current "situation" of a security and its historic trading record, rather than statistical thresholds, such as failed trades.[254] The "Short Sale Ineligible Security" designation would apply where failures to settle become systemic and a fair and orderly market for the security ceased to exist, or where there were other recognized risks to market integrity arising out of continued short sales, and would be rarely used.[255]

3.2.4.2.2 Designation – Short Sale Price Exempt Marker

Most commenters supported the proposal to remove the short sale price exempt marker.[256] There were suggestions that the "short" identifier include additional information, such as whether the short sale was covered or naked, although there was also some concern that the increased cost of compliance might outweigh any potential benefit.[257]

3.2.4.2.3 Reporting – Eliminating Short Position Reports

Most commenters agreed that the information in the CSPR is unhelpful. There were limited comments that IIROC should work with marketplaces to provide some information regarding short sales, or even retaining the CSPR but adding new categories for short positions.[258]

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[250] See *Sentry Select Capital Comment Letter, supra* note 248. See also *IIROC Notice 08-0143, supra* note 59 at 31.
[251] *IIROC Notice 08-0143, supra* note 59 at 30–31 (specifically, see IIROC's responses to comments by Absolute Software Corporation, Globex Mining Enterprises Inc., Platinum Group Metals Ltd., and Cannacord Capital Inc.).
[252] *Ibid.*
[253] *Ibid* at 31 (see IIROC's response to comments from David Patch and Sentry Capital Corp).
[254] *Ibid* at 26–27 (see IIROC's response to comments from Absolute Software Corporation and Investment Industry Association of Canada.
[255] *Ibid* at 27–28 (see IIROC's responses to comments from Cannacord Capital Inc. and ITG Canada Corp).
[256] *Ibid* at 32–33.
[257] See Comment Letter from CNQ to Market Regulation Services Inc. (10 October 2007) at 2, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2007/1154B604-24F8-4A9A-A2AD-C334E5CB1762_en.pdf#search=CNQ%20Write%3E%3D2007%2F10%2F1%20AND%20Write%3C%3D2007%2F11%2F1> [*CNQ Comment Letter*].
[258] *IIROC Notice 08-0143, supra note 59* at 38–40. See also Comment Letter from the Canadian Securities Traders Association, Inc. to Market Regulation Services Inc. (9 October 2007) at 2 (The Canadian Securities Traders Association supported using additional classifications of short sales in CSPR), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2007/140ACDC9-8FEC-49B0-A87B-0CAE756CF558_en.doc> [*CSTA Comment Letter*].

3.2.4.2.4 Reporting – Extended Failed Trade Reporting

Many commenters that were large brokers or dealers took IIROC up on its position that short sales were not responsible for failed trades, and questioned why they should then be required to report EFTs.[259] Others questioned whether UMIR was the right place to address failed trades and suggested that IIROC instead consider whether NI 24-101 addressed IIROC's concerns and that it obtain information on failed trades from CDS.[260]

Some commenters expressed concern on IIROC's selection of 10 trading days after the expected settlement date as the trigger for reporting an EFT. As noted by one commenter "[i]f a report is not required until 10 trading days to have lapsed after the settlement date, a very large proportion of trades that failed for an improper reason could be un-reportable to the regulations service provider. This would jeopardize the ability of the regulators to make a reasonably complete assessment of the causes of failed trades or have sufficient data to determine which securities should be designated as Short Sale Ineligible Securities."[261] Others, however, questioned whether there was any need to report failed trades, since most of them occurred due to administrative errors or delays.[262]

3.2.4.2.5 Intervention – Cancelling or Varying Trades

Generally, comments supported restrictions on the ability of Participants and Access Persons to vary or cancel a failed trade without notice to IIROC or a market regulator. In contrast, commenters voiced strong opposition to IIROC cancelling failed trades on its own initiative. IIROC noted that this cancellation power would only be used as a last resort and only where there was no reasonable prospect that the failure would be rectified in accordance with the requirements of the marketplace or clearing agency.[263]

3.2.4.3 2008 Amendments – What Changed?

Some of the 2007 Proposed Amendments were approved in October 2008[264] (the "**2008 Amendments**") in the midst of the 2007-2008 financial crisis. However, the amendments were considerably narrower in scope than initially proposed. Only the definition for Short Sale Ineligible Securities came into effect immediately. The repeal of Rule 3.1 and the elimination of Short Position

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[259] See *IIROC Notice 08-0143, supra* note 59 at 33–34 (see comments by Bank of Montreal Nesbitt Burns and Cannacord Capital Inc.).
[260] See Comment Letter from the Investment Industry Association of Canada to Market Regulation Services Inc. (9 October 2007) at 1, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2007/16E6BF9C-94DE-475C-A162-3AE545CE35DC_en.pdf#search=IIAC%20Write>%3D2007%2F9%2F1%20AND%20Write<%3D2007%2F11%2F1>. See also Comment Letter from ITG Canada Corp. to Market Regulation Services Inc. (9 October 2007) at 2, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2007/6D364A66-97E5-407B-A75C-1B1230905447_en.pdf#search=ITG%20Write>%3D2007%2F9%2F1%20AND%20Write<%3D2007%2F11%2F1> [*ITG Comment Letter*]. See also *IIROC Notice 08-0143, supra* note 59 at 34–35.
[261] Comment Letter from Trinidad Energy Services Income Trust to Market Regulation Services Inc. (undated) at 2, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2007/22C4C5E0-917F-4C6A-840C-93A7458B407A_en.pdf#search=Trinidad%20Energy%20Services%20Income%20Trust%20Write%3E%3D2007%2F9%2F1%20AND%20Write%3C%3D2007%2F11%2F1> [*Trinidad Energy Comment Letter*].
[262] See Comment Letter from BMO Nesbitt Burns to Market Regulation Services Inc. (9 October 2007) at 2–3, online (pdf): *Investment Industry Regulatory Authority of Canada* <www.iiroc.ca/Documents/2007/8C557615-D305-45BB-A28C-66CD7990A07E_en.pdf#search=BMO%20Burns%20Write%3E%3D2007%2F9%2F1%20AND%20Write%3C%3D2007%2F11%2F1> [*BMO Comment Letter*]. See also Comment Letter from Cannacord Capital Inc. to Market Regulation Services Inc. (17 October 2007) at 2, print: *Investment Industry Regulatory Organization of Canada* [*Cannacord Comment Letter*].
[263] *IIROC Notice 08-0143, supra* note 59 at 37.
[264] *IIROC Notice 08-0143, supra* note 59.

Reports (and the CSPR) were deferred and the implementation of EFT reporting obligations were delayed until 2011.[265]

3.2.4.3.1 Repealing Rule 3.1 – Deferred

IIROC deferred the repeal of Rule 3.1 due to existing market conditions "and the fact that the regulatory framework governing short sales was under active review in the United States and in other foreign jurisdictions".[266]

In the month prior (September 2008), the OSC intervened in the Canadian capital markets, first on September 19, 2008 ("**Original Temporary Order**"), and then again on September 22, 2008 ("**Restated Temporary Order**"), to prohibit the short sale of certain financial issuers listed on the TSX and interlisted with US exchanges ("**Financial Sector Issuers**").[267] The Original Temporary Order was justified as a precautionary measure to "prevent regulatory arbitrage with respect to short selling in Ontario of the Financial Sector Issuers as a result of initiatives by the [SEC] and to promote fair and orderly markets in Ontario for trading in securities of the Financial Sector Issuers".[268] The Restated Temporary Order was ended on October 3, 2008. IIROC noted that it would continue to monitor developments in the Canadian market and new initiatives taken by foreign regulators with respect to short sales and failed trades to determine what further action should be taken.[269]

3.2.4.3.2 Short Sale Ineligible Security

The definition of Short Sale Ineligible Security was approved and came into effect on October 14, 2008. Responding to the comments made, IIROC amended Part 4 of Policy 1.1 to allow it to designate a security short sale ineligible if:

- based on reports of failed trades submitted to IIROC in accordance with Rule 7.10 or other information known to IIROC, a particular security or class of securities has an unusual number or pattern of failed trades by more than one Participant or Access Person;
- the number or pattern of failed trades is related to short selling; and
- the designation would be in the interests of maintaining a fair and orderly market.[270]

IIROC explained that the designation, which applies to a particular security or class of securities, would be used if there were "systemic failures to settle trades".[271] IIROC rejected the use of a statistical threshold because, in its view, it "must determine that short selling is exacerbating the situation" before making a designation.[272] For example, IIROC's view was that there was far greater risk to market integrity if a series of dealers experienced prolonged failed trades for a relatively small number

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[265] See *Rules Notice – Guidance Note – Reminder Regarding the Reporting of Extended Failed Trades*, IIROC Notice 11-0161 (19 May 2011), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2011/369fd3ea-8c58-477d-94eb-4d83b17c1e42_en.pdf> [*IIROC Notice 11-0161*].
[266] *IIROC Notice 08-0143, supra* note 59 at 1.
[267] The SEC and the United Kingdom's Financial Services Authority (the "**FSA**") similarly intervened to prohibit short sales through emergency orders throughout September and October of 2008.
[268] *Rules Notice – Guidance Notice – Restated Reminder Respecting Obligations in the Conduct of Short Sales,* IIROC Notice 08-0101 (23 September 2008), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2008/4FF90709-EB02-4D4E-B676-6356B18C0971_en.pdf#search=08%20%2D%200101> [*IIROC Notice 08-0101*].
[269] *Ibid.*
[270] *IIROC Notice 08-0143, supra* note 59 at 23.
[271] *Ibid* at 10.
[272] *Ibid.*

of shares of a security that is illiquid than from the failure of a single block trade in a highly liquid security, where the failure might possibly be due to administrative problems or custodian delay.[273]

However, IIROC concluded that it would not need to make the designation in "real time", because the circumstances that would lead to the need to designate a security would build over time, and no one factor would lead to the designation being used. Nevertheless, it would need to be made in a timely manner.[274] IIROC further explained that it would only designate a security as short sale ineligible with concurrence from the applicable securities regulator. In addition, IIROC indicated that if it detected "unusual circumstances" and a "problem" was developing, it would provide an IIROC Notice to market participants that should ensure their ability to borrow or obtain securities for the settlement of any sale in respect of a particular security.[275] Certain exceptions were also provided in UMIR to the prohibition on short selling a Short Sale Ineligible Security.[276]

3.2.4.3.3 Designation – Short Sale Marking

As a result of IIROC's decision to defer removing the sale price restrictions in Rule 3.1, no changes were made to the use of the short sale price exempt designation.

3.2.4.3.4 Reporting – Short Position Reporting

Despite the high level of consensus among commenters that the information provided by the CSPR was unhelpful, IIROC withdrew its proposed amendments to eliminate the obligation of Participants and Access Persons to file twice monthly Short Position Reports. It explained that IIROC would pursue the introduction of trade summaries in the most cost-effective and efficient basis, whether from marketplaces acting cooperatively, with IIROC using regulatory information it receives on all trades, or potentially, through a third party information processor, if approved for all regulated marketplaces. IIROC indicated that it would not repeal Rule 10.10, however, until it "is satisfied that adequate information on short sales executed on a marketplace has become generally available" and that there would be a transition period of at least six months to a year where both the CSPR and these summaries would be available.[277]

3.2.4.3.5 Extended Failed Trade Reporting – Delayed

IIROC added Rule 7.10 requiring Access Persons and Participants to report EFTs, regardless of whether the order was for a short sale or any other sale at the account level.

IIROC noted that most commentators were opposed to "locate" and "close-out" requirements similar to those in the US.[278] Alternative measures, such as specific exemptions for highly liquid securities,

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[273] *Ibid.*
[274] *Ibid* at 11.
[275] *Ibid.*
[276] These exemptions included orders entered on a marketplace:
- "[I]n furtherance of the applicable Market Maker Obligations in accordance with the Marketplace Rules of that marketplace;
- for the account of a derivatives market maker and is entered:
  - in accordance with the market-making obligations of the seller in connection with the security or related security, and
  - to hedge a pre-existing position in the security or a related security;
- as part of a Program Trade in accordance with Marketplace Rules;
- to satisfy an obligation to fill an order imposed on a Participant or Access Person by any provision of UMIR or a Policy; or
- that is of a class of security or type of transaction that has been designated by a market regulator.": see *ibid* at 12.

[277] *Ibid* at 6.
[278] *Ibid* at 43.

or for securities listed on US exchanges following the SEC's proposed elimination of sale price restrictions, were rejected.[279]

IIROC responded to comments that suggested that the requirements in NI 24-101 to match trades within prescribed timeframes were sufficient, noting that the proposed 10 trading day after settlement timeframe to report a failed trade under the proposed amendment exceeded the timeframe contemplated in NI 24-101. IIROC also acknowledged that while there is no direct correlation between short selling and failed trades, and that IIROC was not looking to create a US-style fail list, it nevertheless viewed trade failures as an integrity matter.[280] Information on trade failures from CDS, which is on a continuous net settlement basis, only provides information on failed trades at a systemic level. In IIROC's view, this did not allow it to monitor risks to market integrity, which reside with the continuing failure on the part of the original party to the trade. Trade failure reporting would instead be measured at the account level.[281]

IIROC also defended its selection of the 10 trading day after the expected settlement date period, which one commenter found to be "excessively long" on the basis that the 10-day period is designed to minimize the administrative burden on Participants and Access Persons by giving them adequate time to resolve the reason for the failure.[282] This was again consistent with IIROC's view that most failed trades were the result of administrative failures and not abusive market conduct, but failed entirely to address the concern that a window of 13 trading days for equity securities would also allow abusive short trading to go undetected. This may be in part because IIROC's definition of abusive trading is in fact results-based – if a short sale settles within 10 trading days after the expected settlement date, any abusive quality is presumably purged.

IIROC, however, also noted that the policies and procedures of "most Participants" did not bring failed trade information to the attention of compliance, presumably the Participants' internal compliance[283], and IIROC needed to implement a secure electronic method for a Participant or Access Person to report failed trades. Accordingly, IIROC initially deferred the requirement for Participants and Access Persons to report EFTs until March 1, 2009, and would issue an IIROC Notice on or before February 1, 2009, setting out the required reports and procedures.[284]

IIROC ultimately deferred implementation of Rule 7.10 until June 1, 2011,[285] when EFTR rules were implemented for trades executed on a marketplace that settle through the CDS's CNS service.[286]

3.2.4.3.6 Cancelling or Varying Trades

IIROC withdrew the proposed market regulator standalone power to cancel or vary failed trades on the grounds of concerns that the failures were indicative of improper behaviour and that there was no valid reason for the continuing failures to settle.

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[279] See *IIROC Notice 08-0143, supra* note 59 at 47. See also *Market Integrity Notice 2007-017, supra* note 214 at 23–25.
[280] *IIROC Notice 08-0143, supra* note 59 at 33–36.
[281] *Ibid* at 35.
[282] *Ibid* at 36.
[283] *Ibid* at 15
[284] *Ibid* at 17.
[285] *Guidance Note – Deferral of Implementation Date of the Reporting of Extended Failed Trades and Trade Variations and Cancellations,* IIROC Notice 09-0062 (26 February 2009), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2009/0441B12C-9682-4088-93F4-D4B39B36F979_en.pdf#search=09%2D0062> [*IIROC Notice 09-0062*].
[286] See Section 2.4.5, *infra,* discussing settlement and clearing trades. See also *Rules Notice – Implementation Date for the Reporting of Extended Failed Trades,* IIROC Notice 11-0080 (25 February 2011), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2011/d0bf97f1-b15e-4b24-9d2d-8f216ea672a0_en.pdf#search=11%2D0080>.

IIROC deferred the implementation of the "Trade Variation or Cancellation" reporting requirement until the phasing-in of filing requirements for EFTRs; ultimately, until 2011.[287]

3.2.5 IOSCO Principles – Regulation of Short Sales After the Financial Crisis

In the aftermath of the 2007-2008 financial crisis, securities regulators re-examined the regulation of short sales, including the International Organization of Securities Commissions ("**IOSCO**"). IOSCO is an international body of the world's securities regulators that attempts to set global standards for market participants by developing, implementing and promoting adherence to internationally recognized standards for securities regulation.[288] IOSCO is comprised of the following: (i) 129 ordinary members that are composed of national securities commissions, including the SEC, the Australian Securities and Investments Commission ("**ASIC**") and the OSC, or similar governmental bodies with significant authority over securities markets in their respective jurisdictions; (ii) 31 associate members that are supranational governmental regulators and other international standard-setting bodies, as well as other governmental bodies with an appropriate interest in securities regulation; and (iii) 67 affiliate members that are SROs, securities exchanges and other bodies with an appropriate interest in securities regulation.[289]

In early 2009, IOSCO's Technical Committee issued its report *Regulation of Short Selling*.[290] The committee consisted of representatives of the OSC and the Autorité des marchés financiers (the "**AMF**"). In the report, IOSCO recommended four principles for the effective regulation of short sales by securities regulators aimed at eliminating perceived gaps between differing regulatory approaches to naked short selling. A brief overview of the four principles (the "**IOSCO Four Principles**") is set out below.[291]

> ("**IOSCO Principle 1**"): Short selling activities should be subject to appropriate controls to reduce or minimize the potential risks that could affect the orderly and efficient functioning and stability of the capital markets. IOSCO recommended "that the "regulation of short selling should *as a minimum requirement impose a strict settlement (such as compulsory buy-in) of failed trades*" [emphasis in original].[292] IOSCO also noted that some jurisdictions have compulsory buy-in or close-out requirements, supported by mandatory pre-borrowing, or locate requirements, as well as T+3 as the standard settlement cycle.
>
> ("**IOSCO Principle 2**"): Short selling should be subject to a reporting regime that provides timely information to the market or market regulators.
>
> ("**IOSCO Principle 3**"): Short selling should be subject to an effective compliance and enforcement regime. IOSCO noted that regulators should monitor and inspect settlement failures regularly, implement a "flagging" regime and identify potential market abuses and systemic risk.

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[287] *IIROC Notice 09-0062*, *supra* note 285. See also IIROC Notice 11-0079 *Implementation Dated for the Reporting of Trade Variations and Cancellations,* IIROC Notice 11-0079 (25 February 2011), online (pdf): *Investment Industry Regulatory Organization of Canada* <docs.iiroc.ca/DisplayDocument.aspx?DocumentID=DB9F34C4ED8F4A0F9673DA7FB703FE17&Language=en> [*IIROC Notice 11-0079*].
[288] *International Organization of Securities Commissions* online: <www.iosco.org.>.
[289] *International Organization of Securities Commissions* "About IOSCO", online: <www.iosco.org/about/?subsection=about_iosco>.
[290] Technical Committee of the International Organization of Securities Commissions, *Regulation of Short Selling, Consultation Report*, (March 2009), online (pdf): *IOSCO* <www.iosco.org/library/pubdocs/pdf/IOSCOPD289.pdf>.
[291] See *IIROC Notice 11-0075*, *supra* note 150 (a detailed analysis of IOSCO's recommendations and IIROC's assessment and response are set out in Appendix C).
[292] Technical Committee of the International Organization of Securities Commissions, *Regulation of Short Selling, Consultation Report*, (March 2009) at 8, online (pdf): *IOSCO* <www.iosco.org/library/pubdocs/pdf/IOSCOPD289.pdf>.

("**IOSCO Principle 4**"): Short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development. IOSCO expressed concern that short selling regulation allows desirable market transactions and that there should be clear definitions of exempted activities and the manner in which these activities should be reported.

3.2.6 The 2012 Amendments to UMIR

IIROC revisited certain proposed amendments and put forward further amendments to UMIR for comment in 2011[293] (the "**2011 Proposed Amendments**"), which included the following:

- repealing the sale price restrictions in UMIR Rule 3.1;
- introducing pre-borrowing requirements and specific consideration of the problems posed by "naked shorting"; and
- increasing monitoring and transparency measures, with reference to the IOSCO Four Principles, taking into account the "unique characteristics and practices of the Canadian market".

While IIROC included an overview of the IOSCO Four Principles in its *Market Integrity Notice*, it proposed few changes in line with those proposed by IOSCO. IIROC took the view that UMIR adequately addressed abusive short selling through prohibitions on manipulative and deceptive activities. It saw no systemic risk posed by short selling.[294]

With respect to IOSCO Principle 1 and the minimum suggested requirement of imposing strict settlement rules for failed trades, IIROC concluded that Policy 2.2 – and the reasonable expectation of settlement requirements – provided adequate discipline for abusive short selling and did not permit naked short selling. IIROC also noted that its studies show that Canadian short sales have a low trade failure rate.[295] Presumably, IIROC is referring here to its three-year study from May 1, 2007 to April 30, 2010 (the "**Trends Study**"),[296] and its Failed Trade Study.[297] In IIROC's assessment, given that most trade failures result from administrative errors, "hard" close-out provisions were not appropriate. Similarly, in IIROC's view, historic low trade failure rates made it unnecessary to impose general locate or pre-borrowing requirements. Proposed amendments to allow IIROC to impose pre-borrow requirements where there are EFTs were seen as enhancing IIROC's monitoring of short sales.[298]

With respect to IOSCO Principle 2, suggesting that short selling should be subject to a reporting regime that provides timely information to the market or market regulators, IIROC noted that the

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[293] *IIROC Notice 11-0075, supra* note 150.
[294] See *Ibid* at 15. See also "Price Movement and Short Sale Activity: The Case of the TSX Venture Exchange", IIROC (February 2011) at 9, print: *Investment Industry Regulatory Organization of Canada*.
[295] We note that IIROC has not provided any explanation as to why trade failure rates are allegedly low in Canada.
[296] The Trends Study examined overall trading activity, short selling and failed trades in this period, and followed on an earlier study undertaken by IIROC from May 1, 2007, to September 30, 2008 ("**Prior Study**"). Both the Trends Study and the Prior Study are described in *IIROC Notice 11-0075*: see *IIROC Notice 11-0075*, *supra* note 150 at 30–33. The Trends Study's conclusions included findings that there was no significant change in the period studied in patters of short selling compared to trading generally, and that the number of failed trades, as a percentage of overall trades, generally declined, with an average of 5.28% of failed trades closed through a buy-in.
[297] RS undertook a 2006 study of failed trades in Canadian marketplaces: see *Market Integrity Notice 2007-017, supra* note 214. Among the findings of the study, failed trades accounted for 0.27% of the total number of executed trades; administrative error was the predominant cause of failed trades, accounting for approximately 51% of fails; and less than 6% of fails resulted from short sales, with fails accounting for 0.07% of total short sales and buy-ins accounting for 4% of failed trades. The average failed trade remained outstanding for 4.2 days and approximately 96% of failed trades settled within 10 trading days of the expected settlement date: see also, *IIROC Notice 11-0075, supra* note 150 at 34–35.
[298] See *IIROC Notice 11-0075*, *supra* note 150 at 47–49.

CSPR did not provide meaningful information and that it proposed to produce and publicly release semi-monthly short sale summaries based on aggregated trading data.[299] In its specific responses to IOSCO Principle 2, IIROC also noted that it believed that daily trading data for a particular security can be distorted by the volume of trades, particularly those with limited liquidity or high volatility, and that "short sale" and "SME" flags should not be included in publicly released data, but should be available to IIROC in real time.[300] In IIROC's view, aggregated trading data permits it to determine established patterns of failure among Participants, and securities and patterns with respect to EFTs.[301] However, UMIR did not, and still does not, require information on derivative data to be included in Short Position Reports, although information on listed derivatives is otherwise available. IIROC did not anticipate any initiatives to provide more information on over-the-counter positions "in the foreseeable future".[302]

With respect to IOSCO Principle 3 and the suggestion that short selling should be subject to an effective compliance and enforcement regime, IIROC noted that it monitors trade failure rates generally through EFTRs and information provided by CDS.[303] Effective June 1, 2011, participants are responsible for the settlement of each trade and compliance with requirements of UMIR to report EFTs. IIROC looked to future development by the OSC and CDS of a database of daily initial trade failure reports using CNS, as well as an alert monitor for a combination of price movement and changes in patterns of short selling to determine if abusive short selling is occurring.[304]

With respect to IOSCO Principle 4, which provided that short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development, IIROC noted that the 2011 Proposed Amendments would separate out trading activities of arbitragers, market makers and certain institutional accounts pursuing "directional neutrality" through the proposed "short marking exempt" designation.[305] This would allow IIROC to continue to monitor other short selling activities.

IIROC's 2011 Proposed Amendments continued to refine UMIR in line with its longstanding views that short selling posed no systemic risk, and that abusive short selling could be adequately detected and addressed through reporting of EFTs and, if necessary, through measures directed at specific instances of abusive and manipulative market conduct. Notably, the 2011 Proposed Amendments do not fully endorse, let alone adopt, all of IOSCO's recommendations. Rather, IIROC's comments reflect a firm view that with the adoption of the 2011 Proposed Amendments, UMIR adequately addressed these principles, or that they were simply not applicable to or appropriate for the Canadian market.

3.2.6.1 Proposed Amendments

3.2.6.1.1 Repeal of Rule 3.1 and the Introduction of the SME Order Designation

Repealing the share price restrictions remained at the top of IIROC's proposed amendments to UMIR. IIROC noted that, aside from emergency measures in 2008, the SEC had repealed the sale price restrictions effective July 7, 2007. IIROC also took notice of SEC Rule 201 (implemented on February

[299] *Ibid* at 16.
[300] *Ibid* at 49–53.
[301] *Ibid* at 50.
[302] *Ibid* at 51.
[303] *Ibid* at 16.
[304] *Ibid* at 53–54.
[305] *Ibid* at 17.

11, 2011), which provided that the tick test did not apply to short sales unless a circuit breaker had been triggered by a 10% decline in a particular security.[306]

The repeal of the sale price restrictions eliminated the need to mark orders as short sale price exempt – for example, interlisted securities – because that designation was used to identify orders that were not subject to the tick test. IIROC proposed to repurpose the short sale price exempt designation, which applied to specific securities, to certain *accounts* that would be exempt from the general short-marking requirements under UMIR 3.2 and 6.2; for example, for directionally neutral sales or purchases from arbitrage accounts and automated orders from institutional customer accounts – i.e., the SME order designation. IIROC proposed that UMIR 6.1 would now require that all short sale orders be marked as either "short" or as an "SME" order.[307] IIROC looked to the designation of SME orders to filter out non-directional trading activities, which it referred to as "noise", from its surveillance and short position reports.[308]

3.2.6.1.2 Restrictions on Short Sales – Pre-Borrowing Requirements

IIROC did not propose to adopt a general pre-borrow or locate requirement for short sales, viewing such measures as unwarranted in Canadian markets in light of the historic low rates of failed trades.[309] Instead, IIROC gave itself the power to designate a security as a "Pre-Borrow Security" if trading in a particular security had a history of EFTs. IIROC added UMIR 6.1(5), which would require Participants and Access Persons to make arrangements to borrow designated Pre-Borrow Securities.[310]

IIROC also proposed to require Participants and Access Persons trading as a principal, as well as their customers, to borrow or arrange to borrow securities based on a history of EFTs. Rules 6.1(3) and 6.1(4) were added to require Participants or Access Persons to pre-borrow securities in the following circumstances:

- Participants, acting as agent for a client or non client with a prior EFT on *any* listed security, are required to make arrangements to borrow securities necessary to settle the resulting trade before entering into an order for a short sale for the client or non-client, unless (a) the Participant makes reasonable inquiries and is satisfied that the reason for the prior failed trade was solely due to administrative error (and not an intentional or negligent act), or (b) IIROC consents to the sale [UMIR 6.1(3)].[311]

- Participants acting as principal and Access Persons who have a prior EFT for a particular security cannot enter into an order for the short sale of *that* security, unless

[306] *Regulation SHO*, Release No 34-6159 (26 February 2010), online: *US Securities and Exchange Commission,* and *Final Rule: Regulation SHO*, Release No 36-63247 (4 November 2010), online: *US Securities and Exchange Commission* (both cited in *IIROC Notice 11-0075*, *supra* note 150 at 4).
[307] *IIROC Notice 11-0075, supra* note 150 at 40. See also *Rules Notice – Guidance Notice – UMIR – Guidance on "Short Sales" and "Short-Marking Exempt" Order Designations,* IIROC Notice 12-0300 (11 October 2011), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2012/37862a81-d93b-4a21-9843-c5fc3ced83f2_en.pdf#search=12%2D0300>.
[308] *Rules Notice – Request for Comments – Canadian Securities Administrators/Investment Industry Regulatory Organization of Canada Joint Notice 23 – 312 – Transparency of Short Selling and Failed Trades*, IIROC Notice 12-0076 (2 March 2012) at 4, 12, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2012/52b74851-979d-49fe-9497-7b3087d3c370_en.pdf#search=12%2D0076> [*IIROC Notice 12-0076*].
[309] See *IIROC Notice 11-0075*, *supra* note 150 at 49.
[310] *Ibid* at 40 (proposed amendment to Rule 6.1(5)).
[311] *Ibid* (proposed amendment to Rule 6.1(3)).

> it makes arrangements to borrow the securities necessary to settle the resulting trade before it enters the order, unless IIROC consents to the sale [UMIR 6.1(4)].[312]

Participants and Access Persons would be required to have policies and procedures in place to do the following:

- adequately regulate entering short sales orders where a security is designated as a "Pre-Borrow Security";
- borrow or arrange to borrow securities designated as "Pre-Borrow Securities", or listed securities for orders executed for clients or non-clients with prior EFTs, or a particular security by the Participant or Access Person acting as principal if either has had an EFT in respect of that particular security; and
- ensure that orders are properly identified as "short" or "SME".[313]

Despite the existence of pre-borrow requirements in other jurisdictions, as well as IOSCO's recommendation that locate or pre-borrowing requirements be adopted to support the settlement of short trades, IIROC concluded that historic failed trade rates did not warrant imposing general pre-borrow or locate requirements. Instead, IIROC took the position that the proposed and targeted pre-borrowing requirements due to EFTs were preferable.[314] In taking this position, IIROC did not explain why historic low failed trade rates would guarantee low failed trade rates in the future. IIROC's pre-borrow requirement is a tool that may be used to address specific instances of trade failures or abusive market conduct after trade failure has already occurred for a significant period of time, rather than a preventative measure against failed trades.

IIROC referred to Policy 2.2 and the 2005 requirement that Participants have a reasonable expectation of settling any trade as sufficient to address problems posed by naked shorting. A reasonable expectation of settlement applies to all trades – long and short – but this expectation may be substantially different depending on whether the order is one to buy or sell. A purchaser entering into an order to buy securities only needs to have sufficient funds to close. What is required for a short seller to reasonably expect to settle the trade can be more complicated if the trade is not already covered. Whether a Participant or Access Person has a reasonable expectation of settling the trade may change from the time an order for a short sale is placed and settlement. Moreover, one Participant may have a reasonable expectation to settle a short sale while another may not, even though they are entering into a short sale for securities in the same issuer. In effect, IIROC is acknowledging that it will allow naked short selling subject to one restriction, as confirmed in 2004 – a vendor may not make a sale *knowing* that the securities cannot be borrowed and then not take "reasonable steps" at that time to attempt to borrow the securities to make delivery on closing.

IIROC does not interpret Policy 2.2 to require a Participant or Access Person entering into a short sale to have a positive affirmation that it can borrow or otherwise obtain the securities necessary to settle the trade prior to entering into the order.[315] This means that a Participant or Access Person could enter into what is technically a naked short sale – in the sense that the order is not covered at the time it is made – without violating Policy 2.2. However, in IIROC's view, a Participant or Access Person would no longer have a reasonable expectation of settling a short sale (contrary to Policy 2.2) as soon as the Participant or Access Person knew that it would be difficult to obtain the particular

[312] *Ibid* (proposed amendment to Rule 6.1(4)).
[313] *Ibid* at 10–11.
[314] *Ibid* at 49.
[315] *Ibid* at 8.

securities needed to settle a short sale. In such cases, a Participant or Access Person who could not borrow or locate the particular securities, and thereby end up with a failed trade thereafter, would be prevented from entering short sales for the same security on a client's behalf or on its own account. However, other Participants or Access Persons who can borrow that security – or at the least, do not yet know that they may not be able to borrow the securities – can continue to enter into short sales for securities in the same issuer.[316]

3.2.6.1.3 Restrictions on Short Sales – Circuit Breakers and Ongoing Enhancement of Transparency

At the time of the 2011 Proposed Amendments, IIROC had separately sought comments on the use of a single stock circuit breaker ("**SSCB**") to address short-term unexplained price volatility.[317] As a result, the 2011 Proposed Amendments do not address SSCBs or market-wide circuit breakers ("**MWCBs**") as part of the amendments relating to short sales. However, despite its outstanding requests for comments on the advisability and use of SSCBs, IIROC appeared to have rejected the underlying premise for a SSCB in respect of short sales on the grounds that it reinforced a preconception that a rapid price drop was the result of abusive short selling.[318] While IIROC concluded that there was no need for a similar circuit breaker in Canada, it sought comments on what regulatory arbitrage opportunities might be created and limited for interlisted securities where a circuit breaker was triggered in a US marketplace.[319]

IIROC noted that while the CSPR "has a number of problems and limitations", it did not propose to reintroduce the proposed elimination of Rule 10.10 because "the CSPR is a 'known' report that is comparable to short position reports in other jurisdictions".[320] Instead, IIROC noted that it was working toward introducing its own semi-monthly short sale summaries at the same time the "short exempt" and SME order marking changes came into effect.[321] In IIROC's view, continued production of CSPRs supported its objective of increasing public awareness of short selling trading activity in Canada. In IIROC's view, the availability of both CSPRs and IIROC's own trading summaries would give users of the CSPR an opportunity to "evaluate the information provided by trading summaries" and would provide IIROC "with an opportunity to track the relationship between the information provided in the CSPR and the marketplace trading summaries".[322]

3.2.6.2 Industry Comments to the 2011 Proposed Amendments

3.2.6.2.1 Repeal of Rule 3.1 and Introduction of the SME Order Designation

As was the case in 2007, there was significant, if not nearly universal, support among industry participants for the repeal of Rule 3.1. Again, there were voices of opposition from retail investors and small issuers.

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[316] *Ibid.*
[317] *Rules Notice – Request for Comments – Summary of Comments Received on Proposed Guidance Respecting the Implementation of Single-Stock Circuit Breakers,* IIROC Notice 12-0041 (2 February 2012), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2012/10054421-7c8d-4c6c-b4e4-9ac67568f4d4_en.pdf#search=12%20%2D%200041> [*IIROC Notice 12-0041*] (referring to IIROC Notice 10-0298 – *Rules Notice – Request for Comments – UMIR – Proposed Guidance Respecting the Implementation of Single-Stock Circuit Breakers,* IIROC Notice 10-0298, (18 November 2010)).
[318] *IIROC Notice 11-0075, supra* note 150 at 5.
[319] *Ibid* at 37.
[320] *Ibid* at 30.
[321] *Ibid* at 29.
[322] *Ibid* at 30.

Commenters had mixed views on repurposing the short exempt designation for the SME order designation. Some saw repurposing the short-exempt marker as efficient and practical.[323] Others opposed it, some on concerns relating to the technical aspects of repurposing the marker[324] and others because it could potentially lead to investor confusion.[325]

3.2.6.2.2 Restrictions on Short Sales – Pre-Borrowing Requirements

There was also significant, if not nearly universal, concern among industry participants regarding the introduction of any pre-borrow requirements. Many larger dealers saw imposing pre-borrowing requirements at the client account level as being unworkable.[326] Pre-borrowing requirements were characterized by some commenters as "an example of regulation without clear justification"[327] and as a measure that would not effectively deter manipulative behaviors of individuals who want to naked short.[328]

Several commenters saw the proposed pre-borrowing requirements as measures that evolved in the US markets and that were inappropriate for the Canadian market.[329] The Investment Industry Association of Canada (the "**IIAC**") expressed concern that the inability to borrow most venture stocks would simply result in a prohibition on short selling in the venture market, where naked shorting has "long been utilized in junior markets, in particular by Western-based firms."[330] It questioned why pre-borrowing requirements were necessary at all given the Canadian regulatory framework for settling failed trades.[331] It similarly objected to the need for dealers to determine when an EFT should trigger a pre-borrowing requirement. The IIAC was of the view that requiring EFTs at the dealer level would not likely address the perceived harms of short sales, which it saw as being systemic in nature.[332] In contrast, however, the Canadian Securities Traders Association, Inc. (the "**CSTA**") expressed agreement in principle with implementing pre-borrowing requirements as a means of bolstering consumer confidence in the absence of a tick test. However, the CSTA also expressed some caution and asked IIROC to consider the costs of implementing the pre-borrowing requirements against the benefits, taking into account both existing rules in Policy 2.2 preventing

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[323] See Comment Letter from TD Newcrest to the Investment Industry Regulatory Organization of Canada (26 May 2011) at 2, print: *Investment Industry Regulatory Organization of Canada* [*TD Newcrest Comment Letter*]. See Comment Letter from the Canadian Securities Traders Association, Inc. to the Investment Industry Regulatory Organization of Canada (30 May 2011) at 2, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2011/52b7befb-4887-4923-8d49-2cfaf678663d_en.pdf#search=CSTA%20Write%3E%3D2011%2F1%2F1%20AND%20Write%3C%3D2011%2F9%2F1> [*CSTA 2011 Comment Letter*]. See also Comment Letter from CIBC World Markets to the Investment Industry Regulatory Organization of Canada (27 May 2011) at 3, print: *Investment Industry Regulatory Organization of Canada Inc* [*CIBC World Markets 2011 Comment Letter*]. See also Comment Letter from the Investment Industry Association of Canada to the Investment Industry Regulatory Organization of Canada (26 May 2011), online (pdf): *Investment Industry Association of Canada* <iiac.ca/wp-content/themes/IIAC/resources/1566/original/IIAC%20Response%20letter%20re%20Short%20Sale%20Regs%20-FINAL%20(2).pdf> [*IIAC 2011 Comment Letter*].

[324] Comment Letter from TMX Group to the Investment Industry Regulatory Organization of Canada (26 May 2011) at 2, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2011/8f1fc471-db24-428f-9852-9e98f47e9e05_en.pdf#search=TMX%20Group%20Write>%3D2011%2F2%2F1%20A%20AND%20Write<%3D2011%2F9%2F1>.

[325] Comment Letter from Chi-X Canada ATS Ltd. to the Investment Industry Regulatory Organization of Canada (26 May 2011) at 2, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2011/aa6a34ac-2120-429c-a4f7-793495620100_en.pdf#search=CHI%2Dx%20Write%3E%3D2011%2F2%2F1%20A%20AND%20Write%3C%3D2011%2F9%2F1> [*Chi-X Comment Letter*].

[326] *CIBC World Markets 2011 Comment Letter, supra* note 323 at 2.

[327] See *ibid.* See also *IIAC 2011 Comment Letter, supra* note 323.

[328] See Comment Letter from Scotia Capital Inc. to the Investment Industry Regulatory Organization of Canada (25 May 2011) at 4, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2011/8263ac12-c5d4-4b5c-b778-e35709025d8a_en.pdf#search=Scotia%20Capital%20Write%3E%3D2011%2F2%2F1%20AND%20Write%3C%3D2011%2F9%2F1>.

[329] *Ibid* at 5. See also, *IIAC 2011 Comment Letter, supra* note 323.

[330] *IIAC 2011 Comment Letter, supra* note 323 at 3.

[331] *Ibid.*

[332] *Ibid* at 3–4.

manipulative and deceptive trading practices around short sales and the absence of a "significant issue with failing to deliver short sales in Canada."[333]

3.2.6.2.3 Restrictions on Short Sales – Circuit Breakers and Ongoing Enhancements of Transparency

IIROC did not seek, nor did it receive, specific comments on the use of other restrictions on short sales, such as the introduction of circuit breakers in Canada as part of its request for comments on the Proposed 2011 Amendments. Similarly, it did not seek or receive comments on its decision to continue to require Participants and Access Persons to file Short Position Reports on a semi-monthly basis.

3.2.6.3 2012 Amendments – What Changed?

IIROC adopted the 2011 Proposed Amendments in 2012 and they became effective on September 1, 2012 (the "**2012 Amendments**").[334]

3.2.6.3.1 Repeal of Rule 3.1 and the Introduction of the SME Order Designation

IIROC expanded the definition of SME order to include trading in "directionally neutral" accounts where trades are automatically generated.[335] The repeal of Rule 3.1 and the introduction of the SME order designation lead primarily to administrative changes to ensure that all short sales are either marked as "short" or as an SME order.

3.2.6.3.2 Restrictions on Short Sales – Pre-Borrowing Requirements

In making the 2012 Amendments, IIROC agreed with comments from industry participants that general pre-borrow requirements would be "unnecessary and burdensome", but that the imposition of pre-borrow requirements due to EFTs would serve as an incentive for investors and Participants to settle trades within the 10 trading day window following settlement. Curiously, though, IIROC also noted that "these 'failures' represent a very small percentage of failures, but they have an inordinate impact on rates of cumulative trade failure".[336]

IIROC noted that the amendments dealing with the definition of a "Pre-Borrow Security" "[address] the systemic problems arising from short sales" and that the "extended failed trade threshold addresses 'potential abusive short selling' which may be occurring at the account level (such as when an account holder engaged in 'naked' short selling without an intention of effecting settlement on the settlement date)".[337] Otherwise, IIROC did not anticipate the pre-borrow requirements to have any impact on short selling absent abnormal market activity or in instances where the person entering the order had prior EFTs.[338]

IIROC responded to concerns about the practicalities dealers faced in determining whether a client or non-client should be exempt from pre-borrowing requirements. The amendments to Rule 6.1(3) permit a Participant to enter a short sale order for a client or non-client with a prior failed trade if the

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[333] *CSTA 2011 Comment Letter*, *supra* note 323 at 2.
[334] *IIROC Notice 12-0078*, *supra* note 62.
[335] *Ibid* at 1.
[336] *Ibid* at 23.
[337] *Ibid* at 24.
[338] *Ibid* at 25.

Participant has either pre-borrowed the securities necessary to settle the trade or is satisfied, after reasonable inquiry, that the failed trade was not the result of any intentional or negligent act.[339] Participants and Access Persons were required to ensure that they have policies and procedures in place to adequately regulate the entry of short sale orders where IIROC has designated a security as a "Pre-Borrow Security", or the Participant or Access person has previously executed an EFT.[340]

3.2.6.3.3 Restrictions on Short Sales – Circuit Breakers and the Ongoing Enhancement of Transparency

As noted above, IIROC had published separate guidance on SSCBs and it did not propose to introduce SSCBs or MWCBs as part of the 2011 Proposed Amendments.[341] When IIROC introduced SSCBs on an "initial implementation phase" on February 2, 2013,[342] a month before the 2012 Amendments were approved, the SSCB was described as being part of a multi-tiered strategy to address volatility in general, and not the perceived dangers of short selling in particular.[343] Rather, as discussed in Section 3.2.6.1.3, IIROC noted that it did not support restrictions on short sales when a circuit breaker is triggered because "sharp price declines are rarely associated with short selling activities". IIROC noted that in more than 80% of the cases of interlisted securities subject to a short sale circuit breaker in the US, the decline was attributable to the release of negative material news or sector-specific events, and that short sales leading up to the circuit breaker being tripped were not significantly different than trading activity after the circuit breaker expired.[344]

However, other transparency enhancing measures recommended by IOSCO were not embraced. While the CSPR continued to be seen as a less-than-useful tool for regulatory purposes, IIROC rejected any additional account-level requirements for short position reporting. While other jurisdictions, such as the EU, introduced account level-thresholds and reporting obligations for short positions in an issuer,[345] IIROC rejected individual holding triggers, noting that in 2009, the average short position in a TSXV-listed security was 0.01%. Instead, IIROC's view was that holder-level reporting "is really only relevant if the shorting activity is of a nature or extent that it is impacting market prices. If such an impact is observed, account level information can be requested [by IIROC] from the Participant."[346]

Transparency, however, did not extend to providing public information about failed trades. Rather, the 2012 Amendments gave IIROC enhanced tools to monitor failed trade rates, such as reports based on information provided by CDS through its CNS system, which IIROC saw as bolstering investor confidence by enhancing transparency to IIROC – and not investors – of short selling activities and failed trades.[347]

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[339] *Ibid* at 11, 14 and 23. See section 3.2.6.1.2 above. Rule 6.1(3) was later renumbered to 6.1(6): see *Rules Notice – Notice of Approval – Provisions Respecting Third-Party Electronic Access to Marketplaces*, IIROC Notice 13-0184 (4 July 2013), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2013/b65d657d-e162-48fe-8d20-32f95a140c75_en.pdf>.
[340] *IIROC Notice 12-0078, supra* note 62 at 11–12.
[341] See *Rules Notice – Guidance Note – Guidance Respecting the Implementation of Single-Stock Circuit Breakers*, IIROC Notice 12-0040 (2 February 2012), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2012/7cf90cce-57ae-4760-822a-46b1525e2051_en.pdf#search=12%2D0040> [*IIROC Notice 12-0040*]. IROC would issue a Request of Comments on the use of MWCBs later in September 2012: see also *Rules Notice – Request for Comments – Proposed Guidance on Market-wide Circuit Breakers,* IIROC Notice 12-0282 (26 September 2012), online (pdf): *Investment Industry Regulatory Organization of Canada.* <www.iiroc.ca/Documents/2012/56175812-23cb-4914-98e7-a1e353e4c3dc_en.pdf#search=12%2D0282> [*IIROC Notice 12-0282*].
[342] *IIROC Notice 12-0040, supra* note 342. See also *IIROC Notice 12-0041, supra* note 317.
[343] See *IIROC Notice 12-0040, supra* note 341 at 2.
[344] *IIROC Notice 12-0078, supra* note 62 at 28.
[345] See for example, EU reporting thresholds, described *infra*, in section 4.3.
[346] See *IIROC Notice 11-0075, supra* note 150 at 52.
[347] *IIROC Notice 12-0078, supra* note 62 at 9.

3.2.7 After the 2012 Amendments

3.2.7.1 IIROC/CSA Joint Notice of Disclosure and Transparency

On the same day that IIROC approved the 2012 Amendments,[348] IIROC and the CSA (the "**Working Group**") issued a joint notice (the "**Joint Notice**") requesting comments on disclosure and transparency measures on short sales and failed trades in Canada.[349]

The Working Group noted that while it sought comments on introducing transparency to failed trades, it was examining issues of trade settlement more broadly and would wait until IIROC had more experience with Participants' EFTR compliance, with EFTRs having become effective on June 1, 2011. The Working Group sought specific comments on whether additional measures were warranted to (a) enhance regulatory reporting and transparency for short sales and (b) introduce some transparency of failed trades. The Working Group explained:

> While the UMIR Amendments promote improvements in these areas, the Working Group requests further stakeholder input on whether additional measures are desirable or needed. The Working Group also notes that IIROC's regulatory jurisdiction is limited to trading by Participants and Access Persons on marketplaces and that CSA rulemaking may be necessary if any measures require a broader scope.
>
> The events during the financial crisis in late 2008 provoked an inquiry into whether enhanced transparency of short selling would improve securities regulation. The Working Group believes that, for the Canadian setting, a careful balance between the potential benefits and costs of transparency of short selling activity must be struck, and [it] is soliciting commenters' views on how to best achieve such balance.[350]

The Working Group once again reviewed the IOSCO Four Principles. As with IIROC, the Working Group rejected certain key IOSCO recommendations, including compulsory buy-ins or general locate and pre-borrow requirements. The Working Group concluded that the data of failed trades in Canada – and particularly that most failed trades are due to administrative problems with long sales – made a compulsory buy-in requirement unnecessary and that existing buy-in procedures, as well as IIROC's power to require pre-borrowing in certain circumstances, were sufficient. The Working Group concluded that the 2012 Amendments were sufficient to comply with the IOSCO Four Principles.[351] Similarly, while the Working Group noted the SEC "locate" and "close-out" measures for failed trades,[352] it did not seek comments on whether similar requirements should be imposed in Canada.

Despite IIROC and the industry's long and general consensus that CSPRs did not produce meaningful data, the Working Group did not recommend that they be eliminated. The Working Group's explanation of the 2012 Amendments reflected IIROC's earlier expressed view that changes made to the short marking regime would help it filter out noise and identify directional positions – i.e., true shorts.[353]

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[348] *Ibid.*
[349] *IIROC Notice 12-0076*, *supra* note 308.
[350] *Ibid* at 3.
[351] *Ibid* at 17–19.
[352] *Ibid* at 19–20.
[353] *Ibid* at 4.

The Working Group solicited comments on the adequacy of:

i. IIROC-aggregated short sale trading data: Specifically, the Working Group questioned whether: (a) short sale summaries should be made publicly available and, if so, how often; (b) anonymized individual short sale transaction data should be made public on a time-deferred basis; and (c) SME order designations should be made public.[354]

ii. current public disclosure of short positions to IIROC and the public: The Working Group noted that while regulators outside North America required disclosure of significant individual short positions and that the *Dodd-Frank Wall Street Reform and Consumer Protection Act* mandated the SEC to take a number of steps, including prescribing new rules governing public disclosure of short sales by institutional investment managers subject to section 13(f) of the Exchange Act on at least a monthly basis, the Working Group ruled out introducing similar individual short sales or short position reporting requirements on buy-side investors or derivative contracts. The Working Group again sought comments on whether the existing public disclosure of short positions was adequate – and, if not, what additional securities should be included, and whether custodians and dealers who are not Participants should also be required to report their short positions.[355]

iii. transparency of failed trades: The Working Group stated that it did not focus specifically on failed trades caused by short sellers, but looked for ways to reduce failed trades to help provide "an effective control over some manipulative activities (including abusive short selling)" and "an important means to mitigate broader systemic problems, particularly in the clearing and settlement system that underpins the efficiency and integrity of our capital markets".[356] The Working Group sought specific input on the type of failed trade information that would be most useful to participants – noting that this information could be obtained from a variety of sources, including the CSA and CDS' CNS facilities.[357]

The Working Group considered six relevant comment letters[358] in response to its request for comments. After reviewing these comments, the Working Group concluded that no additional measures beyond the 2012 Amendments were required, explaining as follows:

> There was no clear consensus among the commenters that specific improvements were needed; the majority of respondents believe that the current requirements in [UMIR], including amendments that became effective on October 15, 2012 …, are adequate.[359]

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[354] *Ibid* at 3–5.
[355] *IIROC Notice 12-0076*, *supra* note 308 at 5–6.
[356] *Ibid* at 6.
[357] *Ibid* at 7.
[358] See *Rules Notice – Request for Comments – CSA/IIROC joint Notice 23-315 – Summary of Comments on CSA/IIROC Joint Notice 23-312 – Request for Comments – Transparency of Short Selling and Failed Trades,* IIROC Notice 13-0064 (23 February 2013) at 6, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2013/96c64758-f32b-47f2-841c-b886fe309596_en.pdf#search=13%20%2D%200064> [*IIROC Notice 13-0064*]. IIROC received seven comment letters during the comment period which ended on May 31, 2012 (specifically, comments received from the Investment Industry Association of Canada, CIBC World Markets Inc., TD Asset Management Inc., CNSX Markets Inc., the Canadian Foundation for Advancement of Investor Rights ("**FAIR Canada**"), the Caisse de dépôt et placement du Québec and OpsRisk Ltd). In a footnote to *CSA/IIROC Joint Notice 23-312, supra* note 164, IIROC states that one comment letter (from CIBC World Markets Inc.) was received during the comment period that commented on a different IIROC Notice and therefore was not included in the summary. IIROC also received one additional comment letter (from Scotiabank Global Banking and Markets Inc.) outside of the comment period, on June 1, 2012. The Comment Letter received by IIROC from the Caisse de dépôt et placement du Québec is not available on IIROC's website.
[359] *Ibid* at 2.

IIROC's characterization that the comments lacked a clear consensus was made despite the fact that several commenters were in favour of enhanced transparency. Scotiabank Global Banking and Markets Inc. and CNSX agreed that CSPRs did not provide timely or adequate information on short sales. Only CNSX expressed the view that CSPRs should be eliminated. Instead, three commenters were of the view that more information regarding short sales would be beneficial.[360] While CNSX expressed confidence that the 2012 Amendments enabled IIROC to detect abusive short selling on a timely basis, and that there was no need to make short sale summaries publicly available, other commenters were of the view that short sale summaries should or inevitably would be publicly available.[361] While two commenters agreed that there would be no benefit in disclosing individual positions on an anonymous basis,[362] two others were of the view that this information could be of value to the public.[363]

The Working Group concluded that, "[a]fter reviewing the comments, data on short sales and failed trades and recent international developments in the regulation of short sales", additional measures were not needed or desirable beyond those made in the 2012 Amendments.[364] IIROC did not address concerns raised by commenters that went beyond the questions asked, such as a specific request for additional guidance on the use of the new SME order marker and pre-borrow securities – and, in particular, what IIROC would consider to be evidence demonstrating that a dealer had made reasonable efforts to ensure that a "pre-borrow" was secured in cases where pre-borrowing was required for a security or account.[365]

3.2.7.2 Tweaking UMIR

Since the 2012 Amendments, IIROC's regulatory efforts in connection with short selling have focused primarily on the use of the SME order designation, the implementation of SSCBs and the guidance on short position calculation and reporting.

3.2.7.2.1 Circuit Breakers

On February 2, 2012, IIROC issued guidance on the implementation of SSCBs, the circumstances in which it will intervene and its authority to vary or cancel trades made after a circuit breaker is

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[360] See Comment Letter from Scotiabank Global Banking and Markets to the Investment Industry Regulatory Organization of Canada (1 June 2012), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2012/719416b0-815c-4a7d-b352-0f14d67f4d5a_en.pdf> [*Scotia 2012 Comment Letter*]. See also Comment Letter from TD Asset Management Inc. to the Investment Industry Regulatory Organization of Canada (28 May 2012), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2012/b6c324df-bdfb-4e91-969c-7d9f6169a5de_en.pdf#search=TD%20Asset%20management%20Write%3E%3D2012%2F5%2F1%20AND%20Write%3C%3D2012%2F8%2F1> [*TD 2012 Comment Letter*]. See also Comment Letter from FAIR Canada to the Investment Industry Regulatory Organization of Canada (30 May 2012), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2012/40258619-a65d-4c3b-b690-31e182a3123e_en.pdf#search=cANADIAN%20fOUNDATION%20FOR%20aDVANCEMENT%20Write>%3D2012%2F5%2F1%20AND%20Write<%3D2012%2F8%2F1> [*FAIR Comment Letter*].

[361] *Ibid.*

[362] See *Scotia 2012 Comment Letter supra* note 360. See also Comment Letter from CNSX Markets Inc. to the Investment Industry Regulatory Organization of Canada (31 May 2012), online (pdf): *Ontario Securities Commission* <www.osc.ca/documents/en/Securities-Category1-Comments/com_20120531_23-312_faulknerm.pdf> [*CNSX 2012 Comment Letter*].

[363] See *TD 2012 Comment Letter, supra* note 360. See also *FAIR Comment Letter, supra* note 360.

[364] In particular, the Working Group summarized changes to the rules governing short sales in the European Union (including the introduction of disclosure of investor significant net short positions to regulators at 0.2% of the issued share capital and to the public at 0.5%, and changes introduced by the Securities and Futures Commission of Hong Kong): see *IIROC Notice 13-0064, supra* note 358 at 2–4, 20–21, 21–24.

[365] Comment Letter from CIBC World Markets to the Investment Industry Regulatory Organization of Canada (9 May 2012) at 2, online (pdf): *Investment Industry Regulatory Organization of Canada* <https://www.iiroc.ca/Documents/2012/e36890f5-657b-49f5-91cf-dd02f349d2e6_en.pdf#search=CIBC%20World%20Markets%20Write%3E%3D2012%2F1%2F1%20AND%20Write%3C%3D2012%2F6%2F6 > [*CIBC WM 2012 Comment Letter*].

triggered.[366] It later issued proposed guidance and sought comments on September 26, 2012, on MWCBs to coordinate with market-wide halts in trading in the US.[367]

The SSCB and MWCB were introduced as part of what IIROC described as a "multi-tiered approach to controlling short term, unexplained price volatility", and do not specifically address short sales.[368] In IIROC's description, the first two levels of control to deal with price volatility are at the Participant and marketplace levels. IIROC's use of the SSCB would represent an additional third level of control, followed only then by a MWCB, which IIROC would use to halt trading generally on all marketplaces when declining prices affect the market generally and would be coordinated with MWCBs in US marketplaces.[369]

3.2.7.2.2 SME Designations

IIROC further amended the SME order definition in January 2016 to include ETFs with other directionally neutral trading strategies in order to enhance its ability to effectively monitor directional short selling.[370]

3.2.7.2.3 Short Position Calculation and Reporting

In 2017, IIROC issued guidance to Participants on short position calculation and reporting.[371] Participants were no longer required to file Short Position Reports with exchanges, but only with IIROC.

Participants are required to report an aggregate position for each listed or quoted security based on the aggregate short positions in each account and to calculate short positions from each account separately, without netting positions over accounts for the same beneficial owner using settlement dates for each position. While previous guidance excluded odd-lots from the calculation of short positions, IIROC, in response to comments from some Participants that removing odd-lots from Short Position Reports took additional efforts, amended its guidance to include odd-lot short positions.[372] IIROC expressed the view that reporting short positions using the settlement date positions, as opposed to trade date positions, would provide more accurate information by excluding positions that were not reflective of true short positions, such as those related to covering an option exercise that would be "flattened" on settlement by the exercise of the derivative or other related option, or positions in receive versus payment accounts where all sales appear as "short" until settlement date, regardless of whether the sale is a short or long position.[373]

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[366] See *Rules Notice – Guidance Note – Guidance Respecting the Implementation of Single-Stock Circuit Breakers*, *IIROC Notice 12-0040*, *supra* note 341. IIROC expanded the SSCB to a broader range of securities and the time during the trading day when the SSCB would apply: see also *Rules Notice – Guidance Note – Guidance Respecting the Expansion of Single-Stock Circuit Breakers*, IIROC Notice 14-0170 (10 July 2014), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2014/08873044-8215-4128-9d8e-c0074ee786ac_en.pdf#search=14%2D0170> [*IIROC Notice 14-0170*].

[367] *IIROC Notice 12-0282*, *supra* note 341. See also *Rules Notice – Guidance Note – Guidance on Market-wide Circuit Breakers*, IIROC Notice 13 - 0059 (21 February 2013), online (pdf): *Investment Industry Regulatory Authority of Canada* <www.iiroc.ca/Documents/2013/3a1b28bf-e586-479b-b2ea-bfcac791944b_en.pdf#search=13%20%2D%200059> [*IIROC Notice 13-0059*].

[368] See *IIROC Notice 12-0040*, *supra* note 341 at 2. See also *IIROC Notice 13-0059, supra* note 367. IIROC had a long-standing policy to coordinate trading halts with the United States using its powers to halt or suspend trading for regulatory purposes under *UMIR* rule 9.1: see also *IIROC Notice 12-0282*, *supra* note 341 at 5–6.

[369] See *IIROC Notice 12-0040*, *supra* note 341 at 2. See also *IIROC Notice 13-0059*, *supra* note 367 at 3–5, 9.

[370] See *Rules Notice – Notice of Approval – Amendments to the Short-marking Exempt Order Definition*, IIROC Notice 16-0028 (11 February 2016), online (pdf) : *Investment Industry Regulatory Association of Canada* <www.iiroc.ca/Documents/2016/e2d02ba0-8e7d-4ddd-b1fb-258c43fcebaa_en.pdf#search=16%20%2D%200028> [*IIROC Notice 16-0026*].

[371] See *IIROC Notice 17-0241*, *supra* note 53. See also *IIROC Notice 18-0062*, *supra* note 52.

[372] *See IIROC Notice 17-0241*, *supra* note 53 at 2–3.

[373] *Ibid.*

3.2.7.2.4 Borrowing Securities From Fully-Paid Accounts

On June 17, 2019, IIROC announced that it had approved the introduction of a fully-paid securities lending program (the "**FPL Program**")[374] at three dealer members by way of exemptive relief.[375] The FPL program allows dealers, with client consent, to borrow fully-paid securities held on behalf of the dealers' clients.[376] As a result, dealers participating in the FPL Program are not limited to borrowing securities owned by the dealers or held for clients on margin. Once a client enrolls in the FPL Program by executing a securities loan agreement with the dealer, the relevant dealer may borrow the securities at any time.[377]

Under the FPL Program, the dealers borrow from clients as a principal in one transaction, then lend the borrowed securities to institutions, such as hedge funds, institutional dealers and other broker-dealers, in a second transaction. The dealer acts as the counterparty to each transaction. The fees charged for the lending of the securities are shared between the dealer and the client.

We understand that additional protections are provided to retail investors under the terms of the exemptive relief provided to dealer members that participate in the FPL program, the terms of which have not been made public. We also understand that additional dealer members will be able to obtain similar exemptive relief and thereby avail themselves of the FPL Program.

In its risk analysis, IIROC acknowledged that securities lenders face risk, which is why securities lenders have historically been institutional investors. IIROC stated that,

> [s]ecurities lending is an area that is currently dominated by institutions. The FPL program will extend securities lending to retail investors who typically do not have the same level of sophistication, trading knowledge or tools as institutional lenders. There are certain risks associated with being a securities lender that the average retail client may not fully understand.[378]

Given this risk, the FPL Program compensates retail investors by generating income for the investors, as the borrow fees are shared between the dealers and clients.[379] IIROC sees the FPL Program as having a positive effect on settlement efficiency because dealers will have greater access to the supply of securities to meet their delivery obligations on trades, thereby lessening the number of failed trades. The FPL Program also has the advantage of increasing the revenue of dealers through additional borrowing fees, which are already reported to be significant.[380]

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[374] IIROC's Board of Directors provided exemptive relief, subject to certain terms and conditions, to certain requirements under its Dealer Member Rules, including the requirements with respect to: (i) reporting loan accounts separate from trading accounts, (ii) recording cash and securities loan transactions of retail clients in a separate account and (iii) margin: see *Rules Notice – Guidance Notice – Dealer Member Rules – Fully paid Securities Lending,* IIROC Notice 19-0109 (17 June 2019), online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2019/c60682f1-0b5d-49ee-863f-3d005f4ac010_en.pdf#search=19%20%2D%200109>.
[375] *Ibid.*
[376] The FPL Program is restricted to equity securities that are listed on an exchange and held by clients in non-registered accounts. Securities that are traded on a Canadian exchange must have: (i) a 6-month average volume-weighted average price of $2.00 or more, (ii) a 6-month average daily trading volume of 100,000 shares or more, or (iii) a 6-month free float market capitalization of $200 million or more: see *ibid* at 8.
[377] A loan may be terminated by either the dealer or the client at any time: see *ibid* at 8.
[378] *Ibid* at 4.
[379] *Ibid* (IIROC does not provide guidance on the structure or amount of shared fees).
[380] "Defining Canada", Securities Lending Times (16 May 2018), online: *Securities Lending Times* <www.securitieslendingtimes.com/specialistfeatures/specialistfeature.php?specialist_id=265>.

4. COMPARATIVE ANALYSIS: US, EU AND AUSTRALIAN REGULATIONS ON SHORT SELLING

4.1 Overview

Jurisdictions across the world have taken different approaches to regulating short selling. Following the global financial crisis in 2007–2008, short selling came under immense scrutiny. Securities and financial regulators in a number of jurisdictions, including the US, the United Kingdom, Australia, Belgium, France, Germany, Switzerland and several Asian countries, restricted short selling in certain securities using temporary emergency measures and, for the most part, reviewed their regulatory regimes governing short sales.[381] We have considered the current regimes in the US, the EU and Australia, and have reviewed certain policy considerations underpinning the relevant rules and guidelines to better understand the comparative strengths and effectiveness of the Canadian regime.

4.2 United States

4.2.1 Background to Regulation

Section 10(a)(1) of the Exchange Act gives the SEC the power to regulate short sales.[382] As of January 3, 2005, this function has been largely performed through Regulation SHO,[383] the adoption of which arose from the SEC's determination that the prior existing rules on short selling were insufficient.[384]

In 1938, the SEC adopted a tick test under Rule 10a-1 of the Exchange Act.[385] In the late 1970s, the SEC deferred to the rules imposed by national exchanges to control what it referred to as "naked short selling" and elected not to proceed with its own rules at the time. [386] In fact, even though in 2003 the SEC began to consider replacing the uptick rule,[387] prior to 2005, there was hardly any

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[381] The bans in the US and UK lapsed less than one year after their introduction. In July 2008, the SEC issued an emergency order restricting "naked short selling" in 19 financial stocks and upon expiry in August, the SEC issued a ban on September 17, 2008, with a ban on "naked short selling" in all US stocks, and one day later (after an announcement by the FSA in the UK on September 18, 2008, which stated that the FSA would "require daily disclosure of all net short positions in excess of 0.25% of the ordinary share capital of the relevant companies held at market close on the previous working day", a provision that was to remain in force until January 16, 2009), placed an emergency ban on all short sales in approximately 800 financial stocks (except short sales by market makers and those that arise "as a result of automatic exercise or assignment of an equity option held prior to effectiveness of this Order due to expiration of the option"): see Katherine McGavin, "Short Selling in a Financial Crisis: The Regulation of Short Sales in the United Kingdom and the United States" (2010) 30:1 Nw J Intl L & Bus 201 at 202, 238. See also Financial Services Authority, Press Release, FSA/PN/102/2008, "FSA Statement on Short Positions in Financial Stocks" (18 September 2008), online (archived): <webarchive.nationalarchives.gov.uk/20081112125658/http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/102.shtml>. See also *Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, SEC Release No. 58166 (15 July 2008), online (pdf): *US Securities and Exchange Commission* <www.sec.gov/rules/other/2008/34-58166.pdf>. See also *Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, SEC Release No. 34-58572 (17 September 2008), online (pdf): *US Securities and Exchange Commission* <www.sec.gov/rules/other/2008/34-58572.pdf>. See also *Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments,* SEC Release No. 34-58592 (18 September 2008), online (pdf): *US Securities and Exchange Commission* <www.sec.gov/rules/other/2008/34-58592.pdf>.

[382] *Securities Exchange Act of 1934*, 15 USC § 78j, § 10 cl (a)(1).

[383] Regulation SHO was adopted by the SEC in 2004: see *Short Sales*, SEC Release No. 34-50103 (28 July 2004), online: *US Securities and Exchange Commission* <www.sec.gov/rules/final/34-50103.htm>.

[384] See *Short Sales: Proposed Rule*, SEC Release No. 34-48709 (28 October 2003) at II.C.1., online: *US Securities and Exchange Commission* <www.sec.gov/rules/proposed/34-48709.htm> [SEC Release No. 34-48709]. The purpose of Regulation SHO was to reflect the "numerous market developments" that had occurred since the 1930s, when short sale regulations were originally enacted: see also Office of Investor Education and Advocacy, "Key Points About Regulation SHO", (8 April 2015) at III, online: *US Securities and Exchange Commission* <www.sec.gov/investor/pubs/regsho.htm> [SEC, "Key Points about Regulation SHO"].

[385] Norman S. Poser, "Why the SEC Failed: Regulators Against Regulation" (2009) 3:2 Brooklyn J Corporate, Financial & Commercial L 289 at 300.

[386] McGavin, *supra* note 381 at 219.

[387] See SEC Release No. 34-48709, *supra* note 384.

new regulation in respect of short selling.[388] Before Regulation SHO was adopted, "brokers were able to delay delivery of securities almost indefinitely by passing failed trades to other brokers, effectively turning the transaction into an undated futures contract."[389] Many of the principles that appeared in Regulation SHO were outlined in 1976 in Proposed Rule 10b-11 that was never enacted.[390] The global financial crisis in 2007–2008 then served as a catalyst for additional regulations with respect to the short sale of equity securities,[391] and the new regulations attempted to address the problems associated with persistent failed trades and abusive naked short selling.[392]

4.2.2 Differences From the Canadian Regime

In contrast to the Canadian regulations, in the US there exists:

(1) a "locate" requirement (Rule 203(b)(1) and (2) of Regulation SHO);

(2) a "short exempt" mark, which acts as an exception to the tick test applicable upon the initiation of circuit breakers, rather than a designation applied to orders coming from directionally neutral accounts;

(3) a "close-out" requirement (Rule 204 of Regulation SHO);

(4) a 10% price decline trigger that prevents execution of a short sale at an impermissible price (Rule 201 of Regulation SHO), subject to certain exceptions;

(5) daily public disclosure of aggregate short sale volume transaction information per listed security by SROs on their websites, along with one-month delayed information regarding individual short sale transactions; whereas in Canada, aggregate information is published twice monthly by IIROC; and

(6) semi-monthly publication by the SEC of fails-to-deliver of an issuer's equity securities.

4.2.3 Designating Trades

Rule 200(g)(2) of Regulation SHO requires sell orders to be marked "long", "short" or "short exempt".[393] These designations are placed when orders are submitted to the exchange markets for execution,[394] providing real-time information to regulators and creating "an audit trail of short sales that allow[s] market authorities to follow up on suspicious activity."[395] Under the rule, an order can be marked "long" when the seller owns the security being sold and the security is in the physical possession or control of the broker-dealer, or it is reasonably expected that the security will be in the physical possession or control of the broker-dealer prior to the settlement date. Otherwise, the order should be marked "short" or "short exempt". However, the designation of "short exempt" in the US should not be confused with or equated to the Canadian SME order designation, as in the US, a

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[388] Paul Ziegler & Terry Truitt, "Predictors of Naked Short Selling: Analyzing Delivery Failures in US Stock Markets" (2013) 7 Research in Bus & Economics J 1 at 3, online (pdf): *Academic and Business Research Institute* <aabri.com/manuscripts/121208.pdf>.
[389] *Ibid* at 3.
[390] McGavin, *supra* note 381 at 218–219 (Proposed Rule 10b-11 would have imposed borrowing requirements on short sellers).
[391] *Ibid* at 223.
[392] See SEC Release No. 34-48709, *supra* note 384.
[393] SEC, "Key Points about Regulation SHO", *supra* note 384 at III, citing *Regulation SHO*, 17 CFR § 242.200(g) (last modified 2010), online: *Electronic Code of Federal Regulations* <ecfr.gov/cgi-bin/text-idx?SID=cd93bf179023dd4a597161aff68c2b1c&mc=true&node=se17.4.242_1200&rgn=div8> [*Regulation SHO*].
[394] *Regulation of Short Selling: Final Report*, IOSCO Technical Committee Final Report (June 2009), at 3.8, online (pdf): *International Organization of Securities Commissions Technical Committee* <www.iosco.org/library/pubdocs/pdf/IOSCOPD292.pdf> [IOSCO, *Regulation of Short Selling Final Report*].
[395] *Ibid* at 3.25.

"short exempt" mark acts as an exception to the price restriction test described herein, rather than a designation applied to orders coming from directionally neutral accounts.

Pursuant to Rule 201 of Regulation SHO, trading centers are required "to establish, maintain and enforce written policies and procedures that are reasonably designed to prevent the execution or display of a short sale at an impermissible price when a stock has triggered a circuit breaker."[396] A tick test existed prior to Rule 201 coming into force, which the SEC repealed effective as of July 3, 2007.[397] The repeal was done to modernize regulation and also prohibited SROs from imposing their own tick tests.[398] Unsurprisingly, much scrutiny was placed on the repeal in the global financial crisis of 2007–2008, after which the SEC faced tremendous pressure from market participants and the US government, and "sought comments on how best to institute" a new tick test.[399]

Effective since February 28, 2011,[400] the alternative uptick rule provides that once a circuit breaker has been triggered, which occurs if the price of a stock decreases by at least 10% in one day, the uptick rule will apply to short sale orders – and not short exempt orders – in that security for the remainder of the day and the following day, unless an exception applies. While Rule 201 was meant to regulate abusive short selling and prevent stock price manipulation,[401] observers have expressed concern that, among other things, it assumes that rapid price declines are attributable to short selling activity and there is no "regulatory follow-up" contemplated such that a marketplace or dealer can determine whether the price drop was caused by "abusive" short selling.[402]

Pursuant to Rule 201(c) of Regulation SHO, short sale orders may be marked as "short exempt" if the broker-dealer identifies the order as being at a price above the current national best bid at the time of submission of the order to a trading center.[403] Additionally, a broker-dealer may mark orders as "short exempt" pursuant to Rule 201(d) of Regulation SHO, which provides limited exceptions to Rule 201, in relation to the following: (i) a seller's delay in delivery, where the short order is by a person who is deemed to own the security pursuant to Rule 200 of Regulation SHO and intends to deliver the security as soon as all restrictions on delivery have been removed; (ii) certain odd-lot transactions; (iii) certain domestic arbitrage transactions; (iv) certain international arbitrage transactions; (v) sales in connection with over-allotments, rights or standby underwriting commitments; (vi) transactions executed on a volume-weighted average price basis; and (vii) executions of a customer purchase or of a customer "long" sale on a riskless principal basis – as long as the broker or dealer has written policies and procedures in place to ensure certain things, including that the offsetting transaction is allocated to a riskless principal or customer account within

[396] SEC, "Key Points about Regulation SHO", *supra* note 384. An impermissible price is one "that is less than or equal to the current national best bid.": see Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO at II. 1., online: *US Securities and Exchange Commission* <sec.gov/divisions/marketreg/mrfaqregsho1204.htm> [Responses to Frequently Asked Questions Concerning Regulation SHO].
[397] *Regulation SHO and Rule 10a-1*, SEC Release No. 34-55970 (28 June 2007) at I, online (pdf): *US Securities and Exchange Commission* <www.sec.gov/rules/final/2007/34-55970.pdf>.
[398] Poser, *supra* note 388 at 300–301.
[399] Ziegler & Truitt, *supra* note 391 at 4.
[400] "The initial implementation date for this rule was November 10, 2010. However, on November 8, 2010, the SEC announced that it extended the date to February 28, 2011, to give certain exchanges additional time to modify their market opening, reopening, and closing procedures for individual securities covered by the rule, and in order to provide additional time to market participants for programming and testing of systems for implementation.": see *CSA/IIROC Joint Notice 23-312*, *supra* note 164 at 2109, fn 25.
[401] McGavin *supra* note 381 at 234.
[402] *IIROC Notice 11-0075 supra* note 150 at 20.
[403] *Short Sale Price Test Restrictions: A Small Entity Compliance Guide*, SEC Guide (Modified 16 April 2010), online: *US Securities and Exchange Commission* <www.sec.gov/rules/final/2010/34-61595-secg.htm> [Small Entity Compliance Guide].

60 seconds of execution.[404] Accordingly, there are no exceptions from Rule 201 for *bona fide* hedging or market-making, among other activities.[405]

The difference between the Canadian SME order designation and the US "short exempt" mark results in short sale orders made by market makers not being included in short sale volume or short interest disclosure in Canada, but being included in the publicly disclosed short sale data in the US.

4.2.4 What Constitutes a Short Sale

Rule 200 of Regulation SHO incorporates Rule 3b-3 of the Exchange Act and defines a short sale as any sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller.[406] Rule 200 provides that "a person owns a security if he or his agent has title to a security or he has purchased or has entered into an unconditional contract to purchase it but has not yet received it."[407] Rule 200(c) of Regulation SHO provides that a person shall be deemed to own securities only to the extent that he or she has a net long position in such securities.[408] Note that Section 200(f) of Regulation SHO provides that a broker or dealer must aggregate all of its positions in a security to determine its net position.[409] A "sell order may only be marked 'long' if the seller is 'deemed to own' the security being sold and either: (i) the security to be delivered is in the physical possession or control of the broker or dealer, or (ii) it is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than the settlement of the transaction."[410]

4.2.5 Requirements for Conducting a Short Sale

Under Regulation SHO, a broker-dealer must, before effecting a short sale in an equity security, have reasonable grounds to believe that the security can be borrowed and delivered on the expected settlement date.[411] This locate requirement must be met and documented prior to effecting the sale,[412] and is intended to prevent failed trades by requiring broker-dealers to "identify a source of borrowable stock" before execution.[413] There is an exception from the locate requirement for short sales by market makers engaged in *bona fide* market-making,[414] though market makers are not excepted from close-out and pre-borrow requirements (discussed in Section 4.2.6). *Bona fide* market-making does not include activity that is related to speculative selling strategies or investment

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[404] See *Ibid*. See also *Regulation SHO*, *supra* note 393 at § 242.201(d).
[405] Davis Polk, "The SEC's New Short Sale Rule: Implications and Ambiguities", (8 March 2010) at 4, online: *Davis Polk* <www.davispolk.com/files/files/Publication/d03c58f9-d69e-4d99-9076-4de64d43e5b2/Preview/PublicationAttachment/2c637f2a-5c10-466c-bfc3-5b1ef56eaa2c/030810_Short_Sales.pdf>.
[406] *SEC Interpretive Release – Commission Guidance on Rule 3b-3 and Married Put Transactions*, SEC Release No. 34-48795 (17 November 2003) at n 2, online: *US Securities and Exchange Commission* <www.sec.gov/rules/interp/34-48795.htm> [*Commission Guidance on Rule 3b-3 and Married Put Transactions*].
[407] *Ibid* at I.
[408] Responses to Frequently Asked Questions Concerning Regulation SHO, *supra* note 396 at II Question 2.4.
[409] There is an exception if the broker or dealer qualifies for independent trading unit aggregation, in which case each independent trading unit shall aggregate all of its positions in a security to determine its net position under Regulation 242.200(f). In order to aggregate positions under separate trading units (and not as a firm as a whole), the following conditions must be met: (1) the broker or dealer has a written plan of organization that identifies each aggregation unit, specifies its trading objective(s) and supports its independent identity; (2) each aggregation unit within the firm determines, at the time of each sale, its net position for every security that it trades; (3) all traders in an aggregation unit pursue only the trading objective(s) or strategy(s) of the aggregation unit and do not coordinate that strategy with any other aggregation unit; and (4) individual traders are assigned to only one aggregation unit at a time: see *Regulation SHO*, *supra* note 393 at § 242.200(f).
[410] Responses to Frequently Asked Questions Concerning Regulation SHO, *supra* note 396 at I.
[411] SEC, "Key Points about Regulation SHO", *supra* note 384 at III.
[412] *Ibid*.
[413] *Ibid* at IV 3.
[414] *Ibid* at n 7.

purposes of the broker-dealer or that is disproportionate to the usual market-making patterns or practices of the broker-dealer in that security.

Additionally, Rule 203(b)(2)(ii) of Regulation SHO provides an exception to the locate requirement for any sale of a security that a person is deemed to own[415] provided that the broker or dealer has been reasonably informed that the person intends to deliver such security as soon as all restrictions on delivery have been removed. Such circumstances could include a situation in which a convertible security, option or warrant has been tendered for conversion or exchange, but the underlying security is not reasonably expected to be received by the settlement date. In such a circumstance, delivery should be made on the sale as soon as all the restrictions on delivery have been removed and, in any event, within 35 days after the trade date.[416]

The Federal Reserve Board in the US prescribes margin requirements under Regulation T. All accounts from which short sales are made must have 150% of the value of the short sale at the time the sale is initiated, consisting of the proceeds of the short sale plus an additional margin of 50% of the value of the short sale. Pursuant to FINRA Rule 4210, the margin that must be maintained in all accounts of customers shall be the greater of: (i) the amount prescribed by Regulation T and (ii) (a) for each security sold short at less than US$5.00 per share, the greater of US$2.50 per share or 100% of the current market value plus (b) for each security sold short at US$5.00 or above, the greater of US$5.00 per share or 30% of the current market value.

4.2.6 Failed Trades, Close-outs, Buy-ins and Reporting

The SEC adopted temporary Rule 204T in October 2008 and final Rule 204 of Regulation SHO, which became effective on July 31, 2009, to strengthen close-out requirements,[417] help further the SEC's goals of reducing failed trades,[418] as well as the problems posed by persistent failed trades,[419] and address abusive naked short selling. Rule 204 of Regulation SHO requires "brokers and dealers that are participants of a registered clearing agency to take action to close out" fail-to-deliver positions.[420] Under Rule 204(a) of Regulation SHO, in order to close out, the broker-dealer must "purchase or borrow securities of like kind and quantity … by no later than the beginning of regular

[415] Rule 200(b)(3) of Regulation SHO provides that a person shall be deemed to own a security if the person owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange.
[416] See *Regulation SHO*, *supra* note 393 at § 242.200(b)(3) and § 242.203(b)(2)(ii). See also Responses to Frequently Asked Questions Concerning Regulation SHO, *supra* note 396 at II.4.
[417] SEC, "Key Points about Regulation SHO", *supra* note 384 at III. See also *Amendments to Regulation SHO; Final Rule*, Release No 34-60388 (31 July 2009), online (pdf): *US Securities and Exchange Commission* <www.sec.gov/rules/final/2009/34-60388fr.pdf>.
[418] According to a 2011 memo from the Office of Markets in the Division of Risk, Strategy and Financial Innovation (the "**Office of Markets**"), failed trades "declined by 65.7% across all securities and 85.1% for threshold stocks [threshold securities is defined below] since the elimination of the options market maker exception and the implementation of Rule 204T on September 18, 2008.": see Securities and Exchange Commission, Office of Markets, Division of Risk, Strategy and Financial Innovation, "Impact of Recent SHO Rule Changes on Fails to Deliver," (25 April 2011), online (pdf): *US Securities and Exchange Commission* <www.sec.gov/files/failsmemo042511.pdf> at 1 [Riskfin Memo]. In fact, in reviewing fails-to-deliver following implementation of the (then temporary) Rule in 2008, the Office of Markets found that there was a drop of 76.6% when comparing the average daily dollar value of aggregate fails-to-deliver in all securities between January 1, 2008, and September 22, 2008 (US$7,772,000,000), against the period from September 23, 2008, to December 31, 2010 (US$1,818,000,000): see Securities and Exchange Commission, Office of Markets, Division of Risk, Strategy and Financial Innovation, "Impact of Recent SHO Rule Changes on Fails to Deliver," (25 April 2011), online (pdf): *US Securities and Exchange Commission* <www.sec.gov/files/failsmemo042511.pdf> at Table 1. [Riskfin Memo at Table 1].
[419] *Final Rule: "Naked" Short Selling Antifraud Rule*, SEC Release No. 34-58744 (14 October 2008) at 4 - 5, online (pdf): *US Securities and Exchange Commission* <www.sec.gov/rules/final/2008/34-58774.pdf>. Note that "according to the National Securities Clearing Corporation (the '**NSCC**'), 99% (by dollar value) of all trades settle on time." Cited in *"Naked" Short Selling Antifraud Rule*, SEC No. Release 3235–AK06 (14 October 2008) at 4, footnote 9, online (pdf): *US Securities and Exchange Commission* <www.sec.gov/rules/final/2008/34-58774.pdf>.
[420] See *Regulation SHO*, *supra* note 393 at *§ 242.204*. See also SEC, "Key Points about Regulation SHO", *supra* note 384 at III.

trading hours on the settlement day following the settlement date, referred to as T+[3]."[421] For *bona fide* market-making activities, the requirement to close out is T+5.[422]

Certain failed trades are given an extended period of time to close out. Pursuant to Rule 204(a)(2) of Regulation SHO, a seller with a fail-to-deliver position at a registered clearing agency resulting from sales of equity securities the seller is deemed to own, and who intends to deliver the securities as soon as all restrictions on delivery have been removed, must close out the position by no later than the beginning of trading hours on the 35th consecutive calendar day following the trade date. "These situations could include delivery delays related to processing a convertible security, an option, or warrant that has been tendered for conversion or exchange, or delivery delays related to processing to remove a restricted legend from stock that was formerly restricted, but which, pursuant to Rule 144 under the *Securities Act of 1933*, may be sold without restriction" (see Section 4.2.5).[423]

Restrictions are imposed if a position is not closed out. Rule 204(b) of Regulation SHO provides that if the position is not closed out pursuant to Rule 204(a) of Regulation SHO (T+3 or T+5, as applicable), the broker or dealer and any broker or dealer for which it clears transactions may not effect further short sales in a security without borrowing or entering into a *bona fide* agreement to borrow the security until the broker or dealer purchases shares to close out the position and the purchase clears and settles.[424] In other words, a pre-borrow obligation is imposed if a position is not closed out.[425]

As a result of compliance with the close-out obligations pursuant to Rule 204 of Regulation SHO, a participant's failed trade will typically not remain for 13 consecutive settlement days.[426] However, if a failed trade remains for 13 consecutive days, Rule 203(b)(3) of Regulation SHO requires participants of registered clearing agencies to immediately purchase securities to close out failed trades in "threshold securities", being securities with large and persistent failures to deliver.[427] Certain securities may remain on an SRO's list of "threshold securities" because of legitimate reasons not related to the intentional breach of Regulation SHO, including a broker-dealer having temporary problems obtaining the stock it borrowed in time for delivery, difficulty in long sellers producing stock in good deliverable form to their broker-dealer or new delivery failures from long or short sales at the same or other broker-dealers – despite proper action to close out fails.[428]

The Financial Industry Regulatory Authority ("**FINRA**") regulates broker-dealers in the US[429] and enforces Rule 11810, which contains procedures and requirements for a purchaser who failed to receive stocks to force a buy-in, including notice requirements.[430] This Rule does not apply in certain

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[421] See *Ibid*. In March 2017, the SEC reduced the settlement cycle from T+3 to T+2. Accordingly, the close-out timeframe was thereby reduced from T+4 to T+3: see also Small Entity Compliance Guide, *supra* note 403.
[422] *Ibid.*
[423] Responses to Frequently Asked Questions Concerning Regulation SHO, *supra* note 396 at II.4.
[424] SEC, "Key Points about Regulation SHO", *supra* note 384 at III.
[425] Rule 204(e) of Regulation SHO allows a broker-dealer to receive credit for purchasing securities in connection with an open short position in lieu of being subject to the pre-borrow requirement if the purchase is *bona fide*, executed on, or after, the trade date but by no later than the end of regular trading hours on the settlement date, the purchase is sufficient to cover the entire amount of the open short position and the broker-dealer can show it has a net long position on its books and records on the settlement day for which the broker-dealer is claiming a pre-fail credit. Rule 204(e) of Regulation SHO had limited broker-dealers to claim pre-fail credit for all activity only on a single date; however, a no-action letter of the SEC modified this restriction by allowing firms to calculate pre-fail credit by aggregating net purchase activity conducted across multiple days: see FINRA, CBOE, C2, SEC No Action Letter, (6 September 2013), available at <www.sec.gov/divisions/marketreg/mr-noaction/2013/finra-cboe-c2-090613-201.pdf> as summarized in FINRA Letter of Acceptance, Waiver and Consent No. 20130392118-01, RBC Capital Markets, LLC at 3–4.
[426] SEC, "Key Points about Regulation SHO", *supra* note 384 at III.
[427] *Ibid*. Threshold securities are defined in Rule 203(c)(6) of Regulation SHO. Generally, "threshold securities" are equity securities of issuers that fall within the scope of the Exchange Act and for five consecutive settlement days (i) there are aggregate fails-to-deliver at a registered clearing agency of 10,000 shares or more per security, (ii) the level of fails is equal to at least one-half of 1% of the issuer's total shares outstanding and (iii) the security is included on a list published by an SRO.
[428] SEC, "Key Points about Regulation SHO", *supra* note 384 at IV.5.
[429] "About FINRA", online: *FINRA* <www.finra.org/about>.
[430] FINRA Rule 11810 – Buy-In Procedures and Requirements, online: *FINRA* <www.finra.org/rules-guidance/rulebooks/finra-rules/11810> [FINRA Rule 11810].

circumstances, including "where the contract is subject to the 'buy-in' requirements of a national securities exchange or a registered clearing agency, in which case" their respective rules would apply.[431] Pursuant to FINRA Rule 11810, "a securities contract that has not been completed by the seller according to its terms may be closed by the buyer not sooner than the third business day following the date delivery was due."[432]

As of September 16, 2008, the SEC provides a balance of total fails-to-deliver as of a particular settlement date for equity securities,[433] using information recorded in the National Securities Clearing Corporation's (the "**NSCC**") Continuous Net Settlement system aggregated over all NSCC members.[434] Such information includes the issuer's name and trading symbol, Committee on Uniform Securities Identification Procedures number, price and aggregate net balance of shares that failed to be delivered as of a particular settlement date (existing fails together with new fails on the reporting day) for each date.[435]

The Depository Trust Company ("**DTC**") has failure-to-settle charges for participants effective January 1, 2019, consisting of fee interest and a flat fee. Fee interest is charged to the participant in addition to interest for the cost of borrowing to complete the settlement. The below chart, which is in US dollars, provides a breakdown of the flat fee.

Value of Failed Trade	First Occasion	Second Occasion	Third Occasion	Fourth Occasion
$0 – 100,000	$100	$200	$500	$1,000
$100,001 – 900,000	$300	$600	$1,500	$3,000
$900,001 – 1,700,000	$600	$1,200	$3,000	$6,000
$1,700,001 – 2,500,000	$900	$1,800	$4,500	$9,000
$2,500,001 – Up	$1,000	$2,000	$5,000	$10,000

The number of occasions will be determined over a moving three-month period and a participant that exceeds four failure-to-settle occasions in a three-month period will be subject to further fees and/or other actions at DTC's discretion.[436]

[431] *Ibid* at (a)(1).
[432] *Ibid* at (a).
[433] SEC, "Key Points about Regulation SHO", *supra* note 384 at IV.9.
[434] Securities and Exchange Commission, "Fails-to-Deliver Data" (last modified 30 September 2019), online: *US Securities and Exchange Commission* <www.sec.gov/data/foiadocsfailsdatahtm> [*SEC Fails-to-Deliver Data*].
[435] *Ibid.*
[436] See DTCC, "Guide to the 2019 DTC Fee Schedule" (last updated 15 August 2019), online (pdf): *Depository Trust and Clearing Corporation*, <www.dtcc.com/~/media/Files/Downloads/legal/fee-guides/dtcfeeguide.pdf>.

4.2.7 Reporting and Disclosure of Short Sale Volume and Short Positions

In the summer of 2009, the SEC announced several actions seeking to "protect against abusive short sales and make more short sale information available to the public."[437] The SEC worked with various SROs to make short sale volume and transaction data available through the websites of the SROs.[438]

As a result, several SROs now provide daily aggregate short selling volume information – the number of shares that have been shorted on the relevant trading day – for individual securities on their websites, along with one-month delayed information regarding individual short sale transactions in listed equity securities.[439] Short sale volume information is available from a variety of exchanges, including the National Association of Securities Dealers Automated Quotation System (the "**NASDAQ**") and the New York Stock Exchange (the "**NYSE**") for a fee. The NASDAQ publishes daily and monthly short sale volume information for the Nasdaq Stock Market, Nasdaq BX and Nasdaq PSX, including the transaction time, price and number of securities for each short sale transaction. The NYSE, which operates NYSE American and NYSE Arca, makes a product available that contains daily and monthly short sale volume files that contain transactional information, including the symbol; the short exempt volume; the short volume; and the total volume, market, size and price. The NYSE also prepares a separate daily volume summary product that contains certain of the foregoing transactional information. Cboe Global Markets, Inc. (the "**Cboe**"), which operates four US equities exchanges – the BZX Exchange, the BYX Exchange, the EDGA Exchange and the EDGX Exchange – publishes transaction data for its four exchanges, including daily volume files containing aggregate short sale volume by security.

Many investors believe that a rise in short interest positions in a particular equity security can be a bearish indicator.[440] Short position data, which represents the number of shares that have been sold short and have not yet been closed out or covered, is made available from a variety of exchanges in the US though certain information, including from the NASDAQ and the NYSE, can only be accessed upon the payment of a user fee. Specifically, the NASDAQ and the NYSE publish summaries of short interest positions in their listed securities on a semi-monthly basis, including, for example, identifying details of the security, the total uncovered open short positions, the public float at the settlement date and the ratio of the current short interest position over the average daily volume for the current and previous reporting period. The Cboe provides short interest position data on its listed securities on a daily basis, and such data includes the market center, symbol, date, time, short sale type, price, link indicator and short size.

FINRA Rules 4560(a) and (b) require members to maintain and report short positions in all equity securities – other than Restricted Equity Securities, as defined in Rule 6420 – as well as all gross short positions that result from short sales as such term is defined in Regulation 200(a) of Regulation SHO (as discussed in Section 4.2) or where the transactions that caused the short position were marked "long" in accordance with Regulation SHO. FINRA Rule 4560(a) requires members to report such information to FINRA as of (i) the 15th day of the month (and if the 15th is not a settlement date, then

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[437] Securities and Exchange Commission, Press Release, 2009-172, "SEC Takes Steps to Curtail Abusive Short Sales and Increase Market Transparency" (27 July 2009), online: *US Securities and Exchange Commission* <www.sec.gov/news/press/2009/2009-172.htm>.
[438] See *Ibid.* See also Securities and Exchange Commission, "Short Sale Volume and Transaction Data" (last modified 10 August 2016), online: *US Securities and Exchange Commission* <www.sec.gov/answers/shortsalevolume.htm>. Pursuant to Section 13(f) of the *Securities Exchange Act of 1934* and Rule 10a-3T, between late 2008 and August, 2009, large institutional managers that had US$100 million or more in assets under management were required to report to the SEC short sales and short positions in certain securities, other than options, using a non-public Form SH. This disclosure was not made public. Rule 10a-3T expired August 1, 2009: see also *Disclosure of Short Sales and Short Positions by Institutional Investment Managers*, SEC Release No. 34-58785, online (pdf): *US Securities and Exchange Commission* <www.sec.gov/rules/final/2008/34-58785.pdf>.
[439] SEC, "Key Points about Regulation SHO", *supra* note 384 at IV 8.
[440] Nasdaq, "Short Interest," online: *NASDAQ* <www.nasdaq.com/market-activity/quotes/short-interest>.

the previous business day) and (ii) the last business day of the month on which transactions settled.[441] The short interest reports must be submitted to FINRA by the second business day after the designated settlement date mid or end of month.[442] FINRA Rule 4560 was amended on November 30, 2012, to clarify that short positions resulting from short sales that have not yet reached settlement date by the given designated settlement date for reporting purposes should not be included in the firm's short interest report for that reporting cycle.[443] Once collected, FINRA then compiles the short interest data and provides it for publication on the eighth business day after the reporting settlement date.[444] In addition, the November 30, 2012 amendment codified previously issued interpretation[445] where, pursuant to FINRA Rule 4560(b), firms were to record and report short positions existing in each individual firm or customer account on a *gross*, as opposed to a *net*, basis that resulted from (1) a "short sale", as defined in Rule 200 of Regulation SHO, or (2) where the transaction(s) that caused the short position was marked "long" due to the firm's or the customer's net long position at the time of the transaction.[446]

4.2.8 Enforcement Activity

In recent years, the SEC and FINRA have taken enforcement action with respect to violations of Regulation SHO. For example, on June 1, 2015, the SEC charged two Merrill Lynch ("**ML**") entities with using inaccurate data in the course of executing short sale orders. Broker-dealers often compile easy-to-borrow lists ("**ETB Lists**"), which contain what the broker-dealer has deemed to be readily accessible securities for the purposes of compliance with the locate requirement under Regulation SHO. Although personnel at ML would stop using the ETB List once they were informed by their lending desk that certain stocks on the list were no longer readily available, ML's "execution platforms were programmed to continue processing short sale orders based on the ETB list" until the next day's list was prepared.[447] This resulted in the execution of thousands of shares of particular securities that were no longer readily available being sold short. Upon admitting wrongdoing and violating Rule 203(b) of Regulation SHO, ML agreed to a nearly US$11 million settlement.[448]

FINRA has the ability to issue fines in formal disciplinary actions brought by its enforcement staff. For example, in 2015, FINRA fined a unit of Interactive Brokers Group Inc. ("**Interactive**") US$5.5 million for the design of its supervisory system failing to comply with Regulation SHO and violations of several naked short selling rules under Regulation SHO over a period of at least three years. These violations included failing to close out more than 2,300 failed trades, and accepting and executing short orders in those securities without first borrowing – or arranging to borrow – the security approximately 28,000 times in violation of Rule 204 of Regulation SHO. Interactive also failed to comply with the tick test once a circuit breaker was triggered in the execution or display of more than 4,700 short sale orders.[449] Similarly, in March 2019, FINRA imposed a US$2 million fine on

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[441] "FINRA Collection of Short Interest Data for BATS Exchange-Listed Securities," FINRA Regulatory Notice 11-55 (15 December 2011, online: *FINRA* <www.finra.org/rules-guidance/notices/11-55>.

[442] *Short Interest Reporting: FINRA Announces New Web-based System for the Collection of Short Interest Positions*, FINRA Regulatory Notice 16-32 (10 January 2017), at 1–2, online (pdf): *FINRA* <www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-16-32.pdf>.

[443] *Short-Interest Reporting: SEC Approves Amendments to FINRA's Short-Interest Reporting Rule*, FINRA Regulatory Notice 12-38 (August 2012), online (pdf): *FINRA* <www.finra.org/sites/default/files/NoticeDocument/p158162.pdf> [*FINRA Notice 12-38*].

[444] See Nasdaq Trader, "Nasdaq Short Interest Publication Schedule," online: *Nasdaq Trader* <nasdaqtrader.com/Trader.aspx?id=ShortIntPubSch>. "Pursuant to a Securities and Exchange Commission request, FINRA makes short sale trade data publicly available" in two file types: "daily short sale volume files" and "monthly short sale transaction files": see also FINRA, "TRF Regulation SHO - 2019," online: *FINRA* <www.finra.org/filing-reporting/trf/trf-regulation-sho-2019>.

[445] FINRA Notice 12-38, *supra* note 443.

[446] FINRA Rule 4560(b), online: *FINRA* <finra.complinet.com/en/display/display_main.html?rbid=2403&record_id=14597>.

[447] SEC Press Release, "Merrill Lynch Admits Using Inaccurate Data for Short Sale Orders, Agrees to $11 Million Settlement" (1 June 2015), online: *US Securities and Exchange Commission* <www.sec.gov/news/pressrelease/2015-105.html>.

[448] SEC Release No. 75083, (1 June 2015), online (pdf): *US Securities and Exchange Commission* <www.sec.gov/litigation/admin/2015/34-75083.pdf>.

[449] News Release, "FINRA Fines Interactive Brokers $5.5 Million for Regulation SHO Violations and Supervisory Failures", (20 August 2018), online: *FINRA* <www.finra.org/node/86129>.

Cantor Fitzgerald & Co. for the design of its supervisory system failing to comply with Regulation SHO, including using a predominantly manual system that was not reasonable for the firm's business expansion and trading activity, and for violations of Regulation SHO over a period of approximately five years, including the failure to close out at least 4,879 failed trades, and accepting and executing short orders without first borrowing – or arranging to borrow – securities in violation of Rule 204 of Regulation SHO.[450]

In January 2018, the SEC entered an "Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C" of the Exchange Act after it received an Offer of Settlement by Industry and Commercial Bank of China Financial Services LLC ("**ICBCFS**"), deeming it "appropriate, in the public interest and for the protection of investors, to impose sanctions" against ICBCFS.[451] ICBCFS is a broker-dealer and participant of the DTC and provides equity clearing services to a wide range of institutional clients.[452] An investigation by the SEC found ICBCFS failed to close out certain failed trades because it improperly claimed credit against its close out obligations and, as a result, violated Regulation SHO over 4,000 times between April 2013 and August 2016.[453] Specifically, ICBCFS was accused of wrongly claiming credit for (i) positions that were not settled on the settlement date, (ii) securities that were immediately resold and (iii) recreating the fails-to-deliver position and double counting purchases for credit against multiple close-out obligations. As a result of its improper credit claims, ICBCFS incurred numerous prolonged fails-to-deliver. Furthermore, ICBCFS had institutional knowledge of the prolonged fails-to-deliver positions through the preparation of internal reports; however, for over two years, it failed to comply.[454] Without admitting or denying these findings, ICBCFS agreed to pay a US$1.25 million civil monetary penalty to settle the matter and consented to censure and the entry of a cease and desist order.[455]

Also in 2018, the SEC accepted an Offer of Settlement from Bayes Capital, LLC, a former registered broker-dealer, and entered an "Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C" of the Exchange Act concerning repeated violations of the order-marking, locate and circuit breaker requirements in Regulation SHO.[456] Bayes Capital, LLC had mismarked sell orders as long when it did not own the securities being sold. The Offer of Settlement included censure, a cease and desist order for future violations and a US$300,000 civil monetary penalty.[457]

4.3 European Union

4.3.1 Background to Regulation

In the EU, the regulatory approach is composed of four levels because, in 2001, it endorsed the proposals of the Lamfalussy Report, which, at the time, recommended a new approach to improve

[450] News Release, "FINRA Fines Cantor Fitzgerald $2 Million for Regulation SHO Violations and Supervisory Failures", (5 March 2019), online: *FINRA* <www.finra.org/newsroom/2019/finra-fines-cantor-fitzgerald-2-million-regulation-sho-violations-and-supervisory>.
[451] United States of America before the SEC, *In the matter of Industrial and Commercial Bank of China Financial Services LLC*, SEC Release No. 82533 (18 January 2018), File No. 3-18341, Administrative Proceeding, online (pdf): *US Securities and Exchange Commission* <www.sec.gov/litigation/admin/2018/34-82533.pdf> at IV.
[452] *Ibid* at III.
[453] *Ibid.*
[454] "Industrial and Commercial Bank of China Financial Services LLC Agrees to Settle SEC Charges Relating to Numerous Regulation SHO Violations That Resulted in Prolonged Fails to Deliver" (18 January 2018), File No.3 3-18341, Administrative Proceeding, online (pdf): *US Securities and Exchange Commission* <www.sec.gov/litigation/admin/2018/34-82533-s.pdf>.
[455] *Ibid.*
[456] United States of America before the SEC, SEC Release No. 83556 (28 June 2018), File No. 3-18558, in the matter of Bayes Capital, LLC. Administrative Proceeding and in *re Bayes Capital, LLC*, Exch. Act Rel. No. 83556, 2018 SEC LEXIS 1589 (28 June 2018) at III 1, online (pdf): *US Securities and Exchange Commission* <www.sec.gov/litigation/admin/2018/34-83556.pdf>.
[457] Morgan Lewis, 2018 Year in review, Select SEC and FINRA Developments and Enforcement Cases at 52, online: *Morgan Lewis* <www.morganlewis.com/-/media/files/publication/morgan-lewis-title/white-paper/2019/2018-securities-year-in-review_190406_27fe19.ashx?la=en&hash=6B58C731667222F5FD7933547BB316617B8DB751>.

the regulatory process in financial services to make it more effective.[458] The four institutional levels with respect to regulation are as follows:

- Level 1: the European Parliament and Council adopt the basic laws proposed by the European Commission (the "**EC**"), which usually sets out framework principles;

- Level 2: the EC adopts, adapts and updates technical implementing measures along with consultative bodies composed mainly of EU countries representatives;

- Level 3: committees of national supervisors are responsible for advising the EC in the adoption of level 1 and 2 and for issuing guidelines on the implementation of the rules; and

- Level 4: the EC is to have a stronger role in ensuring the enforcement of EU rules by national governments. [459]

This four-level approach was first adopted by the securities sector and then extended to other areas. [460]

Due to the turbulent market conditions and concerns during the global financial crisis in 2007–2008, a large number of European regulators took emergency measures to restrict or temporarily ban short selling, and the Committee of European Securities Regulators (the "**CESR**"), which was a Level 3 institution, launched a review of policy on short selling in order to develop pan-European standards.[461] Once this review was completed in 2009, the CESR released a report in 2010 with its proposal for a pan-European short selling disclosure regime.[462]

After the financial crisis, the EU made certain reforms and "established a new European Systemic Risk Board for monitoring macro-prudential risks and transformed the Level 3 Lamfalussy committees into independent authorities with enhanced powers."[463] One of the three European supervisory authorities established was the European Securities and Markets Authority ("**ESMA**"),[464] a financial regulatory agency that replaced the CESR on January 1, 2011.[465] Its objective is to protect the public interest by contributing to the short-, medium- and long-term stability and effectiveness of the financial system for the EU economy, its citizens and its businesses.[466]

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[458] European Commission, "Regulatory process in financial services" (last visited 24 August 2019), online: *European Commission* <ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-reforms-and-their-progress/regulatory-process-financial-services/regulatory-process-financial-services_en> [EC, "*European Regulatory Process*"].
[459] *Ibid.*
[460] *Ibid.*
[461] See Committee of European Securities Regulators, *CESR Proposal for a Pan-European Short Selling Disclosure Regime* (Paris: Committee of European Securities Regulators, 8 July 2009) at paras 1–2, online (pdf): *European Securities and Markets Authority* <www.esma.europa.eu/sites/default/files/library/2015/11/09_581.pdf>. See also "Committee of European Securities Regulators Definition" (last visited 24 August 2019), online: *Capital.com* <capital.com/committee-of-european-securities-regulators-definition>.
[462] Committee of European Securities Regulators, *Model for a Pan-European Short Selling Disclosure Regime* (Paris: Committee of European Securities Regulators, March 2010) at 3, online (pdf): *European Securities and Markets Authority* <www.esma.europa.eu/sites/default/files/library/2015/11/10_088.pdf> [CESR, *Model for a Pan-European Short Selling Disclosure Regime*].
[463] EC, "European Regulatory Process", *supra* note 458.
[464] *Ibid.*
[465] It is worth noting that ESMA has much more far-reaching powers than its predecessor, the CESR, which is representative of "a major step forward with respect to EU intervention in markets": see Elizabeth Howell, "Short Selling Restrictions in the EU and the US: A Comparative Analysis" (2016) 16:2 J Corporate L Studies 333 at 366; ESMA shall take a leading role in promoting transparency, simplicity and fairness in the market for consumer financial products. ESMA also has the power to take measures where short selling and other related activities threaten the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the EU. See also EC, *Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC*, [2010] OJ, L 331/84 at arts 9(1), 9(5).
[466] *Ibid* at art 1(5).

On November 1, 2012, largely as a result of the sovereign debt crisis, which was caused in part by the global financial crisis of 2007–2008,[467] and with the assistance of the CESR report, the *Regulation (EU) No 236/2012 of the European Parliament and of the Council of March 14, 2012 on short selling and certain aspects of credit default swaps* (the "**EU Short Selling Regulation**") came into force.[468] The EU Short Selling Regulation applies to those financial instruments that are admitted to trading on an EU-regulated market and a multilateral trading facility in the EU, and whose principal trading venue is in the EU.[469]

On December 13, 2013, the EC released a report to the European Parliament and the Council on the evaluation of the effectiveness of the EU Short Selling Regulation (the "**EC Report**"), basing some of its findings on the technical advice given by ESMA in its report on the EU Short Selling Regulation (the "**ESMA 2013 Report**").[470] As stated by ESMA, the EU Short Selling Regulation seeks to achieve the following: "increasing the transparency of short positions held by investors in certain EU securities", reduce settlement and other risks linked with certain types of short selling and ensure the ability for member states to have the power to "intervene in exceptional situations to reduce systematic risks and risks to financial stability and market confidence".[471]

4.3.2 Differences from the Canadian Regime

In contrast to the Canadian rules governing short sales, the EU Short Selling Regulation:

(1) bans short selling, unless short sales are covered in a particular manner (Article 12);

(2) does not require flagging or reporting of short sales – except with respect to significant net short positions – and accordingly, no short sale volume reporting is available;

(3) imposes mandatory buy-in procedures at four days after the expected settlement date (T+6) and enhanced responsibilities and powers of CCPs (Article 15, which will be repealed and replaced in September 2020);

(4) requires that a short seller notify the relevant competent market authority (non-public disclosure) once the net short position of such short seller reaches or falls below a particular threshold (Article 5); and

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[467] "The European sovereign debt crisis was a period when several European countries experienced the collapse of financial institutions, high government debt, and rapidly rising bond yield spreads in government securities" beginning with "the collapse of Iceland's banking system", then Portugal, Greece and Spain in 2009. "Some of the contributing causes included the financial crisis of 2007 to 2008… the real estate market crisis, and property bubbles in several countries", the US recession between December 2007 to 2009 and the ensuing global recession in 2009: see Howell, *supra* note 465 at 334; Beverly Bird & Will Kenton, "European Sovereign Debt Crisis" (12 May 2019), online: *Investopedia* <www.investopedia.com/terms/e/european-sovereign-debt-crisis.asp>.

[468] Adopted November 15, 2011: see EC, *Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps*, [2012] OJ, L 86/1 at 1 and art 48 [*EU Short Selling Regulation*].

[469] *Ibid* at arts 1(a), 2(l), 16.

[470] The EC Report covers the points listed in Article 45 of the EU Short Selling Regulation and was "prepared in light of discussions with the competent authorities and ESMA. On 22 October 2012 the [EC] formally mandated ESMA to carry out a quantitative analysis of the available short selling data and a consultation of competent authorities and market participants. On the basis of this work, ESMA issued its technical advice on the evaluation of the [*EU Short Selling Regulation*] on 3 June 2013": see European Commission, *Report from the Commission to the European Parliament and the Council on the evaluation of the regulation (EU) No 236/2012 on short selling and certain aspects of credit default swaps* (Brussels: European Commission, 13 December 2013) at 2, online (pdf): *European Commission* <ec.europa.eu/transparency/regdoc/rep/1/2013/EN/1-2013-885-EN-F1-1.Pdf> [EC, *EC Report*]. See also European Securities and Markets Authority, *ESMA's technical advice on evaluation of the Regulation (EU) 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps* (Paris: European Securities and Markets Authority, 3 June 2013), online (pdf): *European Securities and Markets Authority* <www.esma.europa.eu/sites/default/files/library/2015/11/2013-614_final_report_on_ssr_evaluation.pdf> [ESMA, *ESMA 2013 Report*].

[471] European Securities and Markets Authority, "Short Selling" (last visited 1 November 2019), online: *European Securities and Markets Authority* <www.esma.europa.eu/regulation/trading/short-selling>.

(5) requires that a short seller make public disclosure once the net short position of such short seller reaches or falls below a particular threshold (Article 6).

4.3.3 Defining a Short Sale

A short sale is defined in Article 2 of the EU Short Selling Regulation as "any sale of the share or debt instrument which the seller does not own at the time of entering into the agreement to sell including such a sale where at the time of entering into the agreement to sell the seller has borrowed or agreed to borrow the share or debt instrument for delivery at settlement, not including…a transfer of securities under a securities lending agreement".[472] In terms of ownership, in circumstances "[w]here natural or legal persons are the beneficial owners of a share…[such share] shall be deemed to be owned by the ultimate beneficial owner…[and] the beneficial owner shall be the investor who assumes the economic risk of acquiring a financial instrument."[473]

4.3.4 Requirements to Conduct a Short Sale

Article 12 of the EU Short Selling Regulation provides that all short sales must be covered by (i) actually borrowing the shares or making alternative provisions resulting in a similar legal effect; (ii) having agreements to borrow – or another absolutely enforceable claim – under contract or property law to be transferred ownership of a corresponding number of securities so that settlement can be effected when due; or (iii) arrangements having been made with a third party confirming the location of the borrowed shares and the short seller having taken measures via such third party, such that there is a reasonable expectation that settlement can be effected when due.[474] The foregoing requirements apply to all equity trades, with certain exceptions available, including one for market-making activities.[475] This is because "[m]arket making activities play a crucial role in providing liquidity to markets within the [EU]" and "[i]mposing requirements on such activities could severely inhibit their ability to provide liquidity and have a significant adverse impact on the efficiency of the [EU] markets."[476]

In the EU, the margin requirements are the same for long and short positions, with the relevant exchanges determining the initial margin through risk-based portfolio analysis models.[477] The maintenance margin is the same as the initial margin.

4.3.5 Failed Trades, Close-outs, Buy-ins and Reporting

It is reported that the public may be informed of failed trade statistics for EU securities, but the disclosure policies regarding failed trades for national competent authorities vary across member states.[478] In conducting preliminary searches, we were unable to obtain much public disclosure. We found only the failure to settle transaction information for Italian-listed securities, published by Monte Titoli, a pre-settlement, settlement, custody and asset-servicing entity in Italy that reported having a

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[472] *EU Short Selling Regulation*, *supra* note 468 at art 2(1)(b).
[473] EC, *Commission Delegated Regulation (EU) No 918/2012 of 5 July 2012 supplementing Regulation (EU) No 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps with regard to definitions, the calculation of net short positions, covered sovereign credit default swaps, notification thresholds, liquidity thresholds for suspending restrictions, significant falls in the value of financial instruments and adverse events*, [2012] OJ, L 274/1 at art 3(1).
[474] *EU Short Selling Regulation*, *supra* note 468 at art 12(1).
[475] *EU Short Selling Regulation*, *supra* note 468 at art 17(1).
[476] *Ibid* at preamble 26.
[477] IBKR, "Stocks Margin Overview" (last visited 1 November 2019), online: *Interactive Brokers* <www.interactivebrokers.co.in/en/index.php?f=26658&hm=eu&ex=gl&rgt=1&rsk=0&pm=1&rst=1010041008080801 01>.
[478] European Central Bank, *Settlement Fails – Report on Securities Settlement Systems (SSS) Measures to Ensure Timely Settlement* (Frankfurt: European Central Bank, April 2011) at 4, online (pdf): *European Central Bank* <www.ecb.europa.eu/pub/pdf/other/settlementfails042011en.pdf> [European Central Bank, *Settlement Fails Report 2011*].

settlement rate of approximately 97% in 2018,[479] and a breakdown of settlement outcomes on a per-week basis from 2016 to date.[480] We were unable to access information regarding failed trades for any other member state in the EU. As such, it is very challenging to draw any meaningful conclusions about failed trades in the EU.[481]

On January 13, 2011, the EC sought public comment seeking to establish an effective EU securities settlement regime.[482] In order to harmonize certain aspects of the settlement cycle and settlement discipline, and to provide a set of common requirements for central securities depositories ("**CSDs**") operating securities settlement systems across the EU, *Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directors 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012* ("**EU Settlement Regulation**") came into force on September 17, 2014, other than with respect to the settlement discipline regime that will come into force in September 2020.[483]

The EU Settlement Regulation supports the objectives of TARGET2-Securities ("**T2S**"),[484] a project launched by the Eurosystem that provides "a common platform on which securities and cash can be transferred between investors across Europe."[485] Currently, 21 CSDs from 20 European countries use T2S.[486]

The EU Settlement Regulation will require a CSD, for each securities settlement system it operates, to establish a system that monitors failed settlements.[487] Every CSD will also be required to provide periodic reports to the competent authorities as to the number and details of settlement fails and any other relevant information.[488] These reports will be made public by CSDs in an aggregate and anonymized fashion on an annual basis.[489] The competent authorities are to share any relevant information on settlement fails with ESMA.[490] Therefore, commencing in September 2020, the public will be able to access information with respect to failed trades for European equity securities. Furthermore, CSDs, CCPs and trading venues will be required to have procedures that enable them to suspend any participant that fails consistently and systematically to deliver stock on the intended settlement date, along with disclosing to the public the identity of the participant after the participant has an opportunity to submit its observations.[491] Each CSD will also be required to have procedures to provide a penalty mechanism that is to serve as an effective deterrent for participants that cause

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[479] London Stock Exchange Group, "About Us – Monte Titoli" (2019), online: *London Stock Exchange Group* <www.lseg.com/markets-products-and-services/post-trade-services/settlement-and-custody/monte-titoli-eng/about-us>.
[480] London Stock Exchange Group, "Settlement Outcomes", online: *London Stock Exchange Group* <www.lseg.com/markets-products-and-services/post-trade-services/monte-titoli/english/intermediaries/statistics-operational-data/settlement-outcomes>.
[481] European Central Bank, *Settlement Fails Report 2011*, *supra* note 478 at 1.
[482] Commission of the European Communities, *Public Consultation on Central Securities Depositories (CSDs) and on the Harmonisation of Certain Aspects of Securities Settlement in the European Union* (Brussels: Commission of the European Communities, 13 January 2011) at 3–4, online (pdf): *European Commission* <https://ec.europa.eu/finance/consultations/2011/csd/docs/consultation_csd_en.pdf>.
[483] See EC, *Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directors 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012*, [2014] OJ, L 257/1 at preamble 5 and art 76 [*EU Settlement Regulation*]. See also EC, *Commission Delegated Regulation (EU) 2018/1229 of 25 May 2018 supplementing Regulation EU No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on settlement discipline*, [2018] OJ, L 230/1 at art 42 [*EU Settlement Supplement*].
[484] Pershing, "The Central Securities Depositories Regulation (CSDR)" (2 October 2019), online: *Pershing* <www.pershing.com/uk/en/news/what-is-big-in-our-world/regulation/csdr>.
[485] European Central Bank, "What is TARGET2-Securities (T2S)?" (last visited 1 November 2019), online: *European Central Bank* <www.ecb.europa.eu/paym/target/t2s/html/index.en.html>.
[486] *Ibid.*
[487] *EU Settlement Regulation*, *supra* note 483 at art 7(1).
[488] *Ibid.*
[489] *Ibid.*
[490] *Ibid.*
[491] *Ibid* at preamble 14, art 7(9).

settlement fails.[492] The penalty mechanism must include cash penalties that are to be calculated on a daily basis for each business day that the transaction fails after its intended settlement date until the end of a buy-in procedure.[493]

Article 15 of the EU Short Selling Regulation requires CCPs providing clearing services to ensure that there are adequate arrangements in place for the buy-in of shares.[494] Buy-in procedures are automatically triggered if a seller is not able to deliver shares for settlement in four business days after the day on which settlement is due (T+6).[495] If a buy-in is not possible, the seller is required to pay the buyer an amount based on the value of the shares to be delivered, plus an amount for losses incurred by the buyer as a result of the settlement failure.[496] The CCP must ensure that procedures are in place such that the short seller must make daily payments for each day that the failure continues, and these payments shall be sufficiently high to act as a deterrent to parties failing to settle.[497] For example, as of May 27, 2019, the European Central Counterparty N.V., an equities clearinghouse in Europe, charges a clearing participant a fixed fail fee of €19.50 per business day per late settlement, together with a variable fee of 100bp/365 per day on the cash amount of the settlement until the buy-in day (calculated per calendar month).[498] This is to cover the out-of-pocket costs incurred by CSDs and settlement agents, together with the internal costs of the clearinghouse.[499] These buy-in and late settlement requirements set basic standards in relation to settlement discipline.[500] Article 15 of the EU Short Selling Regulation will be repealed once the EU Settlement Regulation takes effect with respect to settlement discipline.[501] However, the timing for a mandatory buy-in will remain at T+6, other than for illiquid securities which will have a mandatory buy-in at T+9.[502]

As a Level 2 measure on settlement discipline, the *Commission Delegated Regulation (EU) 2018/1229 of 25 May 2018 supplementing Regulation EU No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on settlement discipline* (the "**2018 EU Settlement Supplement**") is to come into force in September 2020.[503] To promote transparency, it is further being required that CSDs use a single template for disclosing settlement fails to the general public, and publish the settlement fail information on their websites.[504]

4.3.6 Reporting and Disclosure of Short Sale Volume and Short Positions

Though it was considered,[505] there is currently no requirement to "flag" short sale orders under the EU Short Selling Regulation. Despite this, the preamble to the EU Short Selling Regulation provides that the EC should consider whether inclusion by investment firms of information about short sales in transaction reports would provide useful supplementary information to enable authorities to monitor levels of short selling.[506] To date, it appears that no short sale volume information is provided

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[492] *Ibid* at art 7(2).
[493] *Ibid.*
[494] *EU Short Selling Regulation*, *supra* note 468 at art 15(1).
[495] *Ibid* at art 15(1)(a).
[496] *Ibid* at art 15(1)(b).
[497] *Ibid* at art 15(2).
[498] European Central Counterparty, "Regulation Fees and Penalties" (27 May 2019) at 3–4, online: *European Central Counterparty* <euroccp.com/home/participants-centre/documentation/>.
[499] *Ibid* at 1.
[500] *EU Short Selling Regulation*, *supra* note 468 at preamble 23.
[501] *EU Settlement Regulation*, *supra* note 483 at preamble 78.
[502] *Ibid* at preamble 17, art 7(3).
[503] *EU Settlement Supplement*, *supra* note 483 at art 42.
[504] *Ibid* at preamble 15 and art 15.
[505] European Commission, *Proposal for a Regulation of the European Parliament and of the Council on short selling and certain aspects of credit default swaps* (Brussels: European Commission, 15 September 2010) at 7, online (pdf): *European Commission* <ec.europa.eu/transparency/regdoc/rep/1/2010/EN/1-2010-482-EN-F1-1.Pdf>.
[506] *EU Short Selling Regulation*, *supra* note 468 at preamble 13.

in the EU. However, it is worth noting that a competent authority may prohibit or impose conditions relating to a person entering into a short sale.[507]

The CESR considered two basic approaches to enhanced transparency when putting together a model for short selling disclosure in Europe:

(1) flagging short sales or short sale orders, whereby a marker would be required for each individual short sale or short sale order that a broker sends to a regulated market or multilateral trading facility for execution, following which such information would be aggregated and then published to the market by listed security; and

(2) requiring short sellers to report on significant short positions to the regulator and/or the market.[508]

In Europe, transparency regarding significant net short positions, including public disclosure above a certain threshold, is believed to be necessary for reasons of financial market stability and investor protection.[509] In addition, it is believed that such transparency will enable regulators to monitor the use of short selling in connection with abusive strategies and the implications of short selling on the proper functioning of markets. Article 5 of the EU Short Selling Regulation requires significant net short positions in shares to be reported to the relevant competent authorities when they are at least equal to 0.2% of a company's issued share capital and every 0.1% over that.[510] A final notification is required once the position has fallen below 0.2%.[511] Notifications required by Article 5[512] must be made no later than 3:30 p.m. the following trading day using the time in the member state of the relevant competent authority who must be notified.[513] Article 11 of the EU Short Selling Regulation requires competent authorities to provide information to ESMA on aggregated net short positions on a quarterly basis.[514] In 2016, the aggregated value of the net short positions in EU shares that were reported to national competent authorities represented 1% of the total market value of EU shares.[515]

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[507] The definition of "relevant competent authority" means in relation to certain financial instrument the competent authority for that financial instrument as defined in point (7) of Article 2 of Commission Regulation (EC) No 1287/2006 and determined in accordance with Chapter III of that Regulation. The definition of "financial instrument" means an instrument listed in Section C of Annex I to Directive 2004/39/EC: see *EU Short Selling Regulation*, *supra* note 468 at arts 2(1)(a), 2(1)(j)(v), 20(2)(a). See also EC, *Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC*, [2004] OJ, L 145/1 at Section C of Annex I and art 4(17).

[508] This is also reflected in the FSA discussion paper as the options for enhanced transparency included reporting and publishing of short positions or reporting and publishing of short sales: see Financial Services Authority, "FSA puts forward options for improving transparency in short selling", *Press Release, FSA/PN/100/2002*, (21 October 2002), online (archived 3 September 2009): <webarchive.nationalarchives.gov.uk/20090903054700/http://www.fsa.gov.uk/Pages/Library/Communication/PR/2002/100.shtml>. See also *CESR*, *Model for a Pan-European Short Selling Disclosure Regime*, *supra* note 462 at paras 17–20.

[509] *EU Short Selling Regulation*, *supra* note 468 at preamble 40.

[510] *Ibid* at art 5.

[511] *Ibid.*

[512] According to the ESMA 2013 Report, between November 1, 2012, and February 28, 2013 (the "**2012–2013 Period**"), 12,603 notifications on 970 securities were made by short sellers in 18 member states of the EU (83% of which were domiciled in the UK or the US) to relevant competent authorities. Broken down further, the top 10 holders were responsible for 28% of all the reported short positions. It is worth noting that in the 2012–2013 Period, 75% of the holders that reported net positions by notifying relevant competent authorities were short on seven different shares or fewer, reflecting that overall holdings were quite diluted, only 15 market participants shorted 50 different shares or more and only four shorted over 100 shares: see ESMA, *ESMA 2013 Report*, *supra* note 470 at 58–59.

[513] *EU Short Selling Regulation*, *supra* note 468 at art 9.

[514] *Ibid* at art 11(1).

[515] European Securities Markets Authority, *Final Report Technical Advice on the evaluation of certain elements of the short selling regulation* (European Securities and Market Authority, 21 December 2017) at 114, online (pdf): *European Securities Markets Authority* <www.esma.europa.eu/sites/default/files/library/technical_advice_on_the_evaluation_of_certain_aspects_of_the_ssr.pdf> [ESMA, *Final Report 2017*].

Article 6 of the EU Short Selling Regulation requires public disclosure of net short positions that are at least equal to 0.5% of the company's issued share capital and every 0.1% above that.[516] The timing for public disclosure made pursuant to Article 6[517] is similar to the notification requirement to competent authorities, and must be made no later than 3:30 p.m. – using the local time of the relevant competent authority – the following trading day. The required notification includes the identity of the person who holds the position; the size of the relevant position; the issuer in relation to which the relevant position is held; and the date on which the relevant position was created, changed or ceased to be held.[518] This disclosure must be made in a manner that ensures fast access to the information, and is required to be posted on a central website operated by the relevant competent authority.[519] ESMA must have a link to all such central websites on its home page as well.[520]

ESMA received a formal mandate from the EC on January 19, 2017, seeking technical advice on the evaluation of certain elements of the EU Short Selling Regulation.[521] In its final report, issued on December 21, 2017, ESMA reconfirmed its view that the notification and reporting thresholds "provide meaningful information to both regulators for supervisory purposes and the market for transparency purposes."[522] In confirming its view from the ESMA 2013 Report, ESMA considered responses to a consultation that sought comment on a variety of issues, including whether or not the thresholds regarding notification to competent authorities and public disclosure should remain as they are.[523] All 10 commentators on this particular issue supported current thresholds, though industry associations highlighted that the reporting of incremental changes at increments of 0.1% is not appropriate and does not result in meaningful disclosure.[524]

The notification requirements in the EU provide regulators with early warning signs of accumulations of large short positions.[525] In arguing for implementation of the notification threshold, the CESR stated that the information provided by such disclosure requirements would provide regulators with increased capacity to monitor circumstances and recognize potentially abusive behaviour, and that without it, the identification of significant short positions would require ample resources.[526] Another

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[516] *EU Short Selling Regulation*, *supra* note 468 at art 6.

[517] Of the total net short positions reported to the relevant competent authorities during the 2012-2013 Period, only 26% triggered the public disclosure requirements (because they were over the 0.5% threshold). Of the 3508 notifications made public by 224 holders, holders domiciled in the US and UK accounted for 90% of such figure, and the ten biggest holders were responsible for 37.5%. The public disclosures represented 1,090 short positions on 427 stocks among which 679 were new short positions directly created above the 0.5% threshold whereas the rest crossed it at some point during the 2012-2013 Period. In collecting this data, ESMA concluded that the reporting thresholds are set in a manner that could "generate both meaningful information for competent authorities and the market as well as a proportionate compliance burden on investors." As a result, ESMA did not advocate for any change to the thresholds. In the EC Report, the EC concurred with ESMA's conclusions that the thresholds were "well-calibrated and appropriate" and therefore did not consider a need to change the thresholds or the methodology for calculating net short positions: see ESMA, *ESMA 2013 Report*, *supra* note 470 at paras 17, 20, 31, 32. See also EC, *EC Report*, *supra* note 470 at 2.

[518] *EU Short Selling Regulation*, *supra* note 468 at arts 9(1), 9(2).

[519] *Ibid* at art 9(4).

[520] *Ibid.*

[521] ESMA, *Final Report 2017*, *supra* note 515 at 5.

[522] ESMA noted that in 2017, "a reduced number of [national competent authorities] are voluntarily publishing on a regular basis, though not daily, aggregated net short positions in the shares of issuers under their competence, based on the public and non-public notifications received and without mentioning the name of the notifying entities for confidentiality reasons." It is worth noting that ESMA recommended in such report that national competent authorities "should be allowed to periodically publish anonymised aggregated net short positions by issuer on a voluntary basis when they consider that the issues… can be adequately addressed in their jurisdiction"): see *Ibid* at paras 263, 243, 245.

[523] ESMA also sought comments on whether there was any benefit to a new requirement to publish anonymized aggregated net short positions by issuer on a regular basis: see *Ibid* at paras 241, 244.

[524] ESMA also requested comment on a new requirement to publish anonymized aggregated net short position data by issuer, and though five of seven respondents supported the idea (and two respondents went further to argue that such information would be more informative to investors than non-anonymized data on individual net short positions above 0.5%), ESMA decided not to pursue this new requirement. One joint response from two associations disagreed with both the potential new requirement and with the publication of individual net short positions because of the risk of market distortion, herding behaviour and squeezing the participants with net short positions: see *Ibid* at paras 245, 250.

[525] CESR, *Model for a Pan-European Short Selling Disclosure Regime*, *supra* note 462 at para 61.

[526] *Ibid.*

benefit that the CESR equated with requiring notification of short positions was that such disclosure would assist in identifying unusual short selling activity and improve the ability of regulators to determine whether intervention is required.[527] In evaluating various thresholds, the CESR noted that excessively high thresholds would rarely be triggered and the market would therefore not receive information; however, if thresholds were set too low, the "warnings" associated therewith would be of little practical value.[528]

In considering public disclosure requirements, the CESR stated that a short selling regime should aim to achieve behavioural change and therefore have individual public disclosure as a "central plank".[529] The CESR believed this public disclosure requirement would assist in constraining aggressive large-scale short selling that may involve unacceptable risks of abuse or disorderly markets,[530] and that if interpreted correctly by the market, this information could provide insight into short sellers' price movement expectations and could improve pricing efficiency.[531] Furthermore, the CESR emphasized its belief that "[f]acilitating ready access to information on short selling would provide informational benefits to the market, improving insight into market dynamics and making available important information to assist price discovery."[532] It is worth noting that in examining transparency, the UK's Financial Services Authority also came to the conclusion that the costs of disclosing aggregate short interest in stocks outweigh the benefits while the cost of public disclosure of significant individual short positions are outweighed by the benefits. [533] As such, disclosure of significant individual short positions would be the best approach. This allows the regulator to quickly identify who holds significant positions and follow-up with any necessary enquiries with that market participant.[534]

In 2013, and again in 2017, ESMA commented that market participants may tend to avoid crossing the 0.5% threshold to avoid disclosure; however, neither report recommended any changes to the disclosure thresholds.[535] In 2017, ESMA suggested that further research would be needed on the public disclosure threshold to increase the public understanding of the impact of the threshold.[536]

4.3.7 Enforcement Activity

Each member state is required to establish rules on penalties and administrative measures applicable to infringements of the EU Short Selling Regulation, particularly Articles 5 and 6.[537] ESMA maintains a list of the range of such sanctions and administrative measures by the member states on its

[527] *Ibid* at para 62.
[528] *Ibid* at para 34.
[529] *Ibid* at para 31.
[530] *Ibid.*
[531] *Ibid* at para 63.
[532] *Ibid* at para 16.
[533] Financial Services Authority, *Discussion Paper 09/1: Short Selling* (London: Financial Services Authority, 2009) at paras 5.25, 5.28, 5.34, online (pdf): *National Archive* <webarchive.nationalarchives.gov.uk/20090224185035/http://www.fsa.gov.uk/pubs/discussion/dp09_01.pdf>.
[534] *Ibid.*
[535] See ESMA, *ESMA 2013 Report*, *supra* note 470 at 4. See also ESMA, *Final Report 2017, supra* note 515 at paras 247, 249, 262.
[536] Though certain information "strongly suggest that investors react to public disclosure by increasing the size of their position, thereby reinforcing herd behavior", the hypothesis has not been specifically tested: see ESMA, *Final Report 2017, supra* note 515 at 126, 127.
[537] *EU Short Selling Regulation*, *supra* note 468 at art 41.

website.[538] Examples of enforcement activity, including bans on net short positions, are described below.

In 2019, the Danish Financial Supervisory Authority (the "**Danish FSA**") in Denmark reprimanded five dealers in separate proceedings for wrongful reporting of a net short position, failure to report a net short position and reporting incorrect net short positions, as applicable.[539]

In 2018, the Federal Financial Supervisory Authority ("**BaFin**"), Germany's financial markets regulator, examined a total of 71 cases for compliance with the prohibition on uncovered short selling (as compared to 100 in 2017), certain of which were conducted in response to complaints, and discontinued 49 investigations (as compared to 79 in 2017), most of which related to human error in reporting.[540] BaFin pursued six cases in administrative fine proceedings (as compared to 13 in 2017).[541] As of December 31, 2018, 18 cases had not yet been completed. Between the period of July 1, 2015, to December 31, 2016, the largest total fine BaFin levied against a company with respect to making uncovered short sales in violation of the EU Short Selling Regulation was €60,000.[542] In addition, BaFin's Securities Supervision Directorate initiated proceedings for breaches of the prohibition of market manipulation and uncovered short sales.[543]

Additionally, in 2018, the Commissione Nazionale per le Società e la Borsa, the government authority of Italy responsible for regulating the Italian securities market, completed 172 cases (as compared to 156 in 2017), of which 162 (as compared to 151 in 2017) concluded with sanctions applied against 445 individuals, including those sanctioned for internal dealing and short selling.[544] Financial administrative penalties totaled approximately €23.1 million in 2018 (as compared to approximately €27.8 million in 2017).

4.4 Australia

4.4.1 Background to Regulation

ASIC is created by and administers the *Australian Securities and Investments Commission Act, 2001* (Cth), 2001/51 (the "**ASIC Act**").[545] Following the 2008 financial crisis, the Australian Government,

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[538] For example: (i) if the United Kingdom's Financial Conduct Authority (the "**FCA**") is satisfied that the EU Short Selling Regulation has been contravened, it may impose a penalty that it considers appropriate, or the FCA may publish a statement censuring the person and in addition, under the *Financial Services and Markets Act 2000*, a court may make an order restraining contravention and order a sum be paid to the FCA; (ii) Bulgaria can impose a fine of €2,500 to €10,000 for a breach of Article 5(1) and €1,000 to €5,000 for a breach of Article 6(1); (iii) Iceland can impose a fine of €900 to €6,947,500 for a breach Article 5(1) or 6(1), depending on the breach and whether the person is an entity or individual; (iv) Italy can levy a fine between €25,000 to €2,500,000 for a breach of Articles 5, 6 or 9; (v) Germany can levy a fine of up to €200,00 for a breach of Articles 5 or 6; (vi) Portugal can levy a fine between €25,000 and €5,000,000 for a breach of Article 5, 6 or 9 (and a fine between €2,500 and €500,000 for a breach of the record-keeping requirement in Article 9); and (vi) Denmark has the ability, through the Danish FSA, to issue a public statement regarding violations of the EU Short Selling Regulation and offenders shall be liable to a fine for violating Articles 5, 6 and/or 9: see European Securities Markets Authority, *List of administrative measures and sanctions applicable in Member States to infringement of Regulation on short selling and credit default swaps* (last updated 26 June 2017), online (pdf): *European Securities Markets Authority* <https://www.esma.europa.eu/sites/default/files/library/list_of_administrative_measures_and_sanctions.pdf>.

[539] Financial Supervisory Authority, Reprimands (2019), online: *Financial Supervisory Authority* <www.dfsa.dk/Supervision/Reprimands?searchString=&facets=()&options=(take:20)(skip:0)(sort:)>.

[540] Federal Financial Supervisory Authority – Bundesanstalt für Finanzdienstleistungsaufsicht, *Annual Report* (Germany: Federal Financial Supervisory Authority, 2018) at 138, online: <www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl_jb_2018_en.pdf?__blob=publicationFile&v=3>.

[541] *Ibid.*

[542] Federal Financial Supervisory Authority – Bundesanstalt für Finanzdienstleistungsaufsicht, "Administrative fines: Data and facts regarding sanctions in securities supervision" (12 April 2016), online: <www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2017/fa_bj_1711_Ahndungspraxis_en.html>.

[543] *Ibid.*

[544] *Relazione per l'anno 2018* (March 2019) at 49, online (pdf): *Commissione Nazionale per le Società e la Borsa* <www.consob.it/documents/46180/46181/Rel2018.pdf/b22cbdc6-5b67-4795-b9ed-b2cfae8f4bb0>.

[545] *Australian Securities and Investments Commission Act, 2001 (Compilation No. 73)* (Cth), 2001/51, Part 1 at Division 1(1), online: *Federal Register of Legislation* <www.legislation.gov.au/Details/C 2019C00207> [*ASIC Act*].

in step with other nations, passed the *Corporations Amendment (Short Selling) Act 2008* (Cth), 2008/146, an amending piece of legislation to the *Corporations Act 2001* (Cth), 2001/50 ("**Australian Corporations Act**") and Corporations Regulations 2001. This legislation prohibited naked short selling and clarified ASIC's power to regulate short selling while also establishing a framework for disclosure in connection with short sales.[546] At the time, the government also sought to make sure that the disclosure regime was in line with the IOSCO Four Principles, while recognizing that appropriately regulated short selling is beneficial to liquidity and to the efficiency and operation of the capital markets.[547] In 2018, ASIC issued a regulatory guide – ASIC RG 196 short selling (the "**ASIC Regulatory Guide**") – to assist market participants and provide an easy-to-understand overview of the short selling provisions.[548]

4.4.2 Differences From the Canadian Regime

In contrast to Canadian regulations, the Australian regulations:

(a) impose very strict requirements to conduct a permitted short sale and general prohibition against naked short selling, unless an exemption applies;

(b) do not include buy-in procedures for failed trades;

(c) require public disclosure by the market operator of aggregate short sale volume transaction information per listed security on the trading day on which the market operator receives the information – not twice monthly, as in Canada; and

(d) require the short seller to report net short sale positions only upon two thresholds being triggered – therefore, not all short positions are reported – along with differences in timing of reporting and public disclosure of such information.

4.4.3 Defining a Short Sale

In Australia, short selling securities without a securities lending arrangement is not permitted, other than in certain limited circumstances for which exemptions exist or ASIC gives relief.[549] It is irrelevant where the seller is located or if the securities are of a foreign issuer outside of Australia. As long as the securities are sold on the Australian Securities Exchange ("**ASX**") or another Australian-licensed market, these rules apply.[550] In order to be permitted to make a short sale, a person is required to rely on an existing securities lending arrangement such that there is an exercisable and unconditional right to vest securities in the purchaser at the time of sale.[551]

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[546] Austl, Commonwealth, The Treasury, *Short Selling Disclosure Regime: Regulation Impact Statement*, Part 1 at 1 online (pdf): *Federal Register of Legislation* <www.legislation.gov.au/Details/F2009L04316/72708018-7927-4d2a-9c99-63c7c8d3684b> [*Regulation Impact Statement*].
[547] *Ibid* at 3.
[548] *ASIC Regulatory Guide 196: Short Selling* (Cth), Australia Securities and Investment Commission (October 2018), online (pdf): *ASIC* <download.asic.gov.au/media/4896780/rg196-published-8-october-2018.pdf > [*ASIC Regulatory Guide 196*].
[549] *Ibid* at RG 196.4, 196.16, and 196.19.
[550] See Ashurst Australia, "Short Selling Reporting Obligations in Australia" (2012), online (pdf): *Ashurst Australia* <www.marketindex.com.au/sites/default/files/short-selling/Short%20selling%20reporting%20obligations%20in%20Australia%2010-12.pdf>.
[551] See *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.2 and 196.3. See also *Corporations Act 2001 (Compilation No. 95)* (Cth), 2001/50, at s 1020B(2), online: *Federal Register of Legislation* <www.legislation.gov.au/Details/C2019C00216> [Australian Corporations Act].

4.4.4 Requirements to Conduct a Short Sale

In order to sell short, the seller must always have a "presently exercisable and unconditional right to vest the products in the buyer,"[552] and specifically, the power to have the absolute ability to give the buyer title to the product.[553] This can be achieved through a securities lending arrangement or any other "firm" (legally binding) commitment to deliver the products to the borrower before the settlement date.[554] According to ASIC, the best evidence of a firm commitment is written confirmation for delivery into settlement,[555] since an agreement that only contains a best efforts commitment to provide securities does not equate to an exercisable and unconditional right to vest.[556] This tight regulation permits short selling under very narrow circumstances. Due to the strict requirements under which a short sale can be conducted, no initial margin is imposed by regulation. The lender of the short sold securities sets collateral requirements based on securities lending market practice; we understand that currently, this amount is usually 105% of the market value of the securities sold short.

ASIC can provide exemptions from the short selling prohibitions,[557] and it exercises this discretion in circumstances where the risk of failure to settle is believed to be low and particularly when the exemption may encourage activities that benefit the market.[558] In September 2018, ASIC issued ASIC Corporations (Short Selling) Instrument 2018/745 (the "**ASIC SS Instrument**")[559] providing new forms of relief.[560] Exemptions from the short selling prohibitions may include:

- circumstances in which there is a prior purchase agreement;
- trades by market makers;
- the exercise of exchange-traded options;
- deferred purchase agreements;
- deferred settlement trading in specific circumstances (e.g., public offers);
- client facilitation services (i.e., a broker may make a short sale in response to client's buy order);
- government bonds;
- corporate bonds if the value on issue is over AU$100 million; and
- selling CHESS (defined below) Depository Interests ("**CDIs**") before conversion.[561]

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[552] *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.22 referencing the Australian Corporations Act, *supra* note 551 at s 1020B(2).
[553] See *Ibid* at RG 196.29. See also the Australian Corporations Act, *supra* note 551 at s 1020B(3).
[554] See *Ibid* at RG 196.30–RG 196.34. For a definition of "securities lending arrangement" see the Australian Corporations Act, *supra* note 551 at s 1020AA(1)(a) and (b).
[555] See *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.30–RG 196.34.
[556] *Ibid* at RG 196.40.
[557] *Ibid* at RG 196.19, referencing the Australian Corporations Act, *supra* note 551 at s 1020F.
[558] See Maria Nikolova, "ASIC modifies rules related to short selling", Finance Feeds (8 October 2018), online (blog): *Finance Feeds* <financefeeds.com/asic-modifies-rules-related-short selling/>.
[559] See *ASIC Corporations (Short Selling) Instrument 2018/745* (Cth) 2018/745, online: *Federal Register of Legislation* <www.legislation.gov.au/Details/F2018L01356> [*ASIC SS Instrument*].
[560] Nikolova, *supra* note 558.
[561] See *ASIC Regulatory Guide 196, supra* note 548 at 10–13. See also *ASIC SS Instrument*, *supra* note 559 at s 5–12. Prior purchase agreements are exempted from s 1020B(4) of the Australian Corporations Act. Selling CDIs before conversion and client facilitation services require individual no-action positions provided on application pursuant to *ASIC Regulatory Guide 108: No action letters* (Cth), December 2009, online (pdf): *ASIC* <www.asic.gov.au/media/5148731/rg108-updated-published-18-june-2019.pdf> [*ASIC Regulatory Guide 108*].

Parties relying on relief from the short selling prohibitions are not required to report their position, with the exception of short sales of CDIs before conversion.[562] However, several exempt parties, such as market makers of ETFs and managed funds, must comply with separate disclosure obligations specific to the activity itself,[563] including, for example, notifying ASIC and keeping certain records.[564]

4.4.5 Failed Trades, Close-outs, Buy-ins and Reporting

The Australian Clearing House Electronic Subregister System ("**CHESS**") is the settlement and electronic securities depository system for equity and equity-related securities in Australia.[565] Pursuant to the settlement procedure guidelines of the ASX, it levies a fail fee on participants who enter settlement with a shortfall of any financial product they are obligated to settle. If the financial product in a delivering holding is insufficient when CHESS attempts to effect settlement, there is shortfall in the amount of the difference between the aggregate obligations and the balance of the holding. CHESS determines which transactions will fail based on the shortfalls that occur in the settlement process. The penalty for each holding that fails to meet a net delivery obligation is calculated on an *ad valorem* basis, subject to a minimum fee and a maximum cap. The fee is 0.10% of the value of the shortfall (based on the shortfall multiplied by the valuation price from the previous day), subject to a minimum fail fee of AU$100.00 and a maximum cap of AU$5,000.00 per settlement holding. The fail fee is calculated on the shortfall outstanding on each settlement day and accumulated daily, and is charged on a monthly basis.[566]

There are no buy-in procedures in Australia.

The Reserve Bank of Australia's Financial Stability Standard for Securities Settlement Facilities mandates that the ASX Settlement Corporation make relevant data on settlement activity available to the public.[567] Thus, a report is available on the ASX website that, for the relevant month, reflects the number of settlements scheduled, the percentage that have initially failed to settle and the percentage of settlements rescheduled to the next settlement day for each trading day.[568] The report also contains the average fail percentage rate of initial fails for the completed previous month(s) – without a breakdown per trading day – and the average of the current month to date.[569] Based on a recent report we accessed, failures to settle occurred in approximately 0.03% of transactions on the ASX for the period between July to September 2019.[570] Note that another report that is accessible on the ASX website contains not only the number of settlements scheduled for a particular settlement date, but also the total scheduled settlement value in AUD and the total settled value in AUD.[571]

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[562] See *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.108–110, 196.127.
[563] See for example, *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.52, RG 196.60. See generally *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.43 – RG 196.114, referencing the *ASIC SS Instrument*, *supra* note 559 at s 5–12.
[564] *Ibid* at RG 196.47–48.
[565] See National Stock Exchange of Australia, "Settlement" (2019), online: *National Stock Exchange of Australia* <www.nsx.com.au/regulation/exchange/settlement/>.
[566] Australian Securities Exchange, "ASX Settlement Procedure Guidelines" (November 2018), online (pdf): *Australian Securities Exchange* <asxonline.com/content/dam/asxonline/public/documents/manuals/chess-asx-settlement-procedure-guidelines/asx015327.pdf> at s 18.2.
[567] See Australian Securities Exchange, "Securities Lending Disclosure" (2019), online: *Australian Securities Exchange* <www.asx.com.au/services/information-services/securities-lending-disclosure.htm> [Securities Lending Disclosure]. See also Australian Securities Exchange, "ASX Clearing and Settlement Boards" (2019), online: *Australian Securities Exchange* <www.asx.com.au/about/asx-clearing-settlement-boards.htm> ("ASX Settlement Corporation is the intermediate holding company for ASX's settlement licensees ASX Settlement and Austraclear". "ASX Settlement is currently the sole provider of settlement services for Australia's equity markets.").
[568] Australian Securities Exchange, "Monthly & Daily Market Equity Fail Report (Volume)" (October 2019), online (pdf): *Australian Securities Exchange* <www.asx.com.au/data/securities_lending_fail_rate_daily.pdf>.
[569] *Ibid.*
[570] *Ibid.* Note that the Australian financial year starts on July 1 and ends the next year on June 30.
[571] Australian Securities Commission, "Settlement & Securities Lending – Comparison Report" (2019), online (pdf): *Australian Securities Exchange* <www.asx.com.au/data/securities_lending_transactions.pdf>.

4.4.6 Reporting and Disclosure of Short Sale Volume and Short Positions

Australia requires short sellers to report (i) circumstances where they are conducting a short sale and (ii) net short positions above two triggering thresholds.[572] "The objective of the disclosure regime is to enhance market confidence and integrity by providing greater transparency to both investors and regulatory bodies about short selling activity on Australian financial markets," and to, among other things, "explain certain share price movements; provide an early signal that individual securities may be overvalued … and deter market abuse."[573]

Similar to the requirement to mark short sales in Canada, a short seller who makes a covered short sale through a broker (an Australian Financial Services ("**AFS**") licensee) must report to the AFS licensee at the time of sale the information about the short sale being executed. [574] Also, an AFS licensee must not make a short sale on a licensed market on behalf of a seller, unless, before making the sale, the AFS licensee has asked the seller whether the requested sale is a short sale and has recorded the response in writing.[575] After obtaining the covered short sale information, an AFS licensee that conducts the short sale must report such sale to the market operator by 9:00 a.m.[576] on the following trading day[577] – unless the broker receives information after 7:00 p.m. but before the start of the next trading day, in which case they must report to the market operator by 9:00 a.m. on the second trading day.[578] The market operator then aggregates this information, consisting of the number of shares that the seller will vest in the buyer under the securities lending arrangement, a description of the securities and the name of the issuer,[579] and publishes it to the market the same day the market operator receives the information from the AFS licensee.[580] As described in the ASIC Regulatory Guide, this disclosure assists investors and companies in (i) explaining share price movements, as the "reporting provides an indication of the proportion of trades in a particular security that are short sales and the overall level of short selling that takes place on the market each day",[581] and (ii) understanding "whether there has been an increase in the level of short selling activity" in a security that has a particularly volatile share price.[582] The disclosure also helps regulators to monitor the market and investigate misconduct.[583]

A short position is created when the quantity of the product that a person has, when acting in a particular capacity, is less than the quantity of the product that the person has an obligation to deliver, when acting in the same capacity.[584] The quantity a person has includes: the securities the person holds on their own behalf; securities they hold for another person (unless that other person has sole discretion over whether to sell); securities that another person holds on the first person's behalf (so long as the first person has the sole discretion over whether to sell); securities the person has agreed to purchase where the transaction has not yet settled; and securities which the person has lent under a securities lending arrangement.[585] The quantity a person is obliged to deliver

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[572] See *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.8, 196.159, 196.166 and 196.194. See also *ASIC SS Instrument*, *supra* note 559 at s 15.
[573] *Regulation Impact Statement*, *supra* note 546 Part 2 at 3.
[574] *ASIC Regulatory Guide 196*, *supra* note 548 at 27.
[575] *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.130, referencing the Australian Corporations Act, *supra* note 551 at s 1020AE.
[576] Unless otherwise stated, all times in Section 4.4 refer to Sydney, New South Wales, time.
[577] *ASIC Regulatory Guide 196*, *supra* note 548 at 27.
[578] *Ibid* at RG 196.135, RG 196.136.
[579] *Ibid* at RG 196.128, RG 196.137, referencing the *Corporations Regulations 2001 (Compilation 148)* (Cth), 2001/193 at s 7.9.100(1), online: *Federal Register of Legislation* <www.legislation.gov.au/Details/F2019C00595/Html/Volume_3#_Toc6404154> [*Regulations 2001*].
[580] See *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.137, referencing the *Regulations 2001*, *supra* note 579 at s 7.9.102.
[581] *Ibid* at RG 196.138.
[582] *Ibid* at RG 196.139.
[583] *Ibid* at RG 196.140.
[584] *Ibid* at RG 196.149, referencing the *Regulations 2001*, *supra* note 579 at 7.9.99(2) and the *ASIC SS Instrument*, *supra* note 559 at s 17(1)(b).
[585] *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.150, referencing the *Regulations 2001*, *supra* note 579 at s 7.9.99(3).

includes: securities the person has sold where the transaction has not yet settled; securities that the person has borrowed where the lender has a right to recall the securities; and "any other non-contingent legal obligation to deliver."[586] Short sellers are not permitted to "net 'long' and 'short' positions that are held in different capacities."[587] For example, where a person is acting on behalf a person under an arrangement and acting on their own behalf under a different arrangement, the person is taken to be acting in a different capacity for each arrangement.[588]

Short positions above a certain threshold must be reported to ASIC.[589] ASIC then aggregates and publishes the information. In putting together the short selling disclosure regime and choosing aggregated short position reporting, consideration was given to the fact that disaggregated information "does not provide the market with an overall indication of the short position in each security" (especially if triggered only upon a threshold).[590] It was believed that a disclosure regime with disaggregated reporting may have been "less effective in promoting pricing efficiency" and may have discouraged short selling and distorted the market.[591] The Australian government gave weight to a broad range of stakeholders, including brokers, industry groups, investment fund managers, regulatory bodies and shareholder groups in introducing aggregated short position reporting requirements. Such groups strongly opposed disaggregated reporting for a variety of reasons, including the perceived negative consequences if the identities of short sellers and their positions were made public and the potential compromise of the proprietary value of trading and hedging strategies.[592] The Australian government also considered approaches in other jurisdictions and felt that aggregated reporting in the US and Canada had merit because all short positions were required to be reported regardless of size.[593] After evaluating the costs and benefits of having thresholds for aggregate short position reporting, the Australian government decided to institute a *de minimis* threshold to exclude small retail investors from any reporting obligation. Though data would be incomplete as a result, the overall impact on the aggregated position reported would not likely be material.

The thresholds for reporting are triggered by a net short position greater than (a) AU$100,000 or (b) "0.01% of the total quantity of securities or products in the relevant class of securities or products".[594] If a person has created a short position in a security as of 7:00 p.m. – or alternatively, at 11:59 p.m. on the trading day in the location of the person[595] – on a reporting day, the position must be reported to ASIC no later than 9:00 a.m. on the day that is three reporting days after the date of the short position.[596] If a person continues to subsequently hold a reportable position, the short position on each subsequent day must be reported to ASIC on or before 9 a.m. each day after

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[586] *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.151, referencing the *Regulations 2001*, *supra* note 579 at s 7.9.99(4).
[587] *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.153.
[588] See *Ibid* at RG 196.153. See also the *ASIC SS Instrument*, *supra* note 559 at s 17(1)(e)(4B)(c) for details on short position reporting modifying the *Regulations* 2001, *supra* note 579 at s 7.9.99(4).
[589] See *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.164, referencing the *ASIC SS Instrument*, *supra* note 559 at s 15.
[590] See *Regulation Impact Statement*, *supra* note 546 at 9-10.
[591] *Ibid.*
[592] *Ibid* at 9.
[593] *Ibid* at 8.
[594] See *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.164 and RG 196.166. Section 15 of the *ASIC SS Instrument* "provides relief exempting sellers from reporting a short position where the seller's short position as at 7 p.m. on a particular day (or alternatively the global end calendar time) is less than or equal to" both the thresholds outlined. See also the *ASIC SS Instrument* at s 16 for definitional changes to "value limit" (i.e., AU$100,000) and "volume limit" (i.e. 0.01% of the "total quantity of securities or products in the same class of securities or products").
[595] See *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.196. Pursuant to the *ASIC SS Instrument*, persons are permitted to calculate their short positions as at a global end calendar time, specifically "11:59 p.m. on the trading day in the location of the person (or another person within the same corporate group) to whom the transaction giving rise to the short position is accounted for in the balance sheet of the person (or the other person)." This is helpful for firms operating in a variety of jurisdictions, as it allows transactions to be calculated as at 11:59 p.m. instead of 7:00 p.m. in the location in which the relevant transaction is booked in a short seller's account.
[596] See *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.161, referencing the *Regulations 2001*, *supra* note 579 at s 1020AB(3) and 7.9.100(4)(a).

the short position is first reported.[597] ASIC publishes the total of short positions in a security issued by a listed entity that were disclosed to it on the previous trading day. Accordingly, the total of net short positions for a listed security on a given reporting day will be available on the ASIC website four trading days after the trade day (T+4).[598]

4.4.7 Enforcement Activity

The Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Bill 2018, which came into force in March 2019, amended the Australian Corporations Act and the ASIC Act to introduce a stronger penalty framework in response to recommendations from the ASIC Enforcement Review Taskforce Report[599] and with the goal of deterring misconduct and improving community confidence in the corporate and financial sector.[600]

4.5 Comparison of Other Regimes to the Canadian Regime

4.5.1 Comparing the Canadian Regime to Other Regimes

Comparing the Canadian short selling regime to regimes in the US, Europe and Australia, it becomes evident that the Canadian regulations are more lenient than regulations in such other markets. We believe that, as a result, there are negative implications on investor protection and the level of risk in the Canadian marketplace with respect to short selling.

4.5.2 Procedures with Respect to Short Sales

Australia, the EU and the US all acknowledge the importance of short sales to capital markets, including their function of providing price discovery and increased liquidity, as well as being a method of risk management.[601] However, each of Australia, the EU and the US impose substantial requirements before a short sale can be executed, effectively banning naked short selling.

In contrast, the Canadian reasonable expectation requirement, as described in Section 2.5.1, does not impose a positive obligation to verify that the seller has the ability to settle.[602] In Canada, no securities lending arrangement is required and there is no locate requirement. As such, it is less challenging to effect a short sale in Canada than in the US and the other jurisdictions examined.

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[597] See *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.163, referencing the Australian Corporations Act, *supra* note 551 at s 1020AB(3) and the *Regulations 2001*, *supra* note 579 at s 7.9.100(4)(b). See also the *Regulations 2001*, *supra* note 579 at s 7.9.100A.
[598] See *ASIC Regulatory Guide 196*, *supra* note 548 at RG 196.180. See also the *Regulations 2001*, *supra* note 579 at s 7.9.102(3A).
[599] Australian Government, "ASIC Enforcement Review Positions Paper 7: Strengthening Penalties for Corporate and Financial Sector Misconduct", (2017) at 1, online (pdf): *Australian Government: The Treasury* <treasury.gov.au/sites/default/files/2019-03/c2017-t232150.pdf> [Positions Paper 7]. The ASIC Enforcement Review Taskforce was established to conduct a review of penalties following a final report of the Financial Systems Inquiry that recommended providing the ASIC with "stronger regulatory tools" to allow the ASIC to deal with misconduct in the credit and financial services industries (the government accepted the recommendations).
[600] Austl, Commonwealth, House of Representatives, *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Bill 2018: Explanatory Memorandum,* (2016-2017-2018) at 1.3, online (pdf): *Parliament of Australia* <parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r6213_ems_17aa08fb-610b-4eef-ae53cc157e44fb58/upload_pdf/688007.pdf;fileType=application%2Fpdf>. For example, the penalties for breach of s.1020(B) of the Australian Corporations Act (the prohibition of certain short sale securities) are (i) for an individual: (a) for a first offence, 60 penalty units, which is equivalent to AU$12,600, and potentially up to six months imprisonment; and (b) for a further offence, up to two years imprisonment, while (ii) for a body corporate: (a) for a first offence, 600 penalty units, which is equivalent to AU$126,000; and (b) for a further offence, 2,400 penalty units, which is equivalent to AU$504,000. See Australian Corporations Act, *supra* note 551 at s 1020(B) and 1311(1). These penalties follow amendments made to the statute in March 2019. Penalty units are set pursuant to the *Crimes Act 1914 (Compilation No. 128)* (Cth), 1914/12, online: *Federal Register of Legislation* <www.legislation.gov.au/Details/C2019C00295> (section 4AA defined penalty units as $210, subject to indexation).
[601] See for example, comments by the CESR that "[l]egitimate short selling plays an important role in financial markets… [i]t contributes to efficient price discovery, increases market liquidity, facilitates hedging and other risk management activities and can possibly help mitigate market bubbles": see CESR, *Model for a Pan-European Short Selling Disclosure Regime*, *supra* note 462 at para 11.
[602] See *Market Integrity Notice 2004-017*, *supra* note 147 at 4. See also *IIROC Notice 12-0078*, *supra* note 62 at 9–10.

4.5.3 Failed Trades

The short sale regimes also differ in terms of the treatment of failed trades. For example, Australia does not make available a buy-in procedure, presumably because the requirements to effect a short sale are so stringent such that the risk of failure would be negligible. In the US, brokers and dealers that are part of a registered clearing agency must close out by no later than T+3 and, depending on the circumstances, there is a procedure available to purchasers under the rules of FINRA to compel buy-ins.[603] In the EU, the buy-in regime is mandatory and kicks in automatically after a failure to deliver shares for settlement within four business days after the day on which settlement is due, representing basic standards related to settlement discipline.[604] In Canada, no buy-in procedure is automatic, but there are processes that may allow purchasers who have not received the shares after the expected settlement date to compel a buy-in.

4.5.4 Designating Trades, Reporting and Disclosure

IOSCO has noted that, broadly speaking, there are two models that are commonly used for short sale reporting – (i) flagging of short sales and (ii) short positions reporting (on a gross or net basis) – and national market authorities could adopt both models to the extent that they want to have a comprehensive reporting regime.[605] Requiring transactional reporting for short sales, similar to what is required in Australia, can achieve the same objective as flagging. When the CSA and IIROC were examining existing short sale regulations in Canada and soliciting feedback on certain aspects of disclosure and transparency measures regarding short sales and failed trades, they reviewed regulations in other jurisdictions and found that jurisdictions that require disclosure of significant short positions with identifying details – similar to what is required in the EU – typically do not also have flagging of short sales in the marketplace.[606]

Unsurprisingly, the type of flagging or reporting, including by who, that may be required, and the method, frequency and substance of how such information is disclosed to the market, varies across jurisdictions.

In Canada, any order on a marketplace to sell a security that is not owned by the seller either directly or indirectly must be marked "short" at the time of entry, unless the order is an SME order. Designating trades as "short" is also required in the US, as is designating trades as "long" or "short exempt".[607] However, the designation of "short exempt" in the US acts as an exception to the tick test once a circuit breaker is triggered; in other words, it only applies with respect to the price restriction test,[608] whereas in Canada, the SME order designation filters out non-directional trading activities from surveillance and short position reports (see Section 2.1.2.2). In Australia, details of a short sale need to be reported to the broker at the time of sale. The broker then reports such information to the market operator, after which the market operator aggregates and publicly discloses it on its website or another forum easily accessible by the public.[609]

In Canada, the US and Australia, short sale volume transaction information is made available. In the US, sales that are marked "short exempt" are included in published data, though it is segregated

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[603] US Securities and Exchange Commission, "Amendment to Securities Transaction Settlement Cycle – A Small Entity Compliance Guide" (21 April 2017), online: *US Securities and Exchange Commission* <www.sec.gov/tm/t2-sbrefa>; FINRA Rule 11810, *supra* note 430.
[604] *EU Short Selling Regulation*, *supra* note 468 at preamble 23, art 15(1)(a).
[605] IOSCO, *Regulation of Short Selling Final Report*, *supra* note 394 at paras 3.21–3.22, 3.23.3.
[606] CSA/IIROC Joint Notice 23-312, *supra* note 164 at 2101, n 5.
[607] *Regulation SHO*, *supra* note 393 at § 242.200(g).
[608] Responses to Frequently Asked Questions Concerning Regulation SHO, *supra* note 396 at I.
[608] *Regulation SHO and Rule 10a-1*, SEC Release No. 34-55970 (28 June 2007) at I, online (pdf): *US Securities and Exchange Commission* <www.sec.gov/rules/final/2007/34-55970.pdf>.
[609] *ASIC Regulatory Guide 196*, *supra* note 548 at 27, 47.

from short data using its own column. In Canada, orders marked with the SME order designation are excluded from such reports. Short sale volume transaction information is made available semi-monthly in Canada, which is in contrast with the US and Australia, where it is made available daily.[610] In the EU, flagging of short sales is not required, nor is short selling volume data publicly available for member states. However, the EU has extensive reporting requirements for individuals with respect to net position reporting and, upon a certain threshold being met, such disclosure is provided on a non-anonymous basis.[611]

In terms of short position reporting, the onus of disclosure falls onto the short seller itself in Australia and the EU, whereas it is an obligation of the broker in Canada and the US. The Technical Committee of IOSCO proposed that "it would be beneficial for the reporting to be done by holders of the short position", as the shortcomings of having brokers responsible for reporting is that "brokers may not have complete information about their clients' positions, and information provided by them is only as good and as accurate as information given to them by their clients."[612] In Australia, the requirement to disclose net short positions is triggered upon two thresholds being met, and the reporting is due at T+3, aggregated and published to the market the next day.[613] In creating the disclosure framework in Australia, it was noted that the approach of publishing aggregated short positions and preserving the confidentiality of individual positions had "merit in the US and Canada because all short positions (regardless of size) are reported".[614]

In the EU, short sellers must report net short positions to the relevant competent authorities once a certain threshold is triggered and a quarterly summary report is given to ESMA based on this information.[615] Furthermore, a short seller is required to publicly disclose net short positions upon a higher threshold being triggered, as it was argued by the CESR in proposing a model of short selling regulation for the EU that individual positions that remain anonymous are less effective as a constraint on aggressive short selling.[616] This public disclosure requirement is unique to the EU in all the jurisdictions we examined. The preamble to the EU Short Selling Regulation provides that enhanced transparency in this regard is likely to be of benefit to both the regulator and market participants, and that the two thresholds for disclosure enable: (i) regulators to, upon receiving a notification privately at the lower threshold, monitor and, where necessary, investigate short selling that could create systemic risks, be abusive or create disorderly markets, and (ii) market participants to, upon public disclosure at the higher threshold, be provided with useful information.[617] Some of the disadvantages to the EU's approach have been noted as running "a significant risk of discouraging short selling activity and distorting the market…because short sellers may face negative consequences if they are subsequently targeted by the media, listed companies or other investors…[and] the proprietary value of trading and hedging strategies" being compromised.[618] None of the US, Canada or Australia require public disclosure of the identity of a particular short seller, regardless of the size of their short position.

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[610] There may be a one-day lag in Australia depending on when the market operator receives the information.
[611] *EU Short Selling Regulation*, *supra* note 468 at arts 6, 9.
[612] IOSCO, *Regulation of Short Selling Final Report*, *supra* note 394 at paras 3.23.8–3.23.9.
[613] *ASIC Regulatory Guide 196*, *supra* note 548 at paras 196.164, 196.170, 196.180.
[614] It is worthy to note that in the past, the Chief Executive of the Investment and Financial Services Association in Australia "suggested that short positions should be made known to regulators in close-to-real-time, but that positions should not be made public for at least two weeks after the transactions": see McGavin, *supra* note 381 at 235. See also Regulation Impact Statement, supra note 546 at 8.
[615] *EU Short Selling Regulation*, *supra* note 468 at arts 5, 11(1).
[616] CESR, *Model for a Pan-European Short Selling Disclosure Regime*, *supra* note 462 at para 18.
[617] *EU Short Selling Regulation*, *supra* note 468 at preamble 7.
[618] *Regulation Impact Statement*, *supra* note 546 at 9.

4.6 Summary

The following chart provides a comparative overview of the relevant regulations in Canada, the US, the EU and Australia regarding short selling:

Rule/Requirement	Canada	US	EU	Australia
Requirements to Conduct Short Sale (Prior to Effecting Sale)	• Reasonable expectation to settle (no knowledge of an inability to settle)	• Locate requirement	• Reasonable expectation of settlement • Must be covered by: o actual borrowing; o having agreements to borrow; or o arrangements with a third party confirming the location of borrowed shares and the short seller having taken measures via a third party such that there is a reasonable expectation that the settlement can be effected when due	• The seller must always have a presently exercisable and unconditional right to vest the products in the buyer, specifically the power to have the absolute ability to give the buyer title to the product
Initial Margin Requirement	• Yes	• Yes	• Yes	• No
Exemptions from Short Sale Requirement	• SME order designation accounts (certain types of accounts with non-directional trading activity)	• *Bona fide* market-making	• Market-making activities	• Exemptions may include: o prior purchase agreement; o trades by market makers; o exercise of exchange-traded options; o deferred purchase agreements; o deferred settlement trading in specific circumstances (e.g., public offers); o client facilitation services (i.e., a broker may make a short sale in response to a client's buy order); o government bonds; o corporate bonds if the value on issue is over AU$100 million; and o selling CDIs before conversion

Rule/Requirement	Canada	US	EU	Australia
Designating Trades (at the Time the Order is Placed)	• Short or SME order	• Long, short or short exempt • Short exempt acts only as an exception to the price restriction test	• None	• None, but see below for reporting requirements when a short sale is being made
Close-out/Buy-in Procedures	• None under UMIR • CDS participants can force settlement through CDS buy-in provisions • Exchanges may also have optional buy-in requirements	• Mandatory close-out T+3, or T+5 for *bona fide* market-making activities • When a position is not closed out, the broker or dealer may not effect further short sales in a security without borrowing or entering into a *bona fide* agreement to borrow the security • If the failed trade remains for 13 consecutive days, participants of registered clearing agencies must immediately purchase securities to close out failed trades in securities with large and persistent failures to deliver (referred to as "threshold securities") • The purchaser that failed to receive stocks can force a buy-in, including notice requirements	• Mandatory buy-in procedures are automatically triggered if the seller is not able to deliver shares for settlement on T+6 • The rules are changing in September 2020; however, the timing will remain the same for buy-ins and a maximum of seven business days will be permitted for illiquid financial instruments	• None
Price Restriction Test	• None	• Yes, a price decrease of 10% or more triggers a price restriction to short sale orders for the remainder of day and the following day, unless exceptions apply	• None	• None

Rule/Requirement	Canada	US	EU	Australia

Consequences for Failed Trades or EFTs	• Pre-borrow requirements are automatically imposed on:
	  ○ a client or non-client making a short sale if that person has previous EFTR for any security, unless the Participant or Access Person, acting as agent is satisfied after reasonable inquiry that the reason for any prior failed trade was not the result of an intentional or negligent act of the person; and
	  ○ a Participant or Access Person acting as principal for a particular security if that security is one for which there is a prior EFTR (absent an IIROC exemption)
	• IIROC may designate a security as a "Pre-Borrow Security"
	• IIROC may designate a security as being a "Short Sale Ineligible Security"
	• CDS charges a fee of $1,000 per day per settlement position
		• Prohibited from further short sales without pre-borrowing
		• DTC has failure-to-settle charges for participants effective January 1, 2019, which consist of fee interest and a flat fee (that varies depending on the number of occasions and amounts as described herein). A participant that exceeds four failure-to-settle occasions in a three-month period will be subject to further fees and/or other actions at DTC's discretion
			• If a buy-in is not possible, the seller is required to pay the buyer the amount based on the value of the shares to be delivered, plus the amount for losses incurred by the buyer as a result of failure
			• Daily cash penalties until the end of a buy-in procedure will apply to participants by CSDs and participants may be suspended for failing to consistently and systemically deliver securities commencing in September 2020
				• The CHESS, pursuant to guidelines of the ASX, levies a fail fee on participants who enter a settlement with a shortfall of any financial product they have an obligation to settle. The fee penalty is calculated on the shortfall outstanding on each settlement day, accumulated daily and charged monthly. The fee is calculated on an *ad valorem* basis (at 0.10% of the value of the shortfall), subject to a minimum (AU$100.00) and maximum (AU$5,000) per settlement holding

Reporting & Publishing Regime for Short Volume	• IIROC publishes the SSTSSR twice monthly showing the number of short sales versus the number of trades, the volume of short sales as a percentage of the total traded volume, and the value of short sale trades and percentage of total traded value	• Daily aggregate short selling volume for individual securities provided on SRO/exchange websites, along with one-month delayed information	• No short volume reported or disclosed	• The short seller is required to report the short sale prior to making it to the broker, and the broker reports to the market operator • The market operator publishes the information the same day or following day
Reporting & Publishing Regime for Short Positions	• IIROC publishes the CSPR twice monthly with aggregate data on the gross short position reporting on a per-security	• Brokers must report gross short positions twice a month to FINRA (once collected, FINRA	• Short sellers must notify the relevant competent authority for significant net short positions that are at least equal to	• The short seller is required to report net short positions greater than (a) AU$100,000 or (b) 0.01% of the total quantity of

Rule/Requirement	Canada	US	EU	Australia
	basis and provides the change in position from the reporting date	publishes them twice a month) • Exchanges provide gross short position reporting twice monthly (a user fee is sometimes applicable)	0.2% of a company's issued share capital and every 0.1% over that • Short sellers must make public disclosure of net short positions that are at least equal to 0.5% of the company's issued share capital and every 0.1% above that • Notification or public disclosure, as applicable, must be made no later than 3:30 p.m. the following trading day (using the local time of the relevant competent authority)	securities or products in the relevant class of securities or products • ASIC publishes the total of short positions in a security issued by a listed entity that were disclosed to it on the previous trading day • If a person has created a short position in a security as at 7:00 p.m. (Sydney time) (or alternatively at the global end calendar time) on a reporting day, the position must be reported to ASIC no later than 9:00 a.m. (Sydney time) on T+3
Reporting and Publishing of failed traded and EFT Data	• Participants and Access Persons must report EFTs after T+12 if securities are not available or if arrangements to borrow securities to settle the trade have not been made • No public disclosure	• The SEC publishes fail-to-deliver information for each trading day twice monthly	• Failed trades will be reported publicly by CSDs commencing in September 2020 on an annual basis	• The ASX website publishes the number of settlements scheduled, the percentage that have initially failed to settle and the percentage of settlements rescheduled to the next settlement day for each trading day in a month. The report also contains the average fail percentage rate of initial fails for the completed previous month(s) (without a breakdown per trading day) and the average of the current month to date

5. SHORT CAMPAIGNS

5.1 Introduction to Short Campaigns – Increased Canadian Activity

A short campaign is an investment strategy where an investor or group of investors (referred to herein as "**short campaigners**") takes a short position in a stock and releases negative information to the market in respect of the company or management of the company to justify their short position and secure greater returns. This practice can be done legally or illegally, depending on the veracity of the information disseminated. For example, wholly accurate statements regarding the company's improper management or accounting practices, fraudulent behaviour or other concerning information is a legal and legitimate way for short campaigners to defend their short position and to engage in a short campaign. On the other hand, campaigns where short sellers publicly disclose information that they know to be misleading or untrue in order to induce other shareholders to sell their shares, thereby deflating the stock price and allowing the short sellers to profit from their short positions, are illegal. Colloquially, this practice is known as a short and distort scheme. In addition, carrying out a short campaign through "naked" short selling may also be illegal – see Section 6.

Over the past few years, there has been an increase in short campaigns in Canada[619] when compared to other similar jurisdictions;[620] therefore, it is not surprising that Canadian regulators and capital market participants are paying more attention to this activity.[621] Below is short campaign data for the US, the EU and Australia provided by Activist Insight:

Country	Year	Total Number of Campaigns	Total Number of Target Companies
Canada	2015	19	15
	2016	21	16
	2017	9	8
	2018	22	17
	2019 (to October 31, 2019)	5	5
Australia	2015	3	2
	2016	3	3
	2017	2	1
	2018	5	4
	2019 (to October 31, 2019)	4	4
US	2015	189	156
	2016	187	157
	2017	141	120
	2018	99	96
	2019 (to October 31, 2019)	102	92
EU	2015	17	16
	2017	13	12
	2017	11	10
	2018	12	11
	2019 (to October 31, 2019)	4	4

[619] Barbara Shecter, "Activist short sellers are increasingly targeting Canadian companies – is Canada Ready?" (6 October 2017), online: *Financial Post* <business.financialpost.com/news/fp-street/rise-of-the-shorts-activist-short sellers-are-increasingly-targeting-canadian-companies> [Shecter, *Is Canada Ready?*].
[620] In "Short & distort? The ugly war between CEOs and activist critics", an article published on Reuters states that "[a]ctivist short campaigns took off around 2010, leading to record levels in recent years". The article provides data that the number of short campaigns grew from 69 campaigns in 2006 to 758 campaigns in 2015. The source and parameters of the data were not provided in the article: see Lawrence Delevingne, "Short & distort? The ugly war between CEOs and activist critics" (21 March 2019), online: *Reuters* <www.reuters.com/article/us-usa-stocks-shorts-insight/short-distort-the-ugly-war-between-ceos-and-activist-critics-idUSKCN1R20AW>.
[621] Shecter, *Ontario regulator on the lookout*, *supra* note 8.

In Canada, 2016 and 2018 were very active years. The 2019 numbers to October 31, 2019 reflect a less active year, but some commentators believe that this lull will be short lived due to the view of some short sellers that they are focused on engaging in more Canadian short campaigns.[622] It is also important to note that the level of activity in 2017 was also low, and that lull was short lived. In the US, there has been a significant decrease in the number of short campaigns since 2015, and while the 2019 numbers to date are higher than those in 2018, they remain significantly lower compared with those from 2015 to 2017. Australia appears to have very few short campaigns. In the EU, numbers have generally decreased since 2015, and may be significantly lower this year based on the 2019 numbers to date. Notably, in the US and EU there was generally a decrease in the number of short campaigns year-over-year from 2015 to 2018, while in Canada the number of short campaigns generally increased other than the lull in 2017. Additionally, there were more short campaigns in Canada during the four-year period from 2015 to 2018 than each of Australia and the EU, and although there was approximately 10 times as many short campaigns in the United States when compared to Canada during that time period, that is disproportionately low when one considers the relative sizes of the two markets.

In a typical short campaign, a short seller will begin by conducting research or monitoring a company in an attempt to discover any misrepresentations, problematic accounting practices, inaccurate reporting or fraudulent activity. In short and distort schemes, it is still important for the short campaigner to discover some information that points to an underlying problem – even if other analysis is totally distorted. Even a kernel of truth will assist with the credibility of the campaign. In fact, regulators may point to this kernel of truth in defence of short campaigners. However, this is not a persuasive defence of short and distort campaigns – misrepresentations are not defensible through the addition of other statements that are true, especially where the misrepresentations are what induces existing shareholders to sell.

A short campaigner usually looks for a stock that is overvalued by the market in order to take a short position and effect the price to what the short seller believes is the true market price – or, in the case of a short and distort scheme, to effect an artificially low price. Thinly traded issuers are often targets of short campaigns, as the high volatility of the trading price and the low liquidity of such issuers' shares make it easier for the short seller to affect the price in a negative direction.[623] Other potential qualities of target companies may include low insider ownership, high levels of debt, relatively small or no dividends, and operations in industries and sectors that are more complex and less understood by the public.[624] Issuers whose shares have been widely purchased on margin are more susceptible because margined shareholders are vulnerable to margin calls that would induce more selling. Margined shares are also easier to borrow in order to cover short sales.

Once a target company has been found, the short campaigner will then take a short position in the company and disseminate information to the market justifying its position. The information may be distributed through a variety of channels and in a variety of formats, such as formal analyst reports,

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[622] David Salmon et al, "Trends in Corporate Governance 2019" (October 2019) at 25, online: *Laurel Hill* <static1.squarespace.com/static/57e964f69f74562656f88bcf/t/5db99646ae69931bf8de9764/1572443719499/2019-128+Trends+in+Governance+Report_WEB.pdf>.

[623] In securities markets, volatility is often associated with big swings in either direction. Thinly traded securities are more susceptible to these large swings in their share price due to the limited number of interested buyers and sellers, leading to large discrepancies between the ask and bid price, causing the share price to fluctuate: see Marshall Hargrave, "Thinly Traded" (30 April 2019), online: *Investopedia* <www.investopedia.com/terms/t/thinly-traded.asp>.

[624] Low insider ownership increases the free float available for short selling. High levels of debt are strongly correlated with investor concerns, as the risk of bankruptcy rises. Dividend payments must be paid to the beneficial owner of the stock by a short seller, making it more expensive to short the shares. Complexity and confusion about a company or its industry causes uncertainty for investors, which short sellers may take advantage of by influencing negative market sentiment about the company's financial or operating performance via a short campaign: see Peter Hodson, "5 Things that help protect investors from short sellers" (6 November 2015), online: *Financial Post* <business.financialpost.com/investing/investing-pro/5-things-that-help-protect-investors-from-short sellers>.

blogs, social media, investment forums and Bloomberg chats.[625] The most effective short campaigns employ a combination of these different mediums and release information via various supposedly "independent" sources, where one party uses different accounts or aliases to disseminate negative information, or parties acting in concert with respect to a short campaign do not disclose that they are working together. A significant hurdle for issuers in defending against short campaigns is the increased anonymity provided by the internet. It is now easier than ever to get information out to the public under the guise of a pseudonym or multiple aliases. On the other hand, notoriety may also be a strong tool in short campaigns. Known as "celebrity short sellers", individuals such as Carson Block and Andrew Left[626] leverage their large following and proven track record in highly publicized short campaigns to exert influence on shareholders of a target company.

A short campaigner may also work with a class action plaintiff lawyer to ensure that the campaign is fought on more than one battle ground. It has become commonplace for one or more class action lawsuits to be launched against a target company within hours of the initiation of a short campaign.

The key difference between a legitimate short campaign and a short and distort scheme is that the information in the latter is intentionally misleading or untrue, and therefore illegal under securities laws. How the two practices are carried out is quite similar, and short sellers employing either method will aim to profit from the decline of the target company's share price. However, how a target company should react changes depending on the nature of the disseminated information and other factors.

5.2 Pre-emptive or Preventative Measures Against Short Campaigns

The following section summarizes certain key pre-emptive or preventative measures against short campaigns. In light of the costs of being the target of a short campaign, including reputation and shareholder value, being prepared to prevent or lessen the impact of a short campaign is critical.

5.2.1 Monitoring

To identify a potential oncoming short campaign, the company should proactively monitor negative information about or discussions in respect of the company online, especially on financial blogs such as Seeking Alpha.[627]

In addition, the company should monitor the stock price and trading volumes of its shares; levels of and changes in short interests in the company;[628] and failed trades relating to the company's shares, where available. An irregular or unexplained change in any of these may be an indication of growing interest by short traders or the market manipulation of the company's shares. For example, an unusual or unexpected increase of short interest or failed trades may be a sign of a short seller building a short position in preparation for an oncoming short campaign.

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[625] A Bloomberg chat is a term that describes the instant messaging tool that allows traders, investors and other market participants to view securities, share information and negotiate trades using a Bloomberg Terminal. For more information, see Brendan Hall, "Bloomberg chat is no idle chatter" (17 August 2016), online (blog): *Conduent* <insights.conduent.com/conduent-blog/bloomberg-chat-is-no-idle-chatter>.

[626] Carson Block is the Founder and Chief Investment Officer of Muddy Waters Research LLC. Andrew Left is the Founder and Executive Editor of Citron Research.

[627] Jeff Katz and Annie Hancock, "Short Activism: The Rise in Anonymous Online Short Attacks" (27 November 2017) at Part V, online (forum): *Harvard Law School Forum on Corporate Governance and Financial Regulation* <corpgov.law.harvard.edu/2017/11/27/short-activism-the-rise-in-anonymous-online-short-attacks> [Katz & Hancock].

[628] For example, as disclosed by data reports, such as the CSPR and SSTSSR.

5.2.2 Good Governance and Transparency

It is important for the company to maintain transparency with the market in respect of day-to-day operations and financial performance at all times. For example, when negative events occur, the company should pro-actively communicate the news to the market before the market can overreact. A company that has a reputation for, and a consistent practice of, transparency is more likely to have the credibility and trust with its shareholders and the market in general to allow it to more effectively respond to a short campaigner that exaggerates or otherwise distorts information. A company that is trusted by the market will more likely be able to properly frame and control the narrative, thereby limiting the deleterious effects to its share price due to negative market sentiment.[629] Trust is built over time through things like conservative accounting practices. Boards should exercise caution when choosing to implement non-standard accounting measures, since this may become a "red flag" for a short campaigner.

5.2.3 Shareholder Engagement

The company should ensure strong shareholder engagement and communications practices, and respond quickly to shareholder concerns.[630] Strong shareholder engagement lowers the potential that such shareholders will sell their shares as a result of unconfirmed allegations made by a short campaigner against the company.

5.2.4 Response Plan

A short campaign can quickly do enormous damage to a company's share price. Short campaigns typically arise without advance notice and usually catch the target company off guard.[631] It is imperative that management have a response plan in place in the event that a short campaign is launched against the company. The key aspect of a response plan is to have a team of advisors engaged and prepared to assist on short notice. At the very least, the team should include external counsel; a key group of independent directors; key management personnel that should include a spokesperson; communications advisors; and an investigation firm with relevant experience.

5.3 Defences Against Short Campaigns

Once a short campaign has been publicly announced, the target company will be under pressure to respond as quickly as possible. In our experience, it is important that the company first consider all of its options with an experienced team of experts before deciding what type of response to provide, including what channel to respond through and how to frame the response.

5.3.1 Conducting an Investigation

Sometimes it is very clear who is behind a short campaign. If it is not, however, it is important for the target company to identify the short seller or group of short sellers[632] behind the short campaign.[633] As previously mentioned, a significant hurdle for issuers in defending against short campaigns is the increased anonymity provided by the internet. It is now easier than ever to get information out to the public under the guise of a pseudonym or multiple aliases. This not only makes the short seller coordinating a campaign harder to identify, but it can also allow one person

[629] Katz & Hancock, *supra* note 627 at Part V.
[630] *Ibid.*
[631] *Ibid.*
[632] For ease of reference, we will refer to a single short seller (or short campaigner) hereinafter, but in practice a short campaign may include a concerted effort from multiple parties.
[633] Katz & Hancock, *supra* note 627 at Part V.

to appear as multiple parties. The short campaigner may be able to strengthen the perceived credibility of the allegations against the issuer by coordinating the release of negative news with other analysts or disseminators, or by releasing news under different names. The short seller, though remaining anonymous, is effectively able to reach a larger number of investors and encourage such investors to believe there is truth to the allegations given that, on appearance, different unrelated parties have corroborated the negative news.

The company may want to consider retaining a forensic analytics firm or a law firm to conduct a thorough investigation into the identity of the short campaigner.[634] The company may also consider contacting regulators to help identify the short campaigners if they have been disseminating false information.[635] However, the company should be aware that this will likely lead to the company itself being subject to investigation by regulators (see Section 5.3.3.8).[636] Once the short campaigner is identified, it is helpful to learn the short campaigner's previous methods or "playbook" in conducting a short campaign, especially if the short campaigner is known for conducting short campaigns (a "celebrity short seller" as discussed in Section 5.1). By studying its previous campaigns and analyzing its previous strategies, the target company may be able to predict the short campaigner's next move and stay one step in front of it.[637]

It is also important to consider whether a publicly identified short campaigner leading the campaign is only the head of the attack. For example, it has been reported that for campaigns against larger companies it may not be unusual for the lead campaigner to partner with one or more hedge funds that will also take a short position and share profits with the lead campaigner through certain arrangements.[638]

5.3.2 Deciding Whether to Engage

The target company will have to decide whether to engage the short seller and, if to engage, whether to do so directly or indirectly. In some circumstances, responding to a short campaign may actually have an adverse effect because the target company's response can legitimize a short campaigner's allegations and bring the campaign to the attention of a larger audience than it otherwise would have reached.[639] In determining whether to engage the short campaigner, the company must first consider the following: (i) the short campaigner's reputation and perceived credibility, (ii) the merit of the short campaigner's claims and (iii) the vulnerability of the company to a short campaign.[640] If the short campaigner has a strong following and a proven reputation for disseminating accurate information, or if the claims are at least in part true and, as a result, there could be damage to the company's share price,[641] the company will likely have to engage in a more aggressive and direct manner.

5.3.3 Responding to the Short Campaign

The target company may respond to a short campaign using a number of methods. Taking into consideration the circumstances and the company's resources, management may want to either directly or indirectly address the short campaign. Indirect responses are primarily business strategies, many of which may not be available to companies with small market capitalization or companies

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[634] *Ibid.*
[635] *Ibid.*
[636] *Ibid.*
[637] *Ibid.*
[638] Carson block, "There's a double standard applied to short sellers: Carson Block" (1 February 2019) at 00h:05m:39s, online (video): *BNN Bloomberg* <www.bnnbloomberg.ca/investing/video/there-s-a-double-standard-applied-to-short sellers-carson-block~1601531>.
[639] Katz & Hancock, *supra* note 627 at Part V.
[640] *Ibid.*
[641] *Ibid* at Conclusion.

that are not financially strong. Direct responses include addressing the short campaign publicly, making regulatory complaints or commencing litigation.[642]

5.3.3.1 Indirect Responses – Repurchasing Shares

One strategy the target company of a short campaign may employ to address a short campaign is to implement a share buyback to repurchase shares and decrease the free float. By repurchasing shares, the company not only demonstrates financial strength and strong cash flow, but also cancels a large amount of shares at one time, thus making it more difficult to short the stock.[643] In 2015, Home Capital Group Inc. ("**Home Capital**") launched a $150 million share buyback, repurchasing 3.9 million shares, in response to a short campaign involving allegations of mortgage fraud.[644]

5.3.3.2 Indirect Responses – Increasing Dividend Payments

When shorting a company's stock, the seller is responsible for covering any dividend payments issued by the company that the lender would have received had it not lent the shares to the borrower. The dividend payment from the company is made to the purchaser of the short sold shares, and the short seller pays the amount of the dividend payment out of pocket to the lender. As such, raising or implementing dividend payments makes a stock less attractive for short sellers[645] and may help in deterring a short campaign.[646] In addition to completing a share buyback, Home Capital raised its quarterly dividend payment by 9% in 2016, thereby making it more expensive for short sellers to hold their position.[647]

5.3.3.3 Indirect Responses – Restricting the Lending of Shares

The target company can seek to restrict its shares from being lent, and therefore make shorting of its shares difficult, by asking its shareholders to physically take their shares in certificated form or place their shares in Direct Registration System ("**DRS**") form. When a shareholder holds stock in a "street name",[648] the broker may lend the shares to short sellers. Shares held in physical certificates cannot be lent without the holder's consent to effect short sales. DRS allows a shareholder to register shares

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[642] Regulatory complaints and litigation are appropriate responses only if there is an element of fraud, manipulation or material misrepresentation: i.e., a short and distort scheme.

[643] Peter Hodson, "Five ways companies can combat short sellers" (29 April 2016), online: *Financial Post* <business.financialpost.com/investing/five-ways-companies-can-combat-short-sellers> [Hodson, *Ways to Combat*].

[644] See Home Capital Group Inc., "Home Capital Group Inc. announces final results of substantial issuer bid" (18 April 2016), online: *Cision News Wires* <www.newswire.ca/news-releases/home-capital-group-inc-announces-final-results-of-substantial-issuer-bid-576048451.html>. See also Joe Castaldo, "The war for control of the Home Capital story", (11 May 2017), online: *Maclean's* <www.macleans.ca/economy/the-war-for-control-of-the-home-capital-story>.

[645] Hodson, *Ways to Combat*, *supra* note 643.

[646] Theoretically, the company can also issue non-cash dividends with trading restrictions, such as a digital security, in order to make it more difficult for the short seller to return the dividend to the lender. For example, in July 2019, Overstock.com Inc. ("**Overstock**") announced a dividend payable in Digital Voting Series A-1 Preferred Stock (the "**A-1 Shares**") of the company to shareholders of record on September 23, 2019. The A-1 Shares would be tradeable only on a blockchain exchange operated by an affiliate of Overstock six months after it was paid. Some suggested that the A-1 Shares caused a short squeeze – as a result of the nature and trading restrictions on the A-1 Shares, short sellers faced potential difficulty in acquiring the A-1 Shares to return such dividend payments to lenders and some instead chose to cover their positions. Bloomberg reported that S3 Partners, a financial analytics firm, showed that approximately 6% of shorted Overstock shares were covered in the three business days preceding September 16, 2019. However, this strategy may not be effective if lenders are willing to accept a cash payment or something else in lieu of the digital security or other atypical dividend. In the Overstock example, the company announced on September 18, 2019 that it would loosen the trading restrictions on the A-1 Shares. See Jeran Wittenstein and Sarah Ponczek, "How Patrick Byrne's Final Act at Overstock Crushed Short Sellers", *Bloomberg* (16 September 2019), online: *Bloomberg* <www.bloomberg.com/news/articles/2019-09-16/overstock-soars-amid-flurry-of-short-covering-as-dividend-looms>. See also Josh Kosman, "Overstock says it will loosen restrictions on bizarre crypto-dividend" (18 September 2019), online: *New York Post* <nypost.com/2019/09/18/overstock-says-it-will-loosen-restrictions-on-bizarre-crypto-dividend/>.

[647] Hodson, *Ways to Combat*, *supra* note 643.

[648] Holding shares in street name is a popular holding form for most investors wherein the shares are held through a brokerage account or asset management account. When shares of a company are bought, it is shown to be held under the broker's name rather than the individual investor: see Joshua Kennon, "What It Means to Own Shares of Stock in a Street Name", *The Balance*, (updated March 24, 2019), online: *The Balance* <www.thebalance.com/what-does-it-mean-to-own-shares-of-stock-in-a-street-name-357538>.

that are beneficially owned through a brokerage account in the shareholder's name, which eliminates the broker's ability to lend the shares without the shareholder's consent.[649] Historically, where DRS was not available, shareholders could refuse to open margin accounts and could instead choose to hold shares in fully paid accounts to restrict the lending of their shares. However, the recent implementation of the FPL Program (as discussed in Section 3.2.7.2.4) allows brokers, upon obtaining the shareholder's consent, to lend shares in fully paid accounts. Nonetheless, decreasing the number of free shares[650] available for lending makes it more difficult and expensive to cover short positions. As such, a short campaign becomes more onerous for the short campaigner.[651]

Although somewhat unorthodox, a target company or its insiders could provide financial incentives to assist shareholders in limiting the number of shares that may be borrowed. For example, the Chairman of an airline lent funds to certain shareholders to convert margin accounts to cash accounts in order to lessen the availability of shares that could be borrowed, and also considered paying institutions to stop entering into lending arrangements in connection with shares of the company.[652] Such conduct may raise regulatory concerns and advice from outside counsel should certainly be sought before engaging in any such activity.

5.3.3.4 Indirect Responses – Strong Performance

The simplest way to respond to a short campaign is sometimes to do nothing and carry on with meeting financial and operating performance goals. While certain allegations made against the company's future success may cause concern in the market, strong performance will work to alleviate those concerns. In late 2015, Nobilis Health Corp. ("**Nobilis**") became the target of an aggressive short campaign, causing the share price to fall by over 50% in a matter of weeks after an article was released on Seeking Alpha.[653] However, after posting strong third-quarter earnings for its 2015 financial year[654] and beating analyst earnings estimates by a large margin, the share price reversed, placing pressure on short sellers. While this strategy is quite straightforward, it is also quite difficult, as only the most financially stable companies can use this defence and short campaigns are unlikely to be launched against companies that have strong financial results that can be substantiated.

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[649] Joshua Kennon, "Direct Registration System (DRS) for Stocks" (updated June 25, 2019), online: *The Balance* <www.thebalance.com/what-is-the-direct-registration-system-or-drs-for-stocks-357536>.

[650] "Free shares" refers to the pool of shares available for a broker to lend out. Not to be confused with the term "free float", which refers to the shares of a company that are not held by corporate management and other insiders.

[651] An alternative course of action has been suggested, whereby shareholders can contact their broker and place a sell order at a very high price, ensuring that the order will not go through. This will mark the shares as "on order" and prevent the broker from lending out the shares, thus limiting the number of free shares available for covering short positions. As we understand, this approach is only theoretical and has not been carried out in practice in a public manner: see "Contracts for Difference FAQs: How to Prevent your Share Holdings from being Shorted", online: *Contracts for Difference* <www.contracts-for-difference.com/Borrowing-lending-shares.html>.

[652] In 1988, American Continental Corp. ("**American Continental**") lent money to shareholders, against the shares of the company held by such shareholders, so that shareholders could remove their American Continental shares from margin accounts and transfer such shares to cash accounts. By providing replacement financing to shareholders who removed their shares from margin accounts, American Continental decreased the pool of borrowable securities, thereby putting pressure on share sellers. Additionally, it was reported that the chairman of the company had also considered paying institutions to stop lending out the shares of American Continental: see "Short-selling Activity in the Stock Market: The Effects on Small Companies and the Need for Regulation at 811-812, online: *Google Books* <books.google.ca/books?id=ctmJB8IRXQcC&pg=PA810&lpg=PA810&dq=%22american+continental%22+%22short+squeeze%22&source=bl&ots=-j_a0fWW-K&sig=ACfU3U2_jyUroUOxlbandE6TtuSkCfCN0w&hl=en&sa=X&ved=2ahUKEwit7JfmhbPlAhXFc98KHZi2AtYQ6AEwAnoECAgQAQ#v=onepage&q=%22american%20continental%22%20%22short%20squeeze%22&f=false>.

[653] See Hodson, *Ways to Combat, supra* note 643. See also Chris Parry, "Nobilis Health (T.NHC) jumps 18% on Q3 results after short seller hit in 2015" (13 January 2016), online (blog): *Stockhouse.com* <stockhouse.com/news/newswire/2016/01/13/nobilis-health-t-nhc-jumps-18-on-q3-results-after-short seller-hit-2015>.

[654] N.HLTH Press Release, "Nobilis Health Corp. Releases Strong Third Quarter 2015 Results, Completes Previously Announced Financial Restatement" (12 January 2016), online: *Stockhouse.com* <stockhouse.com/news/press-releases/2016/01/12/nobilis-health-corp-releases-strong-third-quarter-2015-results-completes>.

5.3.3.5 Indirect Responses – Merger and Acquisition Transaction

A transformational transaction, such as one or a series of material acquisitions by the company, a material investment in the company by a well-known investor,[655] or selling the company may provide objective evidence of increased value that could increase the costs of a short campaign and thereby defeat it. However, it may be difficult to successfully pursue a sale or investment transaction when there exists a cloud of doubt that usually occurs with the commencement of a short campaign. Nevertheless, there are instances where this defence has been successfully carried out. For example, in 2015, Alaris Royalty Corp. ("**Alaris**") became the target of a short campaign led by Broadview Capital.[656] However, by financing Providence Industries with US$30 million in exchange for royalty interests,[657] Alaris acquired equity interests and successfully defended against short sellers. The investment served as a "strong vote of confidence" and helped the company to regain market favour, and the resulting increase in share price[658] made it more expensive to hold a short position in the company.

5.3.3.6 Direct Responses – Public Relations

While implementing a business strategy provides a method of indirectly responding to a short campaign, in most cases a direct response is required to halt the momentum of a campaign and address the short campaigner's allegations.[659] A public response could entail issuing a press release or posting a statement dealing with the allegations during a public conference or earnings call, addressing concerns at a shareholders' meeting, or a combination thereof.[660] The company should also consider working with a public relations firm or its existing investor relations firm to develop an appropriate message and establish effective channels of communication to address relevant stakeholders. It is important that the message address all of the short campaigner's allegations in a detailed and persuasive manner.[661] Simply producing a brief report containing broad and general arguments against the short campaigner, the claims generally or the practice of short selling is likely insufficient. Any response by the target company must be detailed and demonstrate the falsity of each of the short campaigner's claims, the short seller's self-interest in the decline of the company's stock and any credibility concerns in respect of the short campaigner, as well as provide a strong and consistent message about the company's strategy and future. It will be critical that responses comply with applicable securities laws and therefore they must not contain misrepresentations, and responses that contain material information should not be disclosed on a selective basis, but rather be generally disclosed by way of a news release or by other legally appropriate means.

5.3.3.7 Direct Response – Investigating the Allegations

In addition to initially engaging a forensic analytics or law firm to determine the identity of the short campaigner, the company may commission a reputable third party to complete an investigation of the claims made by the short campaigner. A finding by such an investigator that the allegations of the short campaigner are without merit may reassure the public and be sufficient to undermine a short and distort scheme. Proof of an independent investigation concluding that the allegations have no substance can also assist with any regulatory or legal action that the company pursues.

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[655] Christina Pellegrini, *"Buffett's Berkshire Hathaway comes to Home Capital's rescue"* (22 June 2017), online*: The Globe and Mail* <www.theglobeandmail.com/report-on-business/berkshire-hathaway-home-capital/article35418133/>.
[656] Hodson, *Ways to Combat, supra* note 643.
[657] See Kirk Falconer, "Alaris Royalty commits $30mln of equity to Providence Industries" (1 April 2016), online: *The PE Hub Network* <www.pehub.com/canada/2016/04/3323941/>.
[658] Hodson, *Ways to Combat, supra* note 643.
[659] Katz & Hancock*, supra* note 627 at Part V.
[660] *Ibid.*
[661] *Ibid.*

5.3.3.8 Direct Responses – Regulatory Action

Another form of directly addressing a short campaign is pursuing regulatory action against the short seller by making a formal complaint to a market or securities regulator. The following is a discussion of the steps to making a regulatory complaint, securities legislation that may be used against a short campaign and recent case law demonstrating how the regulatory bodies approach certain regulatory action.

If there is an element of fraud or market manipulation – i.e., a short and distort scheme – the target company may choose to pursue a legal remedy and file a formal complaint against the short campaigner with securities regulators, such as the OSC. Complaints can be used as a signalling tool, similar to initiating a civil action (as discussed in Section 5.4), demonstrating that the company is firmly of the view that the allegations against it are false or misleading. It has often been stated that complaining to regulators with respect to short campaigns may be a "double-edged sword", as the company itself is then open to investigation by regulators, as it is likely the only way a regulator would be able to reach the conclusion that the short campaigner has disclosed false or misleading information.[662] However, short campaigners regularly lodge complaints as part of their playbook, so the risk of being investigated is likely high in any event. It is therefore important that the target company at the outset admits to, and corrects or addresses, any deficiencies it may have that are part of the allegations made by short campaigners.

Once a complaint has been filed and it has been determined by the regulator to have merit, staff of the regulatory body will pursue action against the short campaigner. If the action is successful, it will likely end the short campaign; however, it will likely take several months before regulatory action can be successfully completed.

If the staff of a securities regulatory authority has decided to pursue regulatory action against the short campaigner, they must prove that the short campaigner's conduct has breached securities laws of that jurisdiction or it is in the public interest to make an order against the short campaigner.

With respect to a breach of securities laws in Ontario,[663] the impugned conduct would likely be in respect of a short and distort scheme that relates to the following:

(1) engaging in fraud and market manipulation, in contravention of section 126.1 of the OSA; and

(2) making misleading or untrue statements, in contravention of section 126.2(1) of the OSA.

OSC Staff may also bring forward a separate or contemporaneous claim for the OSC to exercise its public interest jurisdiction under section 127(1) of the OSA.

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[662] *Ibid.*

[663] We note that in British Columbia, the *Securities Amendment Act, 2019* has been tabled for first reading. Certain of the amendments proposed better address short and distort campaigns, including, among other things, by making it an offence: (i) while engaged in a promotional activity, which includes any activity that encourages or reasonably could be expected to encourage a person to purchase, not purchase, trade or not trade a security to: (a) represent the future value or price of a security or (b) make a statement or provide information that a reasonable investor would consider important in deciding whether to purchase or trade a security, if the statement or information was false or misleading or omitted a fact necessary to make the statement or information not false or misleading or (ii) to make a statement that the person knows or reasonable ought to know is a misrepresentation. The proposed amendments also prohibit a person from engaging in the conduct that the person knows or reasonably ought to know would result in or contribute to: (i) a misleading appearance of trading activity or an artificial price for a security, (ii) a fraud or an attempt to perpetrate a fraud, or (iii) a fraud perpetrated by another person or another person's attempt to perpetrate a fraud: see Bill 33 - *Securities Amendment Act, 2019*, ss 20 and 25. At the time of publication, Bill 33 was in First Reading before the British Columbia legislature: see also Bill 33, *Securities Amendment Act, 2019*, 4th Sess, 41st Leg, British Columbia, 2019.

5.3.3.8.1 Fraud and Market Manipulation

Section 126.1 of the OSA provides that:

> (1) A person or company shall not, directly or indirectly, engage or participate in any act, practice or course of conduct relating to securities, derivatives or the underlying interest of a derivative that the person or company knows or reasonably ought to know,
>
> > (a) results in or contributes to a misleading appearance of trading activity in, or an artificial price for, a security, derivative or underlying interest of a derivative; or
> >
> > (b) perpetrates a fraud on any person or company.
>
> (2) A person or company shall not, directly or indirectly, attempt to engage or participate in any act, practice or course of conduct that is contrary to subsection (1).[664]

With respect to section 126.1(1)(a), the OSA is silent as to what conduct would result in or contribute to either a misleading appearance of trading activity in or an artificial price for a particular security. As discussed in Section 2.4.1, guidance may be found under NI 23-101CP as to what conduct would violate subsection 3.1(1) of NI 23-101, the language of which is substantially similar to section 126.1(1) of the OSA. Subsection 3.1(3)(f) of the NI 23-101CP sets out that "[e]ntering orders to purchase or sell securities without the ability and the intention to … deliver the securities necessary to properly settle the transaction, in the case of a sale"[665] would normally be considered to result in, contribute to or create a misleading appearance in trading activity in or an artificial price for a security. As such, not having the ability or intent to deliver securities to settle a short sale may constitute market manipulation pursuant to section 126.1(1)(a) of the OSA.

The provisions prohibiting fraud in the OSA, such as section 126.1(1)(b), do not set out the definition or elements of fraud. The definition of fraud has instead been considered at common law. Based on the common law test for fraud set out in *R v. Théroux*, the BCSC in *Anderson v. British Columbia (Securities Commission)*[666] held that:

> "[T]he *actus reus* of the offence of fraud will be established by proof of the prohibited act, be it an act of deceit, a falsehood or some other fraudulent means; and
>
> 1. deprivation caused by the prohibited act, which may consist in actual loss or the placing of the victim's pecuniary interests at risk.
>
> Correspondingly, the *mens rea* of fraud is established by proof of:
>
> 1. subjective knowledge of the prohibited act; and
> 2. subjective knowledge that the prohibited act could have as a consequence the deprivation of another (which deprivation may consist in knowledge that the victim's pecuniary interests are put at risk)."[667]

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[664] *OSA*, *supra* note 13 at s 126.1.
[665] *Companion Policy 23-101 Trading Rules*, OSC NI 23-101 CP (as consolidated 10 April 2017) at ss 3.1(3)(f), online (pdf): *Ontario Securities Commission* <www.osc.gov.on.ca/documents/en/ni_20170410_23-101_unofficial-consolidatation-cp.pdf>.
[666] 2004 BCCA 7, 2004 CarswellBC 9.
[667] *R v. Théroux*, [1993] 2 SCR 5, 1993 CarswellQue 5 at para 24 [*Théroux*].

This definition of fraud has since been applied by the OSC in cases where section 126.1 of the OSA is alleged to have been contravened.[668]

In determining the *actus reus* of fraud, it must be proven that a dishonest act involving deceit, falsehood or other fraudulent means caused a detriment or deprivation to the victim.[669] A "deceit" or "falsehood" is established when it is proven that the person represented a certain situation as something other than what it really was.[670] "Other fraudulent means" is a catch-all concept designed to include all other dishonest situations that cannot be characterized as a "deceit" or "falsehood"[671]. Whether an act constitutes "other fraudulent means" is "determined objectively, by reference to what a reasonable person would consider to be a dishonest act".[672] "Other fraudulent means" essentially describes underhanded conduct that creates a risk of depriving others of their property.[673] One example of this conduct relating to a short and distort scheme may be the failure to disclose important information, although what comprises "important information" may also be subjective and contextual. Short campaigners may disseminate negative information about a target company while omitting positive information that is necessary to understanding the broader picture. The deceit, falsehood or other fraudulent means must cause a detriment or deprivation for the act to constitute fraud. A "deprivation" includes either (i) an actual loss to the victim, (ii) prejudice to a victim's economic interest, or (iii) merely the risk of prejudice to economic interests of a victim.[674] The concepts of "prejudice" and "risk of prejudice" require only that the victim was put at risk of economic loss; actual loss need not be proven.[675]

In respect of the intent requirement under the test for fraud, inferences may be drawn to determine *mens rea*. As it is difficult to determine what a short campaigner was thinking at the time of the alleged fraudulent act, subjective knowledge "may be inferred from the acts themselves"[676] or from the totality of the evidence provided.[677] Subjective knowledge may also be established by evidence showing that the short seller was "'willfully blind' or 'reckless' as to the conduct and truth or falsity of any statements made".[678] Proof of subjective awareness that one was "undertaking a prohibited act [the deceit, falsehood or other dishonest act] which could cause deprivation in the sense of depriving another of property or *putting that property at risk*"[679] [emphasis added] is sufficient to satisfy the *mens rea* component of fraud. Subjective awareness may also be established where the short seller "reasonably ought to have known" that the conduct is prohibited by section 126.1 of the OSA. In *Re Boock*, the OSC recognized that imposing liability where a respondent "reasonably ought to have known" that the conduct in question contravenes section 126.1 of the OSA effectively widens the scope of prohibition against fraud.[680]

A short campaigner who engages in fraudulent conduct, such as misrepresenting important figures, facts or other information about the target company in a short campaign, or who enters into short sale trades to create an artificially low price for the target company's shares, would be in

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[668] See *Re Sextant Capital Management Inc.* (2011), 34 OSCB 5863, 2011 CarswellOnt 3302 at paras 219-230 [*Sextant Capital*]. See also *Re Al-Tar Energy Corp* (2010), 33 OSCB 5535, 2010 CarswellOnt 3966. See also *Re Lehman Cohort Global Group Inc.* (2010), 33 OSCB 7041, 2010 CarswellOnt 5609. See also *Re Global Partners* (2010), 33 OSCB 7783, 2010 CarswellOnt 6337.
[669] *R v Olan* [1978] 2 SCR 1175, 1987 CarswellOnt 49.
[670] *Théroux*, supra note 667 at para 17, as cited in *Re Arbour Energy Inc.*, 2012 ABASC 131 at para 979.
[671] *Sextant Capital, supra* note 668 at para 223.
[672] *Ibid.*
[673] *Ibid.*
[674] *Théroux, supra* note 667 at paras 16-17, as cited in *Sextant Capital, supra* note 668 at para 226.
[675] *Sextant Capital, supra* note 668 at para 227.
[676] *Spork v. Ontario (Securities Commission)*, [2014] OJ No 2148, 2014 ONSC 2467 at para 61, as cited in David Johnston, Kathleen Rockwell & Cristie Ford, *Canadian Securities Regulation*, 5th ed (Ontario: LexisNexis Canada Inc., 2014) at 552.
[677] See *Ibid.* See also *Re Empire Consulting Inc.*, 2012 LNONOSC 584, 35 OSCB 7775 at para 85 (which reads, "[t]he totality of the evidence establishes that the Respondents' actions indicate that they must have had subjective knowledge of their actions").
[678] *Théroux, supra* note 667 at paras 26, 28, as cited in *Sextant Capital* at para 228.
[679] *Théroux, supra* note 667 at para 21 [emphasis added].
[680] *Re Boock* (2013), 36 OSCB 9361, 2013 CarswellOnt 13108 at para 114.

contravention of section 126.1 of the OSA. To date, the OSC has not found any person or company to be in breach of section 126.1 in connection with short selling and, as such, there are no precedents in respect of administrative penalties ordered against the alleged offender.

The use of qualifying language – i.e., language disclaiming liability for losses arising from use or reliance – contained in analyst reports may also increase the difficulty of prosecuting fraud in connection with short campaigns. For example, the terms and conditions attached to the report of Muddy Waters Capital, LLC ("**Muddy Waters**") on Asanko Gold Inc. ("**Asanko**") released on May 31, 2017 (see Section 6.2), contained language disclaiming liability for trading losses caused by the information in the report:

> In no event will you hold Muddy Waters Capital, LLC ("MWC"), Muddy Waters LLC, or any affiliated party, including officers, directors, employees and agents of those companies, liable for any direct or indirect trading losses caused by any information on this site.
> …
> However, such information is presented "as is," without warranty of any kind, whether express or implied. MWC makes no representation, express or implied, as to the accuracy, timeliness, or completeness of any such information or with regard to the results to be obtained from its use.[681]

Broad language disclaiming liability for losses, accuracy of information, an obligation to update and the guarantee of future performance of any security, among other things, frequently included in analyst research reports may not only make it difficult for regulators to prove that the statements contained in the reports are fraudulent and constitute a contravention of securities laws, but may also make it difficult for a target company or shareholder to bring a civil action against a short campaigner (see Sections 5.4.1 and 5.4.2).

If a contravention is found, the OSC has the authority to impose a range of sanctions – from conduct orders restricting an individual's future activity in capital markets (e.g., trading bans) to monetary sanctions for breaches of Ontario securities laws.[682] With respect to imposing administrative penalties, the OSC may order a person or company found to have breached securities law to pay up to $1 million for each failure to comply or disgorgement orders to pay the amount obtained as a result of non-compliance with securities laws.[683] Sanction amounts will depend on the circumstances of each proceeding.

Under 122 of the OSA, the OSC may also lay charges and seek quasi-criminal sanctions against individuals or companies in the Ontario courts.[684] A person or company that is convicted of violating Ontario securities laws may be fined up to $5 million for each conviction or imprisoned up to five years less a day, or both.[685] Further, section 122.1(1) of the OSA allows a court to order the convicted person or company to make restitution or pay compensation in relation to the offence to an aggrieved person or company.[686] If a short campaigner is found to be in contravention of section

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[681] "Muddy Waters is Short on Asanko Gold Inc. (AKG:CN)", *Muddy Waters Capital LLC*, (31 May 2017) at 1, online (pdf): *Muddy Water Research* <d.muddywatersresearch.com/content/uploads/2017/05/MW_AKG_20170531.pdf>.
[682] "Proceedings – Sanctions by the Commission", *Ontario Securities Commission*, (accessed 8 September 2019), online: *Ontario Securities Commission* <www.osc.gov.on.ca/en/Proceedings_sanctions-commission_index.htm>.
[683] *Ibid.*
[684] "Proceedings – Before the Court" (2019), *Ontario Securities Commission*, online: *Ontario Securities Commission* <www.osc.gov.on.ca/en/Proceedings_before-court_index.htm>.
[685] Section 122(1) of the OSA provides that "[e]very person or company that … (c) contravenes Ontario securities law, is guilty of an offence and on conviction is liable to a fine of not more than $5 million or to imprisonment for a term of not more than five years less a day, or to both": see *OSA*, *supra* note 13 at s 122 (1).
[686] Section 122.1(1) of the OSA provides that "[i]f a person or company is convicted of an offence under this Act, the court may, in addition to any penalty, order the convicted person or company to make restitution or pay compensation in relation to the offence to an aggrieved person or company": see *OSA*, *supra* note 13 at s 122.1 (1).

126.1 of the OSA in relation to a short campaign, the penalty or remedy ordered will likely depend on the factual circumstances of the case.

5.3.3.8.2 Misleading or Untrue Statements

Section 126.2(1) of the OSA provides that:

> (1) A person or company shall not make a statement that the person or company knows or reasonably ought to know,
>
> > (a) in a material respect and at the time and in the 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
> >
> > (b) would reasonably be expected to have a significant effect on the market price or value of a security, derivative or underlying interest of a derivative.[687]

Making a misleading or untrue statement in contravention of section 126.2(1) of the OSA requires that the particular statement or omission is, in a material respect, 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.[688] Although the OSA does not define the term "in a material respect", the OSC has stated that the meaning of the words is "contextual and will vary depending on the nature of the document in which the statement is made, the nature of the statement itself and the circumstances in which the statement is made".[689] Section 126.2(1) also applies to, among other things, statements made to an OSC Staff investigator carrying out an investigation under the OSA. The above requirements must be assessed at the time and in the light of the circumstances under which the relevant statement was made.[690]

Even if the statement is misleading or untrue within the meaning of subsection (a) of section 126.2(1), the statement must also "reasonably be expected to have a significant effect on the market price or value" of a security for the act of making the statement to be the one in contravention of securities law.[691] The OSC has clarified that section 126.2(1) of the OSA does not actually require that the relevant statement be made to or be relied upon by any investor. As long as the statement made is misleading or untrue, and it would *reasonably be expected* to have a significant effect on the market price or value of the relevant securities – both in accordance with the provision – then the requirements of an offence set out in section 126.2(1) of the OSA have been met.[692] The use of qualifying language by a short campaigner wherein it notes that its report should not be relied upon and may be inaccurate could be of assistance to a short campaigner in defending against a claim brought under this provision.

To date, the OSC has not found any person or company to be in breach of section 126.2 of the OSA in connection with short selling and has not imposed any administrative penalties. If a contravention of section 126.2 is found, the OSC has the authority to impose a range of sanctions from conduct orders, such as trading bans to monetary sanctions, depending upon the circumstances of the proceeding. Under section 122(1) of the OSA, the OSC may also elect to seek quasi-criminal sanctions

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[687] *Ibid* at s 126.2.
[688] *Re Coventree Inc* (2011), 34 OSCB 10209, 2011 CarswellOnt 9804 at para 385 [*Coventree* cited to CarswellOnt].
[689] *Re Biovail Corp* (2010), 33 OSCB 8914, 2010 CarswellOnt 7449 at para 75 [*Biovail* cited to CarswellOnt].
[690] *Coventree, supra* note 688 at para 385.
[691] *Ibid.*
[692] *Ibid* at para 396.

against an alleged wrongdoer in the Ontario courts and, if convicted, a person or company found to be in breach of such Ontario securities laws is liable to a fine of not more than $5 million for each conviction or to imprisonment for a term of not more than five years less a day, or to both. In addition to any penalty, the court may also order the convicted person or company to make restitution or pay compensation in relation to the offence to the injured person or company.

5.3.3.8.3 Public Interest Jurisdiction

Pursuant to section 127 of the OSA, the OSC may exercise its public interest jurisdiction to sanction persons, absent a breach of the OSA or regulations thereunder, by making certain orders if "in its opinion it is in the public interest". The orders that may be made include an order denying exemptions, a cease trade order relating to specific securities and an order that a person or company be reprimanded.

The public interest jurisdiction of securities regulatory authorities is a uniquely powerful tool. There has been debate as to whether the public interest power should be exercised, absent a breach of securities laws, only in circumstances where the conduct or transaction is clearly "abusive", or whether it may also be exercised "where the market conduct engages the animating principles of [securities legislation]".[693] More recently, particularly in the enforcement context,[694] the public interest power has been narrowly applied only where the conduct is abusive to the capital markets. Accordingly, it may be that the use of the animating principles standard may be waning and the narrower "abuse" standard is preferred.[695] We would also note that consistent with our previously expressed views,[696] the "abusive" standard may also be narrowing by focusing on the reasonable or justifiable expectations of market participants. For example, in *Re Hamilton*, the following was noted:

> The concept of "abusive to the capital markets" is not defined in the cases. Without attempting to provide a fulsome description of that concept, which might inadvertently or unnecessarily restrict the interpretation in future cases, we think this threshold is a high one and connotes, at least, the following concepts:
>
> - serious behaviour that is outside the ordinary course of conduct in the capital markets; and
> - either risk, or actual harm, to the capital markets arising from the conduct.
>
> We also think a useful check on a conclusion that conduct is "abusive to the capital markets" is whether the reasonable expectations of participants in the capital markets would be met with the exercise of the OSC's public interest jurisdiction in the given circumstances.[697]

In the context of short campaigns and short and distort schemes, the public interest power may be used to secure an order to prohibit the short seller from trading in the target company's stock, or by denying the use of prospectus exemptions, thereby severely restricting a short campaigner's ability to trade; or simply by the issuance of a reprimand that would significantly impair a short campaigner's credibility.

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[693] *Biovail, supra* note 689 at para 382.
[694] Decisions not directly related to mergers and acquisitions or other capital market transactions.
[695] See Paul Davis and Allison Vale, "*Hecla* Decision – The British Columbia Securities Commission Continues to Narrow the Use of the Public Interest Power", McMillan Securities Bulletin (December 2016) at 3, online (pdf): *McMillan* <mcmillan.ca/Files/195928_Hecla_DecisionThe_British_Columbia_Securities_Commission.pdf>.
[696] See Paul Davis, et al., "Justifiable Expectations Standard: The Basis for the Exercise of the Public Interest Power of the Ontario Securities Commission" (22 August 2014), online (pdf): *McMillan* <mcmillan.ca/files/Paul_Davis_Justifiable_Expectations_Standard.pdf>.
[697] 2018 BCSECCOM 290, at paras 154 and 155.

A private party, such as a public company, cannot bring an application as a matter of right under section 127 of the OSA,[698] as only OSC Staff can proceed under section 127(1) as of right.[699] This factor limits a private party's ability to seek expeditious relief under the OSC's public interest jurisdiction. A party's ability to bring an application under section 127 is intended to be an extraordinary circumstance,[700] and one who is seeking to bring an application pursuant to section 127(1) of the OSA has the onus of demonstrating that a hearing is in the public interest.[701]

In 2009 – and affirmed again in 2015 – the OSC considered the following factors when deciding whether to exercise its discretion in favour of permitting an application by a relevant private party:

- the applications related to both past and future conduct regulated by Ontario securities laws;
- the applications were not, at their core, enforcement in nature;
- the relief sought was future-looking;
- the OSC had the authority to grant an appropriate remedy;
- the applicants were directly affected by the conduct (past and future); and
- the OSC concluded it was in the public interest to hear the applications.[702]

In addition to the above, timing is also a consideration with respect to applications for standing. In the event an application is brought late in the process, absent new information or critical issues being raised, the OSC will need "convincing evidence showing that the public interest is at stake".[703] This is because late interventions could affect fairness, efficiency and confidence in the capital markets.[704]

Accordingly, it would be rare that a company subject to a short campaign will seek relief through the exercise of the OSC's public interest jurisdiction.

5.3.3.8.4 Jurisprudence

A central issue with respect to bringing a successful claim against an alleged short and distort scheme is the difficulty for regulators, such as the OSC, to determine whether the information is in fact misleading or untrue, and whether the person who disseminated such information knew or reasonably ought to have known it was false. In an attempt to balance free speech and protection of the integrity of the capital markets, regulators have placed a high threshold on the type of behaviour required to decisively reach the conclusion that activity should be sanctioned. Recent decisions from each of the British Columbia Securities Commission ("**BCSC**") and the Alberta Securities Commission ("**ASC**") demonstrate how difficult it is to meet the high threshold for obtaining sanctions against a short campaigner.

[698] *MI Developments Inc.* (2009), 32 OSCB 126, 2009 CarswellOnt 8220 at para 248. [*MI Developments* cited to CarswellOnt].
[699] *Ibid* at paras 108 and 127.
[700] *Re Catalyst Capital Group Inc*, 2016 OSCB 4079, 2016 CarswellOnt 6413 at para 56. [*Catalyst Corus* cited to CarswellOnt].
[701] *Ibid* at para 60.
[702] *MI Developments, supra* note 698 at paras 109–110 and *Central GoldTrust, (Trustees of)* 2015, 38 OSCB 10768, 2015 CarswellOnt 19437 at para 16.
[703] *Catalyst Corus, supra* note 700 at para 61.
[704] *Ibid* at para 60.

(i) *Re Carnes*, 2015 BCSECCOM 187

1. Summary

In *Re Carnes,*[705] Jon Carnes ("**Carnes**") published a negative report (the "**Alfred Little Report**") on TSX-listed Silvercorp Metals Inc. ("**Silvercorp**"), a company in which he held a short position. Carnes received an anonymous tip to investigate the Vancouver-based company, the principal assets of which were operating silver mines in China.[706] The action was brought forward to the panel of the BCSC ("**BC Panel**") by the staff of the BCSC (the "**BC Staff**"), who alleged that Carnes had violated s. 57(b) of the *Securities Act* (British Columbia) (the "**BC Act**"),[707] which is substantially similar to section 126.1 of the OSA, and engaged in conduct contrary to the public interest. Similar to his previous reports on separate campaigns, Carnes published the Alfred Little Report under a false name and false research group in order to increase his credibility.[708] Carnes had also retained a geological consultant (the "**First Consultant**"), under the guise of a false investment company, to produce a report reviewing Silvercorp's technical reports (the "**NI 43-101 Reports**") and filings with the Chinese Land and Resource Bureau (the "**Chinese Reports**").[709] The First Consultant found discrepancies between the two reports but determined that the discrepancies were largely explained by differences in the preparation of the reports and the reporting criteria. The First Consultant determined that the data in the NI 43-101 Reports and the Chinese Reports had no "fatal flaws".[710] Carnes was unsatisfied with the conclusions of the First Consultant and elected to retain a second geological consultant (the "**Second Consultant**").[711]

In August 2011, Carnes purchased $4.1 million of Silvercorp put options[712] that were set to expire on September 17, 2011.[713] On September 5, 2011, Carnes and his research team received the report from the Second Consultant, who had reached similar conclusions as the First Consultant. Carnes' team believed the conclusions in the report were "too soft", "too vague" and "not damaging enough".[714] A few days later, the Second Consultant prepared an updated report that identified additional discrepancies between the NI 43-101 Reports and the Chinese Reports. Carnes also claimed that the Second Consultant provided a verbal opinion that the discrepancies between the Chinese Reports and the NI 43-101 Reports were "simply too large to be explained by the differences in the basis of preparation and different reporting circumstances";[715] however, this verbal opinion was never documented or corroborated.[716]

On September 13, 2011, under the alias Alfred Little, Carnes published the Alfred Little Report, which included excerpts from the Second Consultant's report and his own critical opinion. The Alfred Little Report was released prior to a presentation by Silvercorp at an investment conference to "create the

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[705] *Re Carnes* (14 May 2015), 2015 BCSECCOM 187, online (pdf): *British Columbia Securities Commission* <www.bcsc.bc.ca/Enforcement/Decisions/PDF/2015_BCSECCOM_187/> [*Carnes*].
[706] *Ibid* at para 23.
[707] Section 57(b) of the *Act* provides that a "person must not […] engage in […] conduct relating to securities […] if the person knows, or reasonably should know, that the conduct […] perpetrates a fraud on any person": see *Securities Act,* RSBC 1994, c 418, s 57(b).
[708] *Carnes, supra* note 705 at para 10.
[709] *Ibid* at paras 26, 27.
[710] *Ibid* at para 28.
[711] *Ibid* at para 30.
[712] A put option is an option contract giving the owner the right, but not the obligation, to sell a specified amount of an underlying security at a specified price within a specified timeframe. Similar to holding a short position, the holder of put options is seeking to and does profit from the decline of a company's share price. However, while a short seller's potential for loss is essentially limitless, the potential for loss for a holder of put options is limited to the costs to purchase the option contract. For more details on put options, see Justin Kuepper "Put Option Definition", online: *Investopedia* <www.investopedia.com/terms/p/putoption.asp>.
[713] *Carnes, supra* note 705 at para 33.
[714] *Ibid* at para 36.
[715] *Ibid* at para 40.
[716] *Ibid* at paras 41–42, 51.

most possible damage" to the company.[717] The report also received public support from another well-known short seller, who published a link on his website.[718] On the day the report was released and subsequently shared, Silvercorp's shares fell by 20%.[719] Carnes "closed his short position" [720] on the following day, netting a total profit of $2.8 million.

a. Fraud

After careful review of the Alfred Little Report, the BC Panel found that Carnes had used selected excerpts from the Second Consultant's report to reinforce his own critical opinions. However, while Carnes had only cited portions of the Second Consultant's report that provided negative comments with respect to Silvercorp and had excluded positive comments, the BC Panel held that the alleged fraudulent statements were not objectively false. Instead, Carnes "attempted to create an implication in the reader's mind"[721] by using his own subjective interpretations of the consultant's findings. The Alfred Little Report implied that the Second Consultant made certain negative comments about Silvercorp, while being careful not to explicitly state that the Second Consultant held a negative view of the company.[722] The BC Panel held that Carnes did not provide a "full and fair picture of the consultant's opinion"[723] and questioned his credibility on various matters. However, the BC Panel determined that Carnes had not committed fraud, as his conduct fell short of deceit or falsehood for the purpose of fraud, and so was not in contravention of section 57(b) of the BC Act.[724]

b. Conduct Contrary to Public Interest

The BC Staff alleged that the following conduct by Carnes was contrary to the public interest, such that the exercise of the public interest power by the BC Panel was justified:

1. using a fake name to author his reports;
2. using a fake biography to enhance the credibility of his reports;
3. creating a fake research organization to enhance the credibility of his reports;
4. misleading investors by making his website look like an independent clearinghouse where there were multiple contributors;
5. engaging in conduct that the BC Staff stated constituted fraud;
6. retaining a geological consultant using a fake name, a fake company and a retainer agreement signed with the fake company that was not enforceable;
7. publishing the negative report on Silvercorp at a time that would cause the biggest drop in its share price; and
8. failing to mention that his Silvercorp report was published just four days prior to the expiry of his put options.[725]

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[717] *Ibid* at para 47.
[718] *Ibid* at para 48.
[719] *Ibid* at para 49.
[720] *Ibid* at para 50.
[721] *Ibid* at para 92.
[722] The Second Consultant's report was unbiased towards whether Silvercorp was a good or bad investment. While Carnes' own report, the Alfred Little Report, implied that the Second Consultant held the view that Silvercorp was a bad investment, Carnes was especially careful not to explicitly state that this was the Second Consultant's opinion (as that would have been a false statement).
[723] *Carnes, supra* note 705 at para 103.
[724] *Ibid* at para 103.
[725] *Ibid* at para 133.

To determine whether the public interest power should be invoked, the BC Panel reviewed two of the OSC's leading decisions – *Canadian Tire*[726] and *Asbestos*[727] – as well as the OSC's enforcement decisions of *Biovail,*[728] *Donald,*[729] *Suman,*[730] and *Waheed*[731].

In summarizing the application of *Canadian Tire* to the aforementioned cases, the BC Panel noted that the cases required either evidence of conduct that was "abusive to capital markets" or a breach of an animating principle of securities regulation that was not necessarily accompanied by "abusive" conduct. In analyzing the standard applied in those cases, the BC Panel stated that:

> […] the OSC cases diverge on whether to take a narrower or broader basis for exercising the public interest jurisdiction. The **narrower basis** requires a finding that the conduct was abusive of capital markets, or that a particular financial structure was used with the intent of avoiding contravening a specific provision of the Act. The **broader basis**, represented by the *Biovail* decision, is founded upon the concept that a range of factors should be considered but that an order may be made without a finding of abuse where the conduct is inconsistent with the animating principles of the [BC Act].[732] [emphasis added]

While the BC Panel found Carnes' conduct "unsavory",[733] it was not prepared to exercise its public interest power, as doing so would impose a "fair presentation" requirement that would present an onerous burden on numerous parties, including research analysts.[734] The BC Panel used the term "fair presentation" to refer to a standard where anyone making a report is legally required to provide a "full and fair"[735] unbiased presentation of the facts. In their view, this standard would have been much too strict. Having determined that Carnes' conduct did not constitute fraud contrary to the BC Act, the BC Panel took a cautious approach by applying the narrower standard and refusing to find that Carnes' conduct was "clearly abusive to capital markets".[736] Carnes' conduct was not found to be contrary to the public interest.

2. Observations

The BC Panel was clearly cognizant of the policy implications that would be created for research analysts, newspaper reporters and others who write opinions about public companies if it was to base a finding on the failure to provide a fair and balanced presentation of all known facts relating to concerns addressed in a public report. It would appear that the BCSC would need a clear finding of misrepresentation, or at a minimum, likely fraud – or, in other words, a breach of securities laws – to impose a sanction under its public interest jurisdiction.

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[726] *Re Canadian Tire Corp* (1987), 10 OSCB 857.
[727] *Committee for Equal Treatment of Asbestos Minority Shareholders v. Ontario (Securities Commission)*, 2001 SCC 37 [*Asbestos*].
[728] *Biovail, supra* note 689.
[729] *Re Donald* (1 August 2012), 35 O.S.C.B 7383, 2012 CarswellOnt 9499 [*Donald*].
[730] *Re Suman* (2012), 35 OSCB 2809 [*Suman*].
[731] *Re Waheed* (26 August 2014), 37 O.S.C.B 8007, 2014 CarswellOnt 11912 [*Waheed*].
[732] *Carnes, supra* note 705 at para 128.
[733] *Ibid* at para 141.
[734] *Ibid* at para 140.
[735] *Ibid* at para 103.
[736] *Ibid* at para 141.

(ii) *Re Cohodes*, 2018 ABASC 161

1. Summary

Re Cohodes[737] involved short seller Marc Cohodes ("**Cohodes**"), who was known for taking highly publicized short positions in stocks of Canadian companies, such as Home Capital and Valeant Pharmaceuticals International Inc. (now Bausch Health Companies Inc.).[738]

In May 2017, Badger Daylighting Ltd. ("**Badger**"), a TSX-listed company providing excavation services in Canada and the US, released its financial results for the first quarter of 2017. On the same day that the first quarter results were released, Cohodes publicly announced that he had taken a short position in Badger four months prior and that he was launching a website as part of a campaign against Badger.[739] The website went live a few days later and contained a slide presentation and a short thesis detailing Cohodes' critical views on Badger (the "**Short Thesis**").[740] Cohodes began posting a significant number of tweets on his Twitter social media account claiming, among other things, that Badger was guilty of illegally dumping toxic waste and that the company was a fraud or "criminal operation".[741]

One tweet posted by Cohodes on June 27, 2018 (the "**June 27 Tweet**"), displayed a photograph of a Badger truck at night, in dump position, in what appeared to be a field. Cohodes stated in the tweet that Badger was illegally dumping toxic waste in a field and that their "day was coming".[742] Badger responded that the picture was taken by one of its operating partners and posted online to show that lighting had been installed on the truck for nighttime operations. Further, the truck was not located in a field but rather an oil and gas facility that belonged to one of Badger's clients. The material dumped from the truck was not toxic and the conduct was not illegal; the material had been excavated by Badger and deposited in accordance with the client's directions.[743] Badger claimed that this tweet, along with similar "false representations" of their company, resulted in notable drops in Badger's stock price and spikes in trading volumes.[744] Badger claimed that if Cohodes was "permitted to continue making false statements about Badger, there [would] be substantial harm to Badger's investors, Badger's business and reputation, and the Canadian and Alberta capital markets".[745]

Staff of the ASC ("**ASC Staff**") claimed that Cohodes was intentionally making false statements that he knew would cause or contribute to an artificially low price for Badger shares; that is, conducting a short and distort scheme. Under the authority granted to them by section 33 of the *Securities Act* (Alberta) (the "**AB Act**"),[746] the ASC Staff issued a notice of application against Cohodes, seeking an interim order under section 198,[747] which is similar to section 127 of the OSA, to prevent Cohodes

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[737] *Re Cohodes,* (10 October 2018), ABASC 161, online (pdf): *Alberta Securities Commission* <www.albertasecurities.com/-/media/ASC-Documents-part-1/Notices-Decisions-Orders-Rulings/Enforcement/2019/01/COHODES-Marc-Culver-RULING-2018-10-10-5427434-1.ashx> [*Cohodes*].
[738] See Tom Teodorczuk, "An audience with short seller Marc Cohodes: 'You have to be nine-tenths insane to do it'", (10 September 2018), *Financial News London*, online: *Financial News* <www.fnlondon.com/articles/an-audience-with-short seller-marc-cohodes-you-have-to-be-nine-tenths-insane-to-do-it-20180910>.
[739] *Cohodes, supra* note 737 at para 9.
[740] *Ibid* at para 11.
[741] *Ibid* at para 12.
[742] *Ibid* at para 14.
[743] *Ibid* at para 15.
[744] *Ibid* at paras 16, 18.
[745] *Ibid* at para 19.
[746] "Section 33 of the [AB Act] gives the ASC the authority to respond promptly to threats to the integrity of the Alberta capital market, including by making temporary orders that implement the preventative and protective measures available under s.198. We must be satisfied that such orders are in the public interest […]": see *Ibid* at para 30.
[747] "Section 198(1) of the [AB Act] provides for a variety of measures to address capital market misconduct, including those intended to halt certain types of capital market activity": see *Ibid* at para 32.

from (i) trading in securities of Badger and (ii) "disseminating to the public, or authorizing the dissemination to the public, any statements relating to the business or operations of Badger he knows or reasonably ought to know are misleading or untrue […]".[748] Under section 198 of the AB Act, the ASC has authority to make interim orders in the public interest to protect capital markets until a full enforcement proceeding can be conducted. Importantly, these are merely interim protective measures and not "sanctions for misconduct".[749] The threshold for securing an interim order is low, as the ASC Staff only needed to establish on a *prima facie* basis that securities laws have been contravened.[750]

To secure the interim order, ASC Staff alleged that Cohodes made misrepresentations in violation of section 92(4.1) of the AB Act, [751] which is similar to Section 126.2 of the OSA, and that he was liable for market manipulation under section 93(1)(a)(ii) of the AB Act.[752]

Upon a detailed examination of all the statements made by Cohodes, including the Short Thesis, allegations of illegal toxic dumping and the June 27 Tweet, the ASC found that only the June 27 Tweet was established to be untrue on a *prima facie* basis.[753] Therefore, the action against Cohodes was narrowed to whether his statement about illegal toxic dumping had contravened securities laws. The ASC then shifted their focus onto whether the June 27 Tweet would reasonably have been expected to have a significant effect on Badger's stock price or market value. The ASC Staff argued that Cohodes had a substantial following and meaningful influence, as evidenced by his 25,600 followers on Twitter, and a reputation as a famous short seller.[754] Conversely, Cohodes contended that he did not have great influence in the capital markets and that no one really listened to him.[755]

In respect of Cohodes' credibility, the ASC was not persuaded that his publicly expressed opinions on Badger "commanded sufficient respect among market participants to justify an inference that a reasonable investor would find his statements credible and useful in making an investment decision".[756] The ASC determined that a Bloomberg article written about Cohodes did not by itself establish that he had an "enduring reputation for predictive acuity" such that a reasonable investor would rely on his statements in making decisions to buy, sell or hold Badger stock.[757] It was noted that while Cohodes had an "elevated opinion"[758] of his own ability to detect fraud and improper management practices, there was no evidence that the public held the same opinion. On the issue of Cohodes' social media following, the ASC found that it was highly unlikely that all of his 25,600 followers on Twitter had an interest in Badger stock. This was evidenced by the relatively low amount of "likes" and "comments" on his Badger tweets and the fact that Badger's stock only dropped by 0.6% in one day following the June 27 Tweet.[759] During the 14-month period from May 12, 2017, to July 10, 2018, Cohodes posted 160 tweets relating to Badger, all of which were determined by

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[748] *Ibid* at para 1.
[749] *Ibid* at para 31.
[750] *Ibid* at para 33.
[751] Section 92(4.1) of the *Alberta Securities Act* provides that "No person […] shall make a statement that the person […] knows or reasonably ought to know […] (a) […] at the time and in light of the circumstances in which it is made, (i) is misleading or untrue […] and (b) would reasonably be expected to have a significant effect on the market price or value of a security […]", which is similar to s.126.2 of the OSA): see *Securities Act*, RSA 2000, c S-4, s.92(4.1) [*Alberta Securities Act*].
[752] Section 93(1)(a)(ii) of the *Alberta Securities Act* provides that "No person […] shall directly or indirectly, engage or participate […] in any act, practice or course of conduct relating to a security […] that the person […] knows or reasonably ought to know may (a) result in or contribute to […] (ii) an artificial price for a security […]": see *Alberta Securities Act,* s 93(1)(a)(ii).
[753] *Cohodes, supra* note 737 at para 76.
[754] Cohodes has been the subject of a Bloomberg article as a "celebrity short seller": see Tom Redmond, "The World According to a Free-Range Short Seller With Nothing to Lose", (9 February 2017), *Bloomberg Markets* online: *Bloomberg* <www.bloomberg.com/news/features/2017-02-09/the-world-according-to-free-range-short seller-mark-cohodes>.
[755] *Cohodes, supra* note 737 at para 53.
[756] *Ibid* at para 82.
[757] *Ibid* at para 80.
[758] *Ibid* at para 82.
[759] *Ibid* at paras 73, 90.

the ASC to have no apparent correlation to movements in Badger's share price.[760] While the ASC acknowledged that someone in Cohodes' position might be able to affect the market for shares of a small thinly traded issuer in certain circumstances, this did not apply to a company such as Badger, which had a market capitalization in excess of $1 billion and reasonable liquidity.[761]

The ASC refused to find that Cohodes had committed an actionable misrepresentation. While the June 27 Tweet was misleading in nature, the ASC did not find that it created an artificial price for Badger's shares, and therefore there was no conclusive evidence of market manipulation. As the evidence was insufficient to establish on a *prima facie* basis that Cohodes had contravened the AB Act, the ASC Staff's application for an interim order was dismissed.

2. Observations

The hurdles faced by staff of securities regulators in obtaining a remedy under securities legislation for the disclosure of false or misleading information by short campaigners is clear. Proving that a statement was false is simply not enough. The information must have reasonably been expected to have a significant impact on market price, which to some extent depends on the reliance by investors on false statements made by a short campaigner. With the result achieved in *Cohodes*, staff of securities regulators would be expected to be overly cautious in seeking similar relief.

5.4 Civil Actions

Outside of a prosecution, securities legislation offers few private remedies to issuers that are the targets of short campaigns or to their shareholders to compensate them for their losses, even where securities regulators conclude that the tactics used by the short campaigners violated securities laws.[762] Instead, the target companies and their shareholders are left to seek damages through private law civil claims. While there are a variety of private law claims that could be used to respond to a short campaign or an alleged short and distort scheme, there is no private law or statutory remedy for abusive short selling or naked short selling in and of itself. Rather, the target company and its shareholders are left to characterize their respective losses in a way that matches existing civil claims, and the remedies available to the target company and to its shareholders will vary depending on the nature of the harm alleged.

There are downsides towards pursuing a claim in court. Litigation can be costly and time consuming, and it can distract management and take up resources that are needed for the company to maintain strong business performance. For retail investors, the prospect of bringing a claim against short sellers is daunting – the cost of retaining counsel is beyond the financial resources of most small investors and the financial consequences of an unsuccessful claim, including a "loser pays" costs regime, are potentially devastating. Institutional investors and larger private equity firms may be in a better position to fund litigation and risk an adverse cost ruling, but even then, recovering damages through any of the private law claims discussed below could be quite difficult. The evidentiary onus to prove the existence of a conspiracy between those engaged in a short campaign, for example, is on the plaintiff. As the legal proceedings can continue for years, target companies that are junior issuers may not have the resources to fight against a short campaigner.

The following is a general discussion of the types of claims that a target company and its shareholders may pursue in a civil action against a short campaigner conducting a short campaign or short and

[760] *Ibid* at para 12, 92–93.
[761] *Ibid* at para 83.
[762] Section 122.1 of the OSA gives a court jurisdiction to order restitution or compensation in relation to an offence to an "aggrieved person or company" on conviction of an offence under the OSA, but this is not a remedy available to an issuer or a shareholder absent a prosecution or conviction.

distort scheme. Each potential private law claim has conceptual difficulties, and each will be discussed below.

5.4.1 Corporate Remedies

For the target of a short campaign, a lawsuit is not only a way to pursue monetary damages against the short campaigner, but it also works as a form of partial corrective disclosure in responding to a short campaign. For example, if a company is accused of fraud in a short campaign, the investing public would not expect the company to open itself up for discovery and pursue civil action against the short seller, unless it was innocent of the claims alleged. The target company's failure to pursue legal action may be perceived as validation of the short seller's claims against the company. For this reason, a civil action may sometimes be the only way to prevent the target company's share price from falling drastically in the short term. Additionally, any advancements in the lawsuit in the target company's favour may result in an increase of the share price, making it more difficult for the short seller to hold its position.

The target company could theoretically sue those responsible for a short campaign for damage to its reputation, as well as other economic losses. However, it is important to recognize that the most obvious economic consequence of a short campaign – the loss of market capitalization itself – is not recoverable by the corporation. Market capitalization refers only to the total market value of the target company's outstanding shares.[763] It is not itself a corporate asset or even an accurate proxy for the target corporation's value. However, the loss of market capitalization, which potentially represents the market's perception of the target corporation's actual value in light of the information released in a short and distort campaign, may cause other losses, such as increased financing costs or increased costs in raising additional capital. There are a number of existing forms of civil claims that could be used to seek compensation, including actions for defamation for harm to its reputation and conspiracy claims. The target may even have potential claims for intentional interference with economic interests or unjust enrichment, as discussed below.

5.4.1.1 Conspiracy

Claims based on conspiracy are perhaps one of the more obvious remedies for the target of a short campaign or short and distort scheme. Short sellers may work in concert, with the apparent help of analysts, in what appears to be a concerted effort to cause the target company's share price to drop. While there may be emerging uncertainty as to the strength of the distinction, there are traditionally two forms of private action for conspiracy: (i) civil conspiracy and (ii) unlawful conspiracy. The requirements for each vary somewhat and depend in part on the object of the alleged conspiracy.

To succeed in a claim for civil conspiracy – i.e., where the conspirators did not engage in unlawful conduct – the target would need to establish that the short campaigners' predominant purpose was to cause it economic harm by driving down its share price. Such a claim could be very difficult to credibly establish if the short campaigners did not engage in any unlawful conduct, such as prohibited market manipulation or deception, in which case the most obvious explanation for why the short campaigners engaged in a short campaign is simply to make money.

However, the target company would likely have a stronger conspiracy claim if the short campaigners used a disinformation campaign, amounting to deceptive or manipulative market practices or defamation, in order to drive down the share price – changing the claim from one based on civil

[763] Market capitalization is obtained simply by multiplying the number of the target company's outstanding shares by the current market price for one share: see *Investopedia Online* "Market Capitalization", online: *Investopedia* <www.investopedia.com/terms/m/marketcapitalization.asp>.

conspiracy to an unlawful one. If unlawful means are used, the target company would not need to show that the predominant purpose of the conspiracy was to injure it. Rather, it would be enough to show that the short campaigners knew, or should have known, that the company would be injured as a result of the short campaign.

To date, while companies have brought conspiracy claims against short campaigners, there has not been a Canadian decision on the merits holding them liable for provable financial losses caused by a short campaign.

5.4.1.2 Defamation

Defamation is the other obvious private law claim available to the target of a short campaign. The common law recognizes the interest every person has in their good reputation, including corporations. A short campaigner or even an analyst, or potentially a journalist, may be liable to the target of a short campaign for statements made about the target that impugn or attack the target's reputation – and are not merely critical, unflattering or embarrassing.

If the target company believes that the short campaigner has made misleading or untrue statements about the company or its management to the public or shareholders, it may choose to pursue a defamation claim against the short campaigner. Defamatory statements are presumed to be false, but if the statements are proven true, there is no defamation. Therefore, a short campaigner will have every interest in proving the truth of the statements it made, and through the discovery process, it will gain access to relevant corporate documents to bolster the truth of its claims. A defamation claim is not without potential risk for the target company and can be a double-edged sword; the risk of reputational damage is considerable if the evidence shows that the concerns raised about the target company and its management were not only credible, but true.

If the target company can prove that it was defamed, it can recover general damages for loss of reputation. It may also be able to recover other provable losses beyond the harm to its reputation, such as its loss of market capital, and, in extreme circumstances, aggravated and punitive damages.[764] Defamation, however, is a highly technical cause of action. As noted above, truth is a complete defence to a defamation claim, but it is not the only defence. Short campaigners may be able to justify statements made during a short campaign on the basis of fair comment or on an occasion of qualified privilege, which is highly fact-dependent and largely based on considerations of public interest. If short sellers can bring the statements made during a short campaign into the scope of these defences, then absent any evidence of malice, the target company's defamation claim may not succeed.

There have been concerns that a company may use a defamation lawsuit as a tool to silence legitimate criticism against it. A "strategic lawsuit against public participation", or a "SLAPP lawsuit", is a colloquial term describing a lawsuit used as a weapon to silence legitimate critics and coerce self-censorship by "redirecting their energy and finances into defending a lawsuit and away from their original public criticism".[765] On November 3, 2015, anti-SLAPP legislation[766] was brought into

[764] Where the Court of Appeal for Ontario concluded that Barrick Gold Corp. had been defamed by postings on an industry bulletin board and increased the quantum of both general damages for lost reputation as well as punitive damages based on the defendant's high-handed and malicious conduct: see *Barrick Gold Corp v Lopehandia*, 2004 CarswellOnt 2258, [2004] O.J. No. 2329.
[765] *Salewski v Symons,* 2012 ONSC 1307 at para 4 [*Salewski*].
[766] See *Protection of Public Participation Act*, 2015, SO 2015, c 23. On November 3, 2015, Ontario passed Bill 52 *An Act to amend the Courts of Justice Act, the Libel and Slander Act and the Statutory Powers Procedure Act in order to protect expression on matters of public interest* under the *Protection of Public Participation Act*. Bill 52 provides the anti-SLAPP legislation as amendments to the *Courts of Justice Act, Libel and Slander Act,* and the *Statutory Powers Procedure Act*. The main source of anti-SLAPP legislation is provided by the newly added sections 137.1–137.5 of the *Courts of Justice Act* (as amended), with accompanying amendments to reflect the change in legislation.

effect in Ontario to address the concern of companies, particularly those with substantial resources, misusing defamation claims to stifle legitimate criticism. The anti-SLAPP legislation amended the *Courts of Justice Act* 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.[767] If the judge is satisfied that the criticism expressed by the defendant relates to a matter of public interest, the claim may be summarily dismissed. However, the judge will not dismiss the claim if there are grounds to believe that the claim has substantial merit or that the defendant has no valid defence, or the harm 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 speech and board participation in debates on matters of public interest.[768] With respect to the proportionality of public interest, the Ontario Superior Court of Justice has held that, in order for the claimant to meet this onus in a defamation claim, the evidence of damages suffered or likely to be suffered as a consequence of the impugned statements must be such that there is "credible and compelling evidence of harm that appears reasonably likely to be proved at trial".[769]

The defendant of a defamation lawsuit may be entitled to costs of the motion brought under the anti-SLAPP provisions and of the proceeding on a full indemnity basis if summary dismissal is granted.[770] Additionally, the judge may award damages if the claimant is found to have brought the defamation action in bad faith or for an improper purpose.[771] In effect, the anti-SLAPP provisions present a hurdle for a target company in bringing a defamation claim, as there is risk that such a claim will be dismissed before trial. However, a defamation action remains a good potential response to a target of a short and distort campaign. To date, the only anti-SLAPP case that has been brought in connection with short selling is *Thompson v Cohodes*,[772] in which the Ontario Superior Court of Justice dismissed the anti-SLAPP motion brought by Cohodes, the alleged libeler, as the public interest in allowing the proceeding to continue outweighed the public interest in protecting the expression of the defendant.[773] In considering the harm that had or likely to have been suffered by the plaintiff, the court considered the seriousness of the charge, the mode and extent of the publication, the position and standing of the plaintiff in the community and the defendant's conduct before and after the time of publication.[774]

5.4.1.3 Unjust Enrichment

For those who see the function of capital markets as facilitating long-term investment and the creation of shareholder wealth, it may be tempting to see the profits made by short campaigners as being unfairly earned at the expense of the target company. Unjust enrichment occurs when one

[767] Section 137.1(3) (as amended) of the *Courts of Justice Act* provides that "[o]n motion by a person against whom a proceeding is brought, a judge shall […] dismiss the proceeding against the person if the person satisfies the judge that the proceeding arises from an expression made by the person that relates to a matter of public interest": see *Courts of Justice Act*, RSO 1990, c C.43, s 137.1(3) [*Courts of Justice Act*].
[768] Section 137.1(4) (as amended) of the *Courts of Justice Act* provides that "[a] judge shall not dismiss a proceeding under subsection (3) [of section 137.1] if the responding party satisfies the judge that, (a) there are grounds to believe that, (i) the proceeding has substantial merit, and (ii) the moving party has no valid defence in the proceeding; and (b) the harm likely to be or have been suffered by the responding party as a result of the moving party's expression is sufficiently serious that the public interest in permitting the proceeding to continue outweighs the public interest in protecting that expression": see *Courts of Justice Act*, s 137.1(4).
[769] *Able Translations Ltd v Express International Translations Inc*, 2016 ONSC 6785 at para 83 (as cited in *Thompson v Cohodes*, 2017 ONSC 2590 at para 30 [*Thompson*]).
[770] Section 137.1(7) (as amended) of the *Courts of Justice Act* provides that "[i]f a judge dismisses a proceeding under [section 137.1], the moving party [of the motion] is entitled to costs on the motion and in the proceeding on a full indemnity basis, unless the judge determines that such an award is not appropriate in the circumstances"): see *Courts of Justice Act,* s 137.1(7).
[771] Section 137.1(9) (as amended) of the *Courts of Justice Act* provides that "[i]f, in dismissing a proceeding under this section, the judge finds that the responding party [to the motion] brought the proceeding in bad faith or for an improper purpose, the judge may award the moving party [to the motion] such damages as the judge considers appropriate": see *Courts of Justice Act,* s 137.1(9).
[772] See *Thompson, supra* note 769.
[773] *Ibid* at para 40.
[774] *Ibid* at paras 32–36.

party (i.e., the short campaigner) is enriched at the expense of another (i.e., the target company or its shareholders) in a manner that the law deems as unjust – that is, without any "juristic reason" or legal justification. Conceptually, a successful claim for unjust enrichment could potentially require those who profited in a short campaign to disgorge those profits, regardless of the damages the target company is able to prove. To be successful, however, the target company would need to establish that the short campaigner obtained an enrichment or benefit, that the target suffered a *corresponding* loss or deprivation, and that there was no legal right for the short campaigner's benefit. It may be very difficult to establish a relationship between the target company's losses and the gains made by a short seller. Other factors are at play in the capital markets – considerations such as price discovery complicate establishing any direct connection between the short seller's profits, which are based on the difference between the price at which the seller can sell the target company's shares and then acquire shares to cover its sales, and the target company's losses. Similarly, it may be very difficult to demonstrate that these profits were made unjustly, as shares are sold by willing sellers and bought by willing purchasers.

5.4.1.4 Intentional Interference with Economic Relations

The target of a short campaign could potentially base a claim for intentional interference with economic relations on wrongful conduct aimed at its shareholders, such as fraud or misrepresentation that induce them to sell.[775] The often misunderstood tort of intentional interference with economic relations has been described as creating "parasitic" liability and requires the following: (i) an intent to injure and cause loss to the plaintiff, which in this case is the target company; (ii) interference with the target company's business through illegal or unlawful means; (iii) the unlawful means are directed at a third party, which in this case is the target company's shareholders, who would have their own cause of action as a result of the same unlawful conduct; and (iv) the target company suffered economic loss as a result.[776] What constitutes unlawful means in the context of this tort is likely narrower than what constitutes unlawful means for the purposes of conspiracy.

As with claims based on conspiracy, proving that a short campaigner targeted shareholders with the intention of causing harm to the target will be critical and likely very difficult to establish.

5.4.2 Shareholder Remedies

A corporation is a separate legal person from its shareholders, with its own legal rights and interests. Shareholders "own" the corporation, but so long as the corporation does not dissolve or otherwise wind-up its business generally, they do not have any right to its underlying assets. Rather, shares are a "bundle" of rights, including a right to a proportionate part of the corporation's assets on its winding-up and the right to oversee management through the election of directors at shareholder meetings.[777]

Shareholders face a fundamental problem in recovering damages based on the target company's losses, or even the loss of their investment. Again, market capitalization is not a measure of the market's valuation of the target company; it is not an asset. Under corporate law principles – often

[775] See *Catalyst Capital Group Inc. v. Veritas Investment Research Corp.*, 2016 ONSC 23 at para 39, rev'd on other grounds, 2017 ONCA 85 (where a claim of intentional interference with economic relations survived a motion to strike).
[776] *Bram Enterprises Ltd. v Al Enterprises Ltd,* 2014 SCC 12.
[777] *Re BCE Inc.,* 2008 SCC 69 at paras 34–36.

referred to as the Rule in *Foss v Harbottle*[778] – shareholders do not have an independent right of action based on the loss of value of their shares, because these losses reflect the harm done to the target company. As a general proposition, these actions can only be brought by the target company itself, or by its shareholders on its behalf, with leave of the court under the appropriate corporate statute.[779] Rather, shareholders must find a way to frame their claims in a way that creates a cause of action that accrues to them personally, and that is not merely a reflection of the losses suffered by the target.

Therefore, civil remedies are particularly ill-suited to providing the target company's shareholders with meaningful compensation for their losses. Shareholders may suffer significant financial losses, regardless of whether they sell their shares in the midst of a short campaign or remain shareholders of a company with a diminished market capitalization, which represents the loss in the value of their shares. Shareholders do not have a legally protected interest in either the target company's reputation or its assets. Shareholders who later regret selling their shares during a short campaign have potential claims against short campaigners for damages for their individual losses – most likely sounding in misrepresentation or, potentially, conspiracy or intentional interference with economic relations. Shareholders who do not sell and see the value of their investment diminished in the aftermath of a short campaign have fewer options.

5.4.2.1 Conspiracy

While shareholders could potentially bring claims for damages against short campaigners for conspiracy, an action for conspiracy is not a good fit for shareholder claims. Civil conspiracy, in particular, appears to be a particularly weak claim. Proving that the short campaigners had an ulterior motive of driving down the target company's share price in order to destroy its shareholders' investments risks the appearance of rank speculation verging on conspiracy theory based on personal animus. Such a claim could be very difficult to establish credibly. If the short campaigners did not engage in any unlawful conduct, such as prohibited market manipulation or deception, then the most obvious explanation for why the short campaigners engaged in a short campaign is simply to make money and not to destroy the value of existing shareholders' investments.

Like the target company, however, shareholders would likely have a stronger conspiracy claim if the short campaigners used a disinformation campaign, amounting to deceptive or manipulative market practices or defamation, in order to drive down the share price. Again, the use of unlawful means changes the onus on shareholders – it would be enough to show that the short campaigners knew, or should have known, that the shareholders would be injured as a result of the short campaign.

5.4.2.2 Misrepresentation

Short campaigns often involve a flurry of information about the target company. Shareholders may decide that the concerns raised by the short campaigner is sufficiently credible or worrisome to sell their shares. Depending on the outcome of the short campaign, selling shareholders may regret the

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[778] The Rule in *Foss v Harbottle* has long distinguished between wrongs done to the corporation from wrongs or harm suffered by its shareholders. Shareholders can only sue for wrongs done to them directly and individually, and not for wrongs done to the corporation, even if they suffer indirect economic harm in their capacity as shareholders. Shareholders who want to pursue a remedy on behalf of the corporation must do so through a derivative action brought in the name of the corporation: see *Foss v Harbottle* (1843), 67 ER 189, 2 Hare 461.

[779] See *Canada Business Corporations Act*, RSC 1985, c C 44, s 239. Provincial business corporations acts have equivalent provisions, all of which require a shareholder seeking to bring a derivative action on behalf of a corporation to obtain leave of the court to do so. Leave is contingent on the plaintiff first complying with the statutory prerequisites to a derivative claim, such as giving notice to the corporation's board of directors of his or her intention to apply to the court for leave. Leave will not be granted unless the court is satisfied that the plaintiff is acting in good faith and that the action appears to be in the interests of the corporation. There are certain exceptions, for example, potentially where the corporation has no cause of action it can enforce, but shareholders do have a claim: see also *Meditrust Healthcare Inc. v Shoppers Drug Mart* (2002), 2002 CarswellOnt 3380, 61 OR (3d) 786 at paras 42–43.

decision to divest their interests in the target company, especially if the stock recovers a price that is higher than the price at which they sold. In such cases, selling shareholders who regret liquidating their investment may be able to bring a claim for misrepresentation. Similarly, shareholders who are persuaded by the target company to hold on to their investment may suffer losses if the target company cannot successfully bolster the market's confidence. The target company's public statements may also form the basis of a claim for misrepresentation against the target company and its directors if its response to the short campaign induces shareholders to hold onto their shares. This may be the only recourse for shareholders in the event that the concerns raised by the short campaigner ultimately prove to be true.

Misrepresentation claims can be made when an untrue statement of fact or law is made by one party (i.e., the short campaigner) that induces another to undertake some action (e.g., a shareholder who is induced to buy or sell securities). There are three types of misrepresentation: (i) fraudulent misrepresentation, (ii) negligent misrepresentation and (iii) innocent misrepresentation. Reliance is a key element of any misrepresentation claim – the plaintiff must connect the alleged misrepresentation to a change in position and the losses alleged. The target of a short campaign may not have a claim for misrepresentation since it is difficult to see how the target would rely on any statement made by short sellers to change its position. In contrast, shareholders may very well rely on the statements made by short sellers or the target company in making a decision as to whether to sell or hold the target company's shares. The importance of proving reliance cannot be understated. Each shareholder claiming to have suffered a financial loss as a result of relying on statements made by a short campaigner must establish not only that the statements made were false, but that the shareholder relied (reasonably) on the statements and suffered a financial loss as a result. This makes shareholder claims for misrepresentation against short campaigners difficult to pursue through a class action, and therefore expensive to prosecute.[780]

5.4.2.3 Unjust Enrichment

Shareholders who lose the value of their investment may see the profits made by short campaigners as unfairly earned at the expense of long-term investors. Again, as discussed above, there must be a correlation between the profits earned by the short sellers and the losses incurred by the target company's shareholders. While there is a more direct nexus between a shareholder's decision to sell in a short campaign and the ability of short campaigners to profit, this may not be sufficient to establish that profits made by short sellers resulted in a *corresponding* loss or deprivation suffered by either selling shareholders, or those who retain their investment in the target company. The short sellers' profits represent the difference between the price at which the short sales are made and the cost to settle the sale. It would be exceedingly difficult for any individual shareholder to connect their investment losses to particular profits made given the manner in which securities are traded, and trades are settled, in Canadian marketplaces. It would likely be even more difficult to demonstrate that there was an absence of a legal justification or excuse for the losses – again, shares are sold by willing sellers and bought by willing purchasers on capital markets.

5.4.2.4 Intentional Interference With Economic Relations

A shareholder claim for damages based on the tort of intentional interference with economic relations may offer shareholders a way to seek a personal remedy for harms they suffer as a result of a successful short and distort campaign. Again, as discussed above, this is a "parasitic" tort in that a

[780] The problems posed by the requirement to prove individual reliance was the motivation for the introduction of section 138 to the OSA, which provides a statutory cause of action for misstatements by a reporting issuer in public disclosures but eliminates the need for investors to prove reliance.

shareholder claim is contingent on short campaigners engaging in wrongful conduct aimed at the target company, such as defamation or unlawful conspiracy, such as a misleading short campaign.

Shareholders claiming damages based on intentional interference with their economic relations would need to establish the following: (i) the short campaigner intended to cause shareholders economic loss or harm; (ii) the short campaigner interfered with the shareholders' economic interests through illegal or unlawful means; (iii) those illegal or unlawful means were directed at a third party, namely the target company, and the target company has its own cause of action against the short campaigners as a result, such as conspiracy or defamation; and (iv) the shareholders suffered economic losses, such as the loss of their investment, as a result.[781]

The tort is still in development and the relationship between a shareholder claim for intentional interference with economic relations and the rule in *Foss v Harbottle* is not well explored.[782] Certainly, shareholder claims based on this tort could be vulnerable to a motion to strike on the basis that the claims are truly derivative of the harms suffered by the target, and are not independent shareholder claims. Whether this tort offers shareholders any meaningful prospect for recovering their economic losses at the end of a short campaign remains to be seen.

[781] See *Quadrangle Group LLC v Canada (Attorney General)*, 2015 ONSC 1521 (which was not a short selling case, but was an action by shareholders to recover the value of their lost investment in Mobilicity).
[782] The Ontario Superior Court rejected *Foss v Harbottle* as a basis to strike a shareholder claim for intentional interference in economic relations in this case, where the losses suffered by shareholders (that of their investment) were considered to be separate from the losses suffered by the corporation): see *ibid* at paras 17–18 and 28–29.

6. NAKED SHORT SELLING

6.1 What is Naked Short Selling

Naked short selling is not explicitly defined in UMIR or any other Canadian statutes or regulations. It commonly refers to the short sale of securities where arrangements are not made to borrow the securities necessary to settle the trade. However, regulators would likely define naked short selling as a prohibited short sale. For purposes of Section 6, we will adopt the more common definition of naked short selling.

While IIROC has stated that naked short selling is not permitted under UMIR,[783] it has also confirmed that Rule 2.2 of UMIR does not require a Participant or Access Person that is entering into a short sale to make a "positive affirmation" that it can borrow or otherwise obtain the securities necessary to settle the trade prior to entering the order.[784] Accordingly, all that is required is a "reasonable expectation" that the trade can be settled. However, there is no definitive guidance from IIROC as to what exactly meets this "reasonable expectation" standard. Instead, IIROC has made it clear that the "reasonable expectation" standard, which forms the basis of what constitutes prohibited short selling, is focused on whether the purpose of the trade is manipulative or fraudulent, and on limiting failed trades:

> The [reasonable expectation standard] merely requires that the vendor not make a sale *knowing* that the securities cannot be borrowed and that the vendor take "reasonable steps" to attempt to borrow the securities to make delivery on closing. Having made a sale of a security that has failed to settle because of an inability to borrow the security, a person should not undertake further short sales of that security without knowing where the securities to complete the additional sales will be obtained.[785] [emphasis added]

Accordingly, one may effect a short trade without knowing that the trade can be settled and remain in complete compliance with UMIR, so long as at the time of placing the order, the seller had an intention of covering the trade. In other words, naked shorting, in the more common definition of the term, is not prohibited by the letter of the law, as there is no requirement to arrange for the securities sold to be located or borrowed prior to entering into the short sale.

In the US, Regulation SHO requires that broker-dealers must have either borrowed or entered into an arrangement to borrow the security, or have reasonable grounds to believe the security can be borrowed in time for delivery on the settlement date.[786] ESMA goes even further and requires disclosure of evidence of firm arrangements prior to settlement. Similarly, in Australia, the short seller must have a presently exercisable and unconditional right to vest the shares in the buyer, which can be achieved by a securities lending arrangement, or any other legally binding commitment to deliver the securities before the settlement date.[787] In light of the lack of guidance on a subjective standard and the generous allowance of 10 trading days after the expected settlement date before a failed trade has to be reported in an EFTR, it would appear that there could be a greater number of naked short sales that go undetected in Canada when compared to other markets.

It is important to note that certain types of naked short selling form an integral part of our capital markets. For example, market makers engage in naked short selling to provide liquidity in the market,

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[783] *IIROC Notice 12-0078, supra* note 62 at 9.
[784] *Ibid.*
[785] *Market Integrity Notice 2004-017, supra* note 147 at pages 25–26.
[786] *Regulation SHO, supra* note 393 at § 242.203(b).
[787] See Section 4.4.

which is essential to an efficient market. In the US, market makers are exempt from the SEC's ban on naked short selling under Title 17 of Regulation SHO. In Canada, UMIR provides certain exemptions for market participants that have "Marketplace Trading Obligations",[788] which allows market makers to act swiftly without having to cover their transactions (see Section 2.1.2.2).

6.2 Prevalence of Naked Short Selling and Risks to the Market of Such Activity

The implications of naked short selling may be serious to both investor confidence and market integrity. In fact, it may increase systemic risk. Naked shorting is likely to increase failed trades, which may prove highly disruptive to capital markets.[789]

Also, naked short selling will likely create "phantom" or "counterfeit" shares by artificially increasing the number of shares traded, where shares are being sold – and therefore purchased – without being covered.[790] As a practical matter, this cannot increase the actual number of shares outstanding, but may nevertheless artificially increase shares by effecting a trade without a connection to any physical shares.[791] This may also impact voting rights.[792]

Additionally, price discovery, which is clearly a key benefit of short selling, is likely skewed by naked short selling:

> While temporary price reductions will rebound quickly in covered short sales, this correction will not occur promptly in a naked short sale. Securities market regulators believe that market manipulators use naked short selling to force prices below values that would be possible in covered short selling by creating relatively long-term excess supplies of a stock disproportionate to the number of shareholders willing to lend shares. Moreover, when naked short sellers must cover their positions, they create excess demand for stocks. Thus, naked short selling creates more volatility than covered short selling because naked short sellers can push stock prices down and pay inflated prices to cover their positions.[793]

Moreover, naked short selling provides more economic incentives for persons to participate in manipulative activity, such as short and distort schemes, in light of the need to deploy less capital before pursuing such trades, particularly where borrowing rates are high, or simply to pursue targets in circumstances where shares cannot be borrowed.

Nevertheless, there are proponents who argue that naked short selling will not raise systemic risk issues in the Canadian market and is, in fact, an essential part of the market, particularly for liquidity purposes. Commentators have suggested that while there are borrowing facilities in the Canadian market, it is not practically possible to borrow most non-TSX-listed ("**venture**") stocks and a pre-borrowing requirement would effectively result in a prohibition of short trading in the venture

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[788] See *supra* note 43 (for the definition of "Marketplace Trading Obligations" under UMIR 1.1).
[789] IOSCO, *Regulation of Short Selling Final Report*, *supra* note 394 at 21.
[790] Citizens for Securities Reform, "White Paper: Counterfeiting Stock 2.0", online (pdf): *Counterfeiting Stock* <counterfeitingstock.com/CS2.0/CounterfeitingStock20Full.pdf>.
[791] *Ibid.*
[792] A significant level of or persistent failed trades, whether as a result of naked shorting or otherwise, may have adverse consequences for shareholders who may be relying on the delivery of those shares for voting and lending purposes. See US Securities and Exchange Commission, Federal Register, "Amendment to Regulation SHO" Release No. 34-56212 (7 August 2007), online (pdf): *US Securities and Exchange Commission* <www.sec.gov/rules/final/2007/34-56212fr.pdf>.
[793] See McGavin, *supra* note 381 at 205–206.

markets.[794] It is also suggested that dealers use naked short selling in the junior markets as an effective tool to "prevent junior stocks from being bid up to unreasonable levels".[795] It is clear that IIROC is aware of these views and, as recently as October 2017, the following was reported:

> During a roundtable discussion last year, officials at small-cap firms told IIROC officials they believed some dealers were "unlawfully allowing short sales to occur to the detriment of shareholders and the issuers of these securities," according to Victoria Pinnington, senior vice-president of market regulation at IIROC.
>
> In particular, there was a perception that the back offices of some dealers were allowing for delayed delivery of securities to cover short sales, she said.[796]

IIROC's and the proponents' defence of the reasonable expectation standard and naked short selling is based on the view that failed trades, even in the junior market, are extremely low and therefore naked short selling is not a concern. IIROC also asserts that the predominant cause of failed trades is administrative delay or error, and that very few failed trades are the result of, or in connection with, short selling activity (see Section 7.4.1.2).[797]

However, given the fact that failed trades are not publicly reported, and that the settlement process (see Section 2.4.6) and UMIR give short sellers a significant period of time to cover short sales before a reporting requirement with respect to the trade failure is triggered, it would appear that the actual concerns of naked short selling and failed trades are not fully captured and visible to the market. Furthermore, settlement disruption is not the only systemic risk related to naked short selling.

Nonetheless, even if we limit our review of risks to failed trades, IIROC's focus on failed trades across the entire market may not be helpful to detect or understand systemic risk. Systemic risk can result from the failure of one or a few key companies, and it may therefore be helpful to focus on failed trades in connection with short campaigns on specific companies to provide more meaningful insights into the actual impact of naked short selling and failed trades.

Two days after Kerrisdale Capital Management LLC released its negative report (the "**Kerrisdale Report**") with respect to Northern Dynasty Minerals Ltd. ("**Northern Dynasty**") on February 14, 2017, the number of fails-to-deliver on the NYSE spiked from 5,722 on February 13, 2017, to 300,140 on February 16, 2017.[798] Additionally, the period between March 1 to March 7, 2017, being 11 to 15 trading days after the date of the report, saw another dramatic increase in the number of fails-to-deliver on the NYSE[799] – ranging from 1,720,851 on March 1, 2017 to 191,752

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[794] Letter from the Investment Industry Association of Canada to the Investment Industry Regulatory Organization of Canada (26 May 2011) at 3, online (pdf): *Investment Industry Association of Canada* <iiac.ca/wp-content/themes/IIAC/resources/1566/original/IIAC%20Response%20letter%20re%20Short%20Sale%20Regs%20-FINAL%20(2).pdf>. *IIAC 2011 Comment Letter, supra* note 323 at 3.

[795] *Ibid.*

[796] Shecter, *Is Canada Ready? supra* note 619.

[797] According to *IIROC Notice 08-0143 supra*, note 59, the 2006 study conducted by RS found that failed trades only accounted for 0.27% of the total number of trades executed, and while the more "junior" the marketplace in terms of the type of security traded, the higher the incidence of failed trades, the number was still only between 0.90% and 2.22%. The study also found that:

(a) administrative delay or error accounted for almost 51% of failed trades;
(b) less than 6% of failed trades resulted from short sales;
(c) failed trades involving short sales accounted for only 0.07% of total short sales;
(d) buy-ins were executed in only 4% of failed trades; and
(e) the average failed trade was settled 4.2 days after the "expected settlement date", with 96% of failed trades settled within 10 days after the "expected" settlement date.

[798] US Securities and Exchange Commission, "Fails-to-Deliver data" (accessed August 2019) at February 2017 first half and February 2017 second half, online (zipped file): *US Securities and Exchange Commission* <www.sec.gov/data/foiadocsfailsdatahtm> [SEC, *Fails-to-Deliver data*].

[799] US Securities and Exchange Commission, *"Fails-to-Deliver data", supra* note 798 at March 2017, first half.

on March 7, 2017.[800] This appears to suggest that a significant increase in naked shorting occurred around the time of the short campaign.

Further, looking at the number of fails-to-deliver and the volume of shares traded on the NYSE with respect to Northern Dynasty from February 12, 2016, to February 14, 2018, approximately the one-year periods prior to and following the Kerrisdale Report, it is possible to see that the number of fails-to-deliver was not stable and did not correspond with trading volumes. Rather, the number of fails-to-deliver increased significantly in some periods, including in the weeks before and after the Kerrisdale Report. See Figure 1 below. The volume of shares traded spiked to the highest numbers during the period studied immediately after the date of the Kerrisdale Report. See Figure 2 below. The considerable increase in the volume of shares traded immediately following the Kerrisdale Report was matched with a significant decrease in the share price of Northern Dynasty.

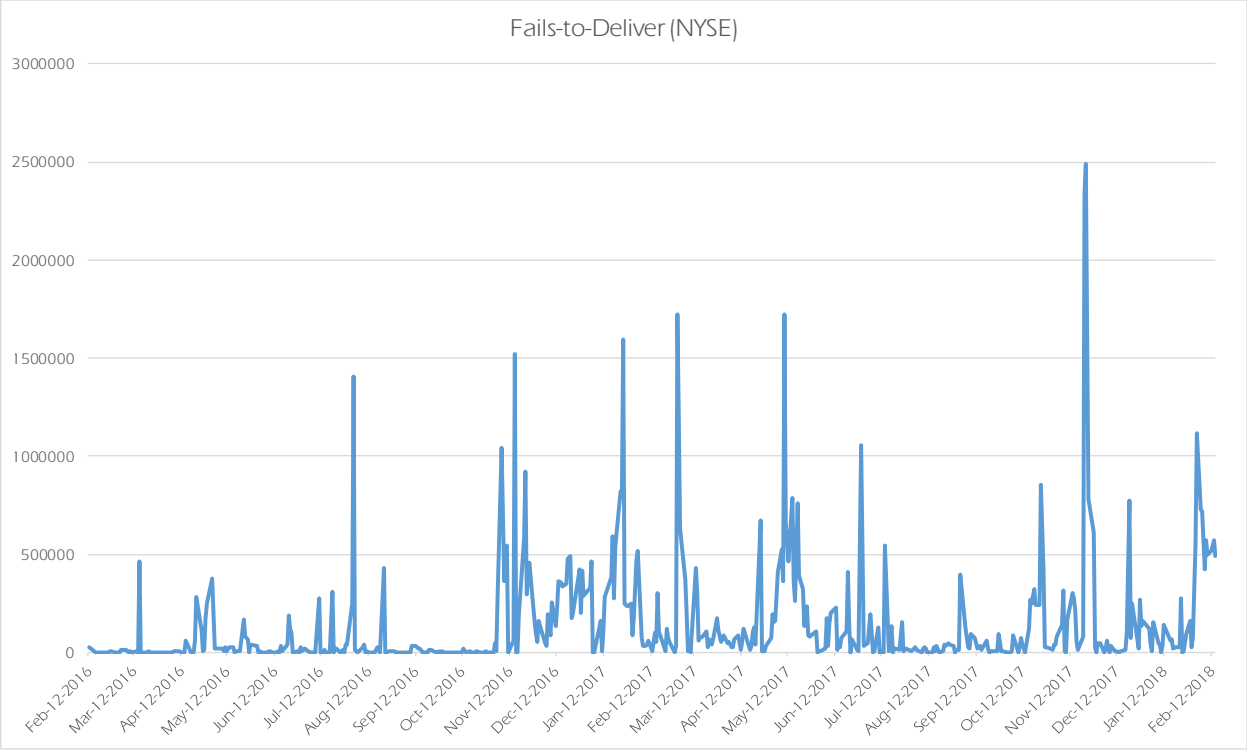

Figure 1: Number of fails-to-deliver of Northern Dynasty Minerals Inc. on the NYSE from February 12, 2016 to February 14, 2018.

[800] The number of fails-to-deliver gradually decreased as follows: 1,720,851 on March 1, 2017; 1,223,045 on March 2, 2017; 630,872 on March 3, 2017; 367,026 on March 6, 2017; and 191,752 on March 7, 2017: see SEC, *"Fails-to-Deliver data", supra* note 798 at March 2017, first half.

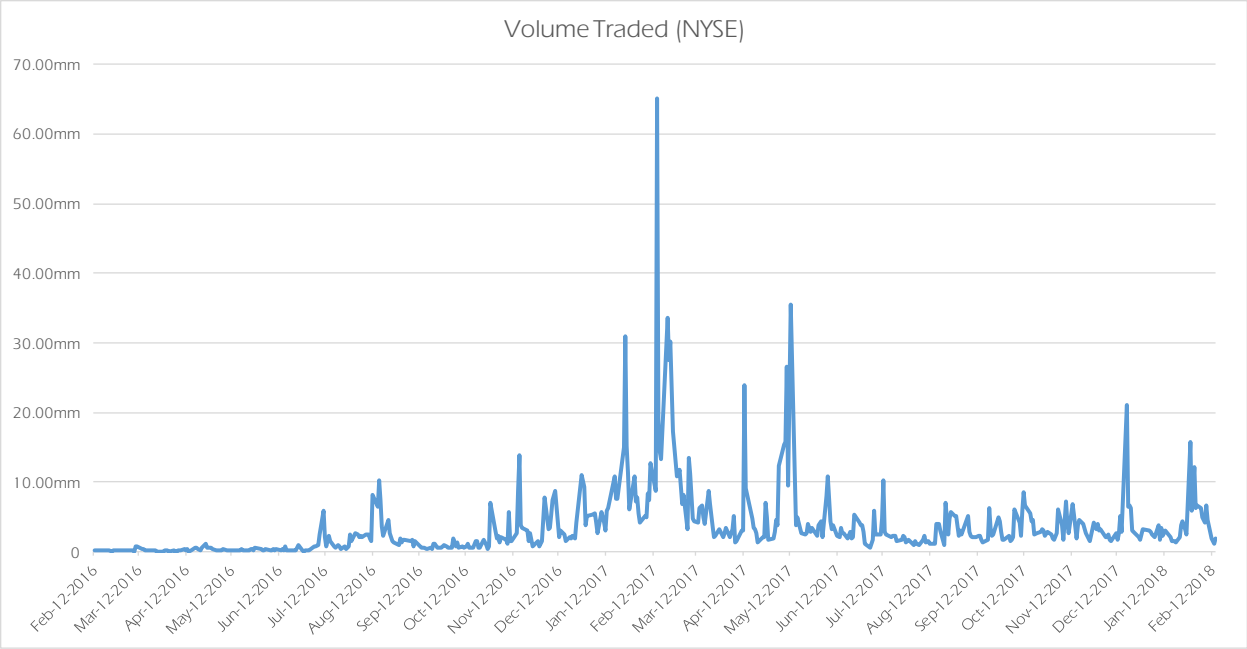

Figure 2: Volume of shares of Northern Dynasty Minerals Inc. traded on the NYSE from February 12, 2016 to February 14, 2018.

When K2 & Associates Investment Management Inc. released its negative report (the "**K2 Report**") on Asanko on June 27, 2016, the number of fails-to-deliver reached 286,608 on July 1, 2016, as compared to 24,276 on June 24, 2016 and 2,071 on June 27, 2016,[801] before settling down again. Interestingly enough, the number of fails-to-deliver was significantly higher in the days leading up to the release of the report – 1,114,789 on June 22, 2016, and 587,398 on June 23, 2016. The number of fails-to-deliver on June 22 and 23, 2016, and on July 1, 2016, were dramatically higher than the surrounding dates,[802] which were generally in the hundreds and thousands. Similarly, the days leading up to and subsequent to May 31, 2017, when Muddy Waters released its report (the "**Muddy Waters Report**") on Asanko, saw abnormally high fails-to-deliver activity on the NYSE, which tapered off by June 12, 2017.[803] Again, this suggests that naked shorting activity occurred around the time of the short campaign, resulting in significant anomalies in the number of fails-to-deliver.

Similar to what was observed for Northern Dynasty, from June 29, 2015, to May 31, 2018, approximately the one-year period prior to the K2 Report and the one-year period following the Muddy Waters Report, the number of fails-to-deliver and the volume of Asanko shares traded on the NYSE experienced abnormal spikes during certain periods, including around the dates of the K2 Report and the Muddy Waters Report. Looking at the data for Asanko, we observed that the number of fails-to-deliver sharply increased immediately prior to the K2 Report and the Muddy Waters Report, with the number of fails-to-deliver reaching the highest point for the period studied immediately prior to the Muddy Waters Report. See Figure 3 below. The volume of shares traded increased substantially immediately prior to the K2 Report, as well as before and after the Muddy Waters Report. In fact, similar to the number of fails-to-deliver, the volume of shares traded is the highest for the

[801] US Securities and Exchange Commission, *"Fails-to-Deliver data", supra* note 798 at June 2016, second half and July 2016, first half.
[802] *Ibid.*
[803] The number of fails-to-deliver ranged from as high as 1,639,301 on May 24, 2017 to as low as 32,800 on June 5, 2017: see US Securities and Exchange Commission, *"Fails-to-Deliver data", supra* note 798 at March 2017, first half.

period studied soon after the Muddy Waters Report. See Figure 4 below. Looking at the number of fails-to-deliver as a percentage of the volume of shares traded,[804] we observe that the percentage spiked immediately preceding the dates of the K2 Report and the Muddy Waters Report, then decreased following the reports. See Figure 5 below. We suggest that this pattern is in part due to short sellers building short positions prior to the reports and, in some cases, being unable to settle the trade on the expected settlement date, then covering their short sales following the release of the negative reports when the share prices had declined.

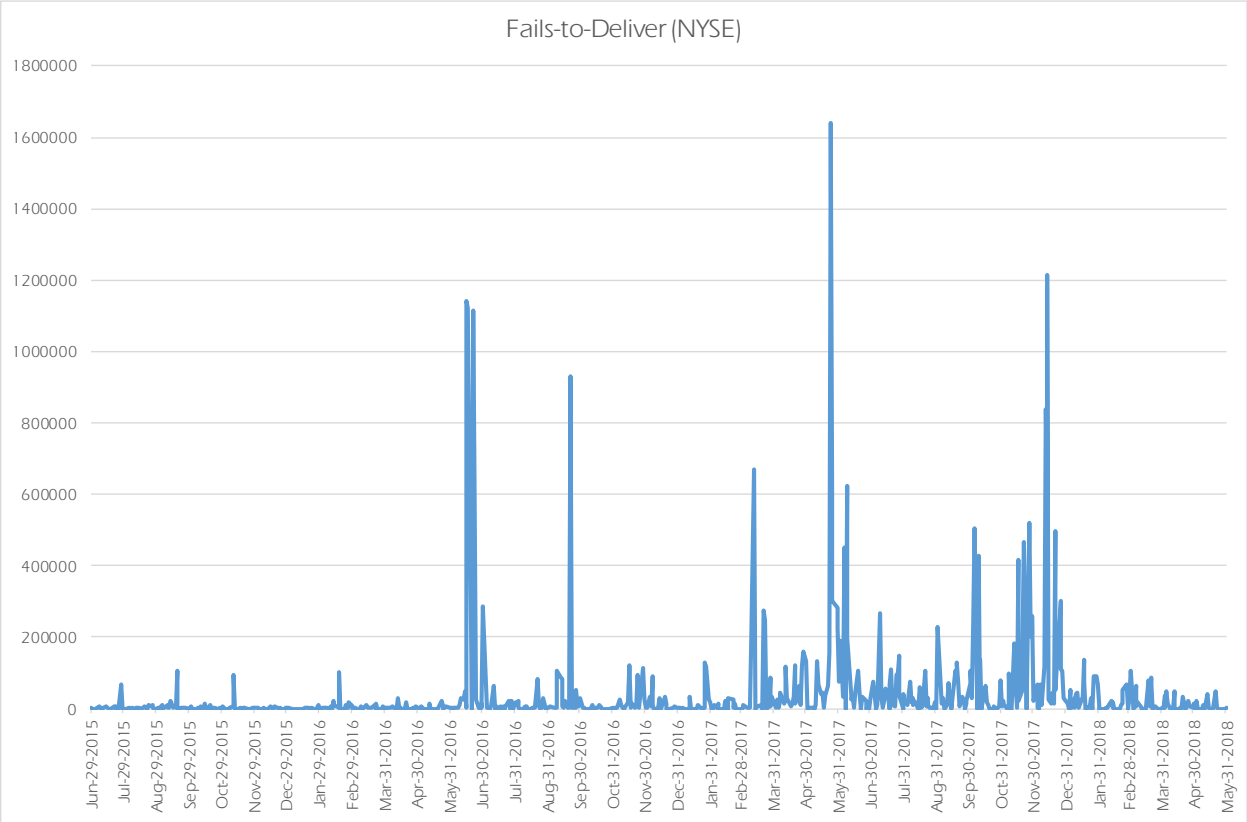

Figure 3: Number of fails-to-deliver of Asanko Gold Inc. on the NYSE from June 29, 2015 to May 31, 2018.

[804] Note that in collecting this data, we matched the volume of shares traded on a particular date to the date that was (i) three trading days following the trade date for dates before September 5, 2017, and (ii) two trading days following the trade date for dates on or after September 5, 2017, in order to account for the standard settlement cycle for equity securities in the US.

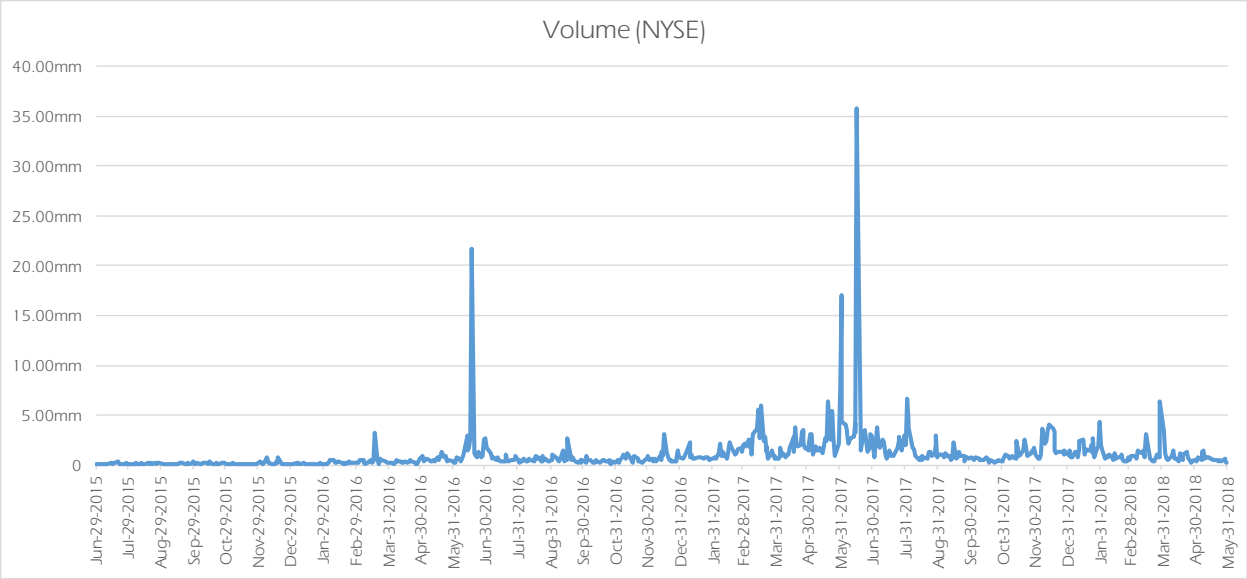

Figure 4: Volume of shares of Asanko Gold Inc. traded on the NYSE from June 29, 2015 to May 31, 2018.

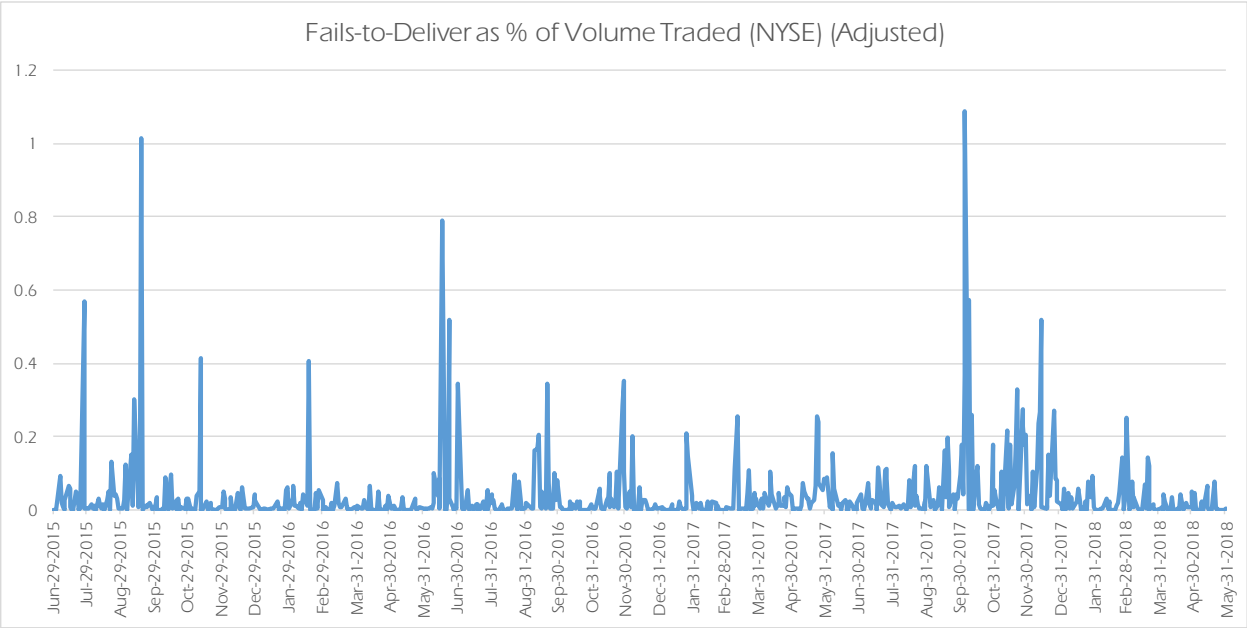

Figure 5: Number of fails-to-deliver as a percentage of volume of shares of Asanko Gold Inc. traded on the NYSE from June 29, 2015 to May 31, 2018. The percentage was calculated by dividing the number of fails-to-deliver on a specific date by the volume traded three trading days prior to such date for dates before September 7, 2017 and two trading days prior to such date for dates on and after September 7, 2017.

If the extraordinary increases in the number of fails-to-deliver and the volume of shares traded experienced by Northern Dynasty and Asanko were with respect to companies that are critical to the Canadian economy, such volatility would represent instances of potential systemic risk. The above data is only in respect of the shares of Northern Dynasty and Asanko traded on the NYSE, as failed trade data is not publicly available in Canada. The patterns observed in the examples above

may also be present in the Canadian data, which would point to the possibility of systemic risk in Canada that needs to be addressed.

6.3 Sanctions Against Naked Short Selling in Canada

There is a dearth of decisions by IIROC and other Canadian regulatory authorities imposing sanctions against illicit short selling activity involving naked shorting in Canada. In the rare event that IIROC or regulators do take action, the short selling activity is typically coupled with one or more other breaches of securities laws or serious acts of misconduct contrary to UMIR.[805] This is in direct contrast to the US, where the SEC has been relatively very active in sanctioning dealers in connection with naked shorting.[806] The lack of sanctions in Canada is likely due to its comparatively relaxed regulatory regime. Relative to the more stringent rules in the US, it is harder for a short seller to be in contravention of Canadian laws in respect of short selling.

For example, in *Re W Scott Leckie*,[807] W. Scott Leckie ("**Leckie**"), who at the relevant time was the Ultimate Designated Person[808] for the Participant firm that employed him, agreed that he contravened UMIR 2.2(2)(b) in respect of trading in shares of Air Canada.

Between April 3 and June 13, 2003, Leckie sold short shares of Air Canada in a client's account with a dealer. The account was opened by Leckie on behalf of the client for such short sales. During this period, the dealer was unable to borrow the shares necessary to cover the client's short position and, as a result, the account was continually being bought in by the dealer at a premium to cover the short position. In order to preserve the short positions, Leckie opened another account for the same client at a different dealer, who was also unable to borrow the shares despite initially indicating he could. Beginning on June 13, 2003, Leckie sold short Air Canada shares in the client's account at the second dealer and then purchased shares into the client's account at the first dealer to cover the short position at the second dealer, then continued these trades until the end of June 2003.

RS found that although Leckie knew that the trades would not result in a change of beneficial ownership, they were not carried out with the intent to manipulate the price of Air Canada shares or to deceive the market, but rather to preserve his client's short position in Air Canada shares. It also noted that the client received no benefit and ultimately lost money on the trades. RS found that Leckie's conduct contravened UMIR 2.2(2)(b) on seven occasions and the parties settled on a fine of $100,000 plus costs of $20,000.

6.4 Ways to Effect Illegal Short Selling – A Look South of the Border

The lack of regulatory sanctioning in respect of short selling does not mean that naked short selling is rare or does not exist. We have noted above the acknowledgment by market participants that naked short selling is prevalent, and under the current regime short sellers can legally enter into transactions that have the effect of naked short selling. In the US, firms have been sanctioned for engaging in such conduct and, while such activities no doubt exist in Canada, there have been very few cases of IIROC – and none found on that issue – or any other regulatory authorities taking actions against firms that engage in such activities.

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[805] See *H&R Enterprises Inc. v Michael Lee Mitton, David Scott Heredia and Jerome Rosen*, 2005 BCSECCOM 612, where Michael Lee Mitton was sanctioned by the BCSC for, among other numerous schemes, effecting undeclared short sales through a cash account at one dealer and subsequently covering the short sale by purchasing the shares through another dealer so as to avoid the margin requirements imposed on short sales.

[806] See Section 4.2.8.

[807] *In the Matter of W. Scott Leckie* (2005), 28 OSCB 6364 at 13.1.5.

[808] An "Ultimate Designated Person" is an individual approved by IIROC to be responsible for the conduct of a designated dealer member and the supervision of its employees and to perform the functions for an Ultimate Designated Person described in IIROC's requirements.

There are many ways to conduct an illegal short sale. For example, one way to effect illegal short selling is by simply marking shares as long when they are in fact short. There are many instances where this type of mismarking has been sanctioned in the US. Several prominent financial institutions have been sanctioned by FINRA and various stock exchanges – some on numerous accounts and by multiple exchanges – for incorrectly marking orders, including reporting short sales as long sales.[809]

Illegal short selling can also occur, whether intentionally or unintentionally, when firms have an inadequate or inaccurate "locate" system to confirm whether securities can actually be borrowed in time to settle a short sale on the delivery date,[810] or when firms rely on inaccurate "easy-to-borrow" lists to locate stock for short selling.[811]

Additionally, in the course of a short campaign, short sellers may intentionally engage in naked shorting with the intent of covering their short position where the share price of the target company has fallen after the trade date, but prior to the need for an EFTR. This allows the short sellers to conduct short campaigns without paying a borrowing fee, thereby deploying less capital.

Two conspiring firms can also achieve the effect of short selling by purchasing a put option for a certain number of shares and matching it to a call agreement, which is never consummated. Instead, the agreement is terminated the day prior to maturity and then a new agreement with respect to the same number of shares is entered into with a new maturity date, which can be repeated numerous times. A short seller may also fulfill a buy-in requirement by further shorting the same security without accurately marking the short, and repeating as necessary, such that in substance the fail trade continues and the short sale is never covered.

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[809] For example, Goldman Sachs was sanctioned by FINRA in June 2014 for inaccuracies in its blue sheet submissions to FINRA, including reporting short sales as long sales on its blue sheets. FINRA also found that Goldman Sachs did not have an adequate audit system in place to provide for accountability of its blue sheet submissions. In July 2006, Goldman Sachs was sanctioned by the NASD for failing to mark order tickets as short and instead incorrectly reporting each transaction as a long sale. In November 2013, Merrill Lynch was sanctioned by NASDAQ for entering orders to sell short and incorrectly identified the orders as long. In August 2009, Morgan Stanley was sanctioned by FINRA for submitting inaccurate short interest position reports. In 2007 and 2008, UBS Securities, LLC was sanctioned by FINRA for mismarking over 10 million sale orders, including short sales mismarked as long sales. Barclays Capital was also sanctioned by FINRA in June 2014 for reporting short sales as long sales on their blue sheets, among other reporting violations. In January 2017, Credit Suisse Securities was sanctioned by FINRA for mismarking tens of thousands of sale orders in its trading system, including short sales that were marked as long. All of these firms have also been sanctioned on numerous other occasions for inaccurately marking or reporting short sale orders.

[810] See example *In the Matter of Goldman, Sachs & Co.,* Release No. 34-76899 (14 January 2016), online (pdf): *U.S Securities and Exchange Commission* <www.sec.gov/litigation/admin/2016/34-76899.pdf>.

[811] See example *In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated and Merrill Lynch Professional Clearing Corporation.,* Release No. 34-75083 (1 June 2015), online (pdf): *U.S Securities and Exchange Commission* <www.sec.gov/litigation/admin/2015/34-75083.pdf>.

7. ANALYSIS AND RECOMMENDATIONS

Above, we canvassed the development of the current short selling regulatory regime in Canada and the significant differences between the Canadian regime and those in the US, the EU and Australia. The differences are stark and raise troubling questions regarding the Canadian regime. We would submit that, in Canada, regulators have favoured liquidity and cost savings (which are clearly very important) above all else, including the reduction of systemic risk.

Based on the foregoing, it is also clear that when compared to other regimes we have reviewed, the Canadian regulatory regime best facilitates short campaigns. This, when combined with the limited ability of shareholders and issuers to defend against short and distort schemes, could have serious consequences from an economic and public interest perspective. In fact, it likely increases systemic risk.

In considering issues of systemic risk, we analyze below key issues that we believe are directly related to whether Canadian securities regulatory authorities are meeting their mandates in connection with the regulation of short selling. The question being whether they are taking sufficient steps to protect investors from unfair, improper and fraudulent practices, and to foster fair and efficient capital markets, as well as contribute to the stability of the financial system and the reduction of systemic risk. In the course of our analysis, we will outline recommendations for change that we believe are necessary to improve investor confidence and market efficiency while appropriately reducing systemic risk.

7.1 Naked Short Selling is Legal in Canada – Failure to Adhere to IOSCO Principle 1

Notwithstanding comments from IIROC to the contrary,[812] naked short selling is legal in Canada. In refusing to impose locate or mandatory pre-borrow requirements for all sales designated as short, IIROC permits naked short selling, unless perpetrated in a manipulative or deceptive manner, meaning to short sell with no intent of delivering the shares on settlement. However, even if such a manipulative and deceptive trade would occur, IIROC appears content with simply ensuring that the perpetrator does not enter into another short sale without having pre-borrowed the security if the manipulative trade continues to fail to settle 10 trading days after the expected settlement date.[813] Industry participants have been clear that naked short selling is not unusual, particularly in the venture market,[814] and even IIROC has recognized that it occurs.[815] Notwithstanding this recognition, IIROC does not think that compulsory buy-ins are necessary.[816]

The cumulative effect of these positions is in direct opposition to IOSCO Principle 1, which provides that short selling activities should be subject to appropriate controls to reduce or minimize the potential risks that could affect the orderly and efficient functioning and stability of the capital markets.[817] In this regard, it is important to remember that the OSC and AMF were members of IOSCO's Technical Committee that put forth these key principles and recommendations.[818] IOSCO believes that there should be a minimum requirement of imposing strict settlement rules for failed trades, as exists in the US and the EU. IIROC believes that the unique attributes of the Canadian market justify a different regulatory regime with respect to this issue. In IIROC's assessment based on

[812] *IIROC Notice 12-0078*, *supra* note 62 at 9.
[813] See section 2.5.2.
[814] *IIAC 2011 Comment Letter*, *supra* note 323 at 3.
[815] *IIROC Notice 08-0143*, *supra* note 59 at 10.
[816] *IIROC Notice 12-0076*, *supra* note 62 at 17.
[817] IOSCO, *Regulation of Short Selling Final Report*, *supra* note 394 at 7.
[818] *Ibid* at 20.

the Failed Trade Study, given that most trade failures result from administrative errors, "hard" close-out provisions are not appropriate.[819] Similarly, in IIROC's view, historic low trade failure rates make it unnecessary to impose general locate or pre-borrow requirements.[820] Interestingly, IIROC does not expressly extrapolate from these studies to conclude that future rates will remain low. In fact, it gives no substantive reason for this historic low rate. Instead, it appears content to rely on the regulatory tools it has to address specific problems in the future on an as-needed and *ad hoc* basis. The studies, which allegedly support these factual assumptions underlying the IIROC regulations, are discussed in Section 7.4. We suggest that at the very least, the studies are not as persuasive as put forward by IIROC, and it may be best to have a new study that is designed and conducted by a qualified third party statistician.

More importantly, however, even if we were to assume that the studies are reliable and justify the conclusions reached by IIROC, we are puzzled as to why such conclusions would lead IIROC to deduct that IOSCO Principle 1 is simply not applicable to Canada. Historically low numbers of failed trades that are predominantly derived from administrative errors are not a justification for ignoring systemic risk. Systemic risks occur rarely across the entire market; they usually start with a sector or a large financial institution and then spread to the entire market.[821] What IIROC needs to prove, at a minimum, is that naked short selling and failed trades are not increased in circumstances when significant companies or key sectors in Canada are under direct attack or distress, such as in a short campaign or a financial crisis. As we note in Section 7.4.2.2, IIROC and the CSA have in fact disclosed data that proves the opposite with respect to failed trades. The ability to use certain tools, such as designations of Short Sale Ineligible Security or Pre-Borrow Security, in a defensive manner does not reduce systemic risk. These reactionary tools can be used to slow down or divert an oncoming disaster, not prevent one. We would suggest that a Canadian securities regulator's mandate requires bolder action. It is critical to remember that IIROC has chosen to not have any front-end (locate or pre-borrow requirements) or back-end (compulsory buy-ins) measures to minimize any potential settlement disruptions.[822]

In our view, the OSC's mandate cannot be satisfied without the imposition of locate or pre-borrow requirements in respect of short sales, subject to limited exceptions. However, we do acknowledge that compulsory buy-ins may not be required depending on the effectiveness of locate or pre-borrow requirements and the breadth of the application of such regulations.[823]

7.2 Lack of Transparency

As outlined in Section 3.2.7.1, on March 2, 2012, the Working Group (the CSA and IIROC) issued the Joint Notice requesting comments on disclosure and transparency measures on short sales and failed trades in Canada.[824] After considering six comment letters, the Working Group concluded that there was no consensus among the commentators and no improvements were needed.[825] IIROC committed to conducting additional empirical studies, "which will help to inform the discussion of whether additional measures may be either needed or desirable in the regulation of short sales and failed trades or to improve transparency",[826] but has failed to carry through on this commitment.

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[819] *IIROC Notice 11-0075*, *supra* note 150 at 36.
[820] *Ibid* at 49.
[821] Corporate Finance Institute, "Systemic Risk", online: *Corporate Finance Institute* <corporatefinanceinstitute.com/resources/knowledge/finance/what-is-systemic-risk/>.
[822] IOSCO, *Regulation of Short Selling Final Report*, *supra* note 394 at para 3.9.
[823] *Ibid* at para 3.7–3.16.
[824] *CSA/IIROC Joint Notice 23-312*, *supra* note 164 at 1.
[825] *IIROC Notice 13-0064*, *supra* note 358 at 2.
[826] *Ibid* at 3.

IOSCO Principle 2 provides that "[s]hort selling should be subject to a reporting regime that provides timely information to the market or to market authorities" [emphasis added].[827] It was noted that local jurisdictions should consider some form of reporting of short selling information to the market instead of just to market authorities, unless it was considered inappropriate to disclose information to the market.[828] Transparency to the market was considered to be important for various reasons, including the following:

- Timely information on short selling would provide market users with an early signal that there may be material grounds for considering individual securities to be overvalued.

- The removal of uncertainty as to how much selling in a share was short or long selling might improve investors' willingness to trade. This is particularly important given the adverse impact that rumours of short selling can sometimes have on trading.

- Information that sales are short creates an awareness that, at some future point, many of those sales will need to be reversed by new purchases.

- Greater transparency may tend to deter attempts at market abuse.[829]

On the other hand, there has been much commentary regarding the risks of transparency with respect to short selling:

- increased transparency leads to the burden of procedural changes and higher costs for reporting;[830]

- increased transparency may lead to more abuse or manipulation,[831] or may simply be ambiguous and open to various interpretations;[832]

- "excessive transparency could alter the risk-reward ratio for short sellers to a degree that the price-correcting benefit of short selling (and the accompanying liquidity) is reduced";[833] and

- transparency may leave short sellers more vulnerable to short squeezes in general, but it often makes it easy for other market participants to determine the identity of the short seller and use that information competitively to move the market against the short seller.[834]

We do not find any of the foregoing arguments against transparency persuasive, except for the concerns regarding costs. There must always be a consideration of the trade-off between costs – both financial and in terms of risks to the markets – and benefits with respect to any regulation. This is particularly important since the OSC, in coordination with the Ontario Ministry of Finance, has

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[827] IOSCO, *Regulation of Short Selling Final Report*, *supra* note 394 at 10.
[828] *Ibid* at 10.
[829] *Report on Transparency of Short Selling,* IOSCO Technical Committee Final Report (June 2003) at 14–15, online (pdf): *International Organization of Securities Commissions Technical Committee* <www.iosco.org/library/pubdocs/pdf/IOSCOPD147.pdf > [IOSCO, *Report on Transparency of Short Selling*].
[830] *Scotia 2012 Comment Letter*, *supra* note 360 at 2. See also *CNSX 2012 Comment Letter*, *supra* note 362 at 2.
[831] *CNSX 2012 Comment Letter*, *supra* note 362 at 3.
[832] IOSCO, *Regulation of Short Selling Final Report*, *supra* note 394 at para 3.18.2.
[833] *Ibid.*
[834] IOSCO, *Report on Transparency of Short Selling*, *supra* note 829 at 15.

recently established a "Burden Reduction Task Force" to focus efforts and to identify steps that can be taken to save time and money for issuers, registrants, investors and other market participants.[835]

The argument that data may be ambiguous and open to various interpretations, as noted by IOSCO, "is not necessarily a good reason why data should not be more widely available, especially if any explanation as to its limitations is also available."[836] We will address in Section 7.2.4 whether the disclosure of individuals and their significant short positions is advisable or in the public interest. Beyond the question of the form this disclosure should take, it is not clear how the disclosure of short selling information could negatively affect price discovery to the point of negatively impacting liquidity and the other benefits of price discovery. With respect to the negative action that may be taken against short sellers if there is disclosure of aggregated information, any aggregate disclosure of short selling has the risk of causing issuers and other market participants to take steps against short sellers, and it is not clear why short sellers should be treated so differently than other sellers or purchasers of shares. Aggregate long data is readily available on a moment-by-moment basis and, absent clear policy reasons, we do not accept that short selling information should be treated differently. Securities regulators have repeatedly championed the merits of transparency[837] and that position should be applauded and supported.

In considering enhanced transparency under the Canadian regulatory regime, we will review four key issues below: (i) the disclosure of gross short position data versus net data, (ii) the disclosure of failed trades, (iii) the frequency of reporting, and (iv) whether individual non-anonymous disclosure should be required.

7.2.1 Disclosure of Gross Versus Net Positions

IIROC publishes two reports with respect to short selling – the CSPR and the SSTSSR. Neither the CSPR nor the SSTSSR include any information about individual Participant accounts, client accounts or individual trades. Both reports contain aggregated gross short positions and gross trades, not net positions or trades.

IIROC had previously recommended abandoning CSPRs for various reasons, including that (i) their preparation imposed administrative burdens; (ii) IIROC did not use CSPRs extensively; and (iii) CSPRs did not provide a complete or meaningful picture of the short position in any security, and did not reflect short positions in securities held by US-based or foreign dealers, non-Participant dealers, custodians, other institutions that are members of CDS or securities listed on the CSE.[838] Note that CSPRs now include short positions for securities traded on the CSE. IIROC ultimately abandoned this proposal on the basis that it would wait until it was satisfied that adequate information on short sales executed on a marketplace had become generally available.[839]

There is no doubt that net reporting on an account or individual basis would be more helpful. Gross data is likely to be misleading and to exaggerate short positions. For example, shorting to cover a position in respect of an unexercised in-the-money warrant is likely not deserving of being publicly disclosed as a true short position and likely distorts information. It is acknowledged, however, that where the disclosure obligations are imposed on Participants and other regulated institutions – and

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[835] *Burden Reduction*, OSC Staff Notice 11-784 (14 January 2019) at 1, online (pdf): *Ontario Securities Commission* <www.osc.gov.on.ca/documents/en/Securities-Category1/sn_20190114_11-784_burden-reduction.pdf>.
[836] IOSCO, *Regulation of Short Selling Final Report*, *supra* note 394 at para 3.18.2.
[837] See *CSA Consultation Paper 91-407 – Derivatives: Registration*, (2013) 36 OSCB 4116, online (pdf): *Ontario Securities Commission* <www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20130418_91-407_derivatives-registration.pdf>. See also US Securities and Exchange Commission, Press Release, "SEC Adopts Rules to Increase Transparency in Security-Based Swap Market" (14 January 2015), online: *US Securities and Exchange Commission* <https://www.sec.gov/news/pressrelease/2015-6.html>.
[838] *Market Integrity Notice 2007-017, supra* note 214 at 26.
[839] *IIROC Notice 08-0143, supra* note 59 at 6.

not on individual account holders – disclosure obligations on a net position may prove to be difficult and costly. In fact, in our comparative study in Section 4, we found no examples of direct disclosure obligations in respect of net positions being imposed on regulated market participants.[840] IOSCO did not express a preference for gross or net positions,[841] and in light of our recommendation below that individual reporting is not required to satisfy the mandate of securities regulators in Canada, we do not recommend net reporting. To the extent additional costs need to be incurred to address deficiencies in the Canadian short selling regulatory regime, they can be better spent in adoption of other more important improvements.

We would note, however, that it may be prudent for the CSA to seek to obtain more complete information by causing other Canadian market participants, such as custodians or other institutions that are members of CDS, to publicly disclose aggregate gross short information so that the market may have more complete and accurate data on short selling.

7.2.2 Disclosure of Failed Trades

Effective June 1, 2011, IIROC began to receive EFTRs regarding trades that failed to settle through CNS[842] for 10 trading days following the scheduled settlement date. CDS also provides daily information to the OSC on failed trades in the CNS system – i.e. trades that fail to settle after settlement date – which IIROC accesses. As of February 2013, IIROC had noted that the data from EFTRs and from CDS "has not shown any trends that would give rise to concerns about fails."[843] IIROC has also committed to continue monitoring this information.

In the Joint Notice, IIROC sought comments as to whether the disclosure of failed trade data was warranted and noted that:

> Reporting [failed trade] rates would provide a means of comparing information on short positions and short selling with trade failures during the same period, therefore allowing the reader to determine whether rates of trade failure may be correlated with rates of short selling of a particular security.[844]

Of the seven comment letters received, three were in favour of disclosing failed trades and one was in favour of more public disclosure of information regarding short sales.[845] It was suggested that failed trade data would assist in timely settlement,[846] detecting trade anomalies or deceptive activity,[847] and may address operational risks.[848]

Only two comment letters were against the disclosure of failed trade data based on IIROC's conclusion that they are not an issue in Canada.[849] One letter argued that such disclosure would

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[840] In Australia and the EU, short interest positions are reported by the short seller directly to the regulator.
[841] IOSCO, *Regulation of Short Selling Final Report*, *supra* note 394 at para 3.23.3.
[842] The requirement to file an EFTR with respect to trades executed on a marketplace that were to settle through the TFT facility of CDS became effective on April 15, 2013: see *IROC Notice 13-0014*, *supra* note 56 at 1. See also *IIROC Notice 11-0161*, *supra* note 265 at 1.
[843] *IIROC Notice 13-0064*, *supra* note 358 at 4.
[844] *CSA/IIROC Joint Notice 23-312*, *supra* note 164 at 2102.
[845] See *TD 2012 Comment Letter*, *supra* note 360 at 4. See also *FAIR Comment Letter*, *supra* note 360 at 2. See also Comment Letter from OpsRisk Limited to the Investment Industry Regulatory Organization of Canada (19 March 2012) at 2, online (pdf): *Ontario Securities Commission* <www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120319_23-312_sommersf.pdf> [*OpsRisk Limited Comment Letter*]. See also *Scotia 2012 Comment Letter*, *supra* note 360 at 3.
[846] *Scotia 2012 Comment Letter*, *supra* note 360 at 3.
[847] *TD 2012 Comment Letter*, *supra* note 360 at 4.
[848] *OpsRisk Limited Comment Letter*, *supra* note 845 at 4.
[849] See Comment Letter from the Investment Industry Association of Canada to the Investment Industry Regulatory Organization of Canada (31 May 2012) at 3–4, online (pdf): *Ontario Securities Commission* <www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120531_23-312_coplands.pdf> [*IIAC 2012 Comment Letter*]. See also *CNSX 2012 Comment Letter*, *supra* note 362 at 4.

not be valuable given the time and effort that would be required to comply.[850] The other letter noted that the publication of failed trade rates and the reasons therefor would require subjective analysis of the information, thereby requiring participants to develop more detailed policies and procedures.[851] However, as noted by the IOSCO's Technical Committee on short selling,[852] such concerns can be addressed by explanations as to the limitations of the data. More importantly, however, as noted in Section 4.5, the Canadian regime has deviated from other regimes without adequate explanation, as failed trade data is disclosed in the US and Australia, and although limited failed trade data is now available in the EU, this will likely change in September 2020.

We believe that this particular failure of transparency is the most surprising and, to some extent, counterintuitive. IIROC has predicated much of the deviations from the IOSCO Four Principles and the regulations of other regimes on the alleged low number and percentage of failed trades in Canada, and yet it has refused to disclose such data. This does not assist with investor confidence in our capital markets, nor market efficiency. We strongly recommend that failed trades, not just EFTs, be disclosed at least twice per month; but, as we note below, we see no reason why daily disclosure is not feasible and appropriate.

7.2.3 Frequency of Reporting

We would suggest that transparency can only be achieved through timely disclosure. Each of the benefits of transparency set out in Section 7.2 are diluted – and, in some cases, may be negated – with delays in disclosure. For example, the benefits of price discovery and deterring attempts at market abuse are best achieved with timely disclosure. A delay in disclosure of such information for two weeks is not optimal.

We acknowledge that much of the disclosure on short selling in various jurisdictions does not occur daily.[853] However, several SROs in the US provide daily aggregate short selling volume information for individual equity securities on their websites.[854] Also, most data, particularly with respect to short sale volume and failed trades, are collected daily, including in Canada. We would expect that the cost of providing daily disclosure, particularly where such information is already available, such as failed trades and short trades, would be minimal, particularly when measured against the benefits articulated above.

We reiterate that, absent a clear policy or public interest rationale, it is not clear to us why less onerous requirements should be imposed on short trades than those imposed on long trades. Short trading has greater potential to inflict harm on the markets and the economy, and timely transparency appears to be a logical and constructive means to limit the negative potential of short selling and enhance its benefits.[855] We therefore recommend daily disclosure of aggregate short positions, short trading and failed trades.

7.2.4 Individual Disclosure of Significant Short Positions Not Warranted

On December 7, 2015, the Executive Vice President, General Counsel and Chief Regulatory Officer of NASDAQ penned a letter (the "**NASDAQ Letter**") addressed to the SEC imploring it to take action to impose public disclosure requirements on investors in respect of their short positions "in parity

[850] *IIAC 2012 Comment Letter, supra* note 849 at 3–4.
[851] *CNSX 2012 Comment Letter, supra* note 362 at 4.
[852] IOSCO, *Regulation of Short Selling Final Report, supra* note 394 at para 3.18.2.
[853] European Central Bank, *Settlement Fails Report 2011, supra* note 478 at 4; US Securities and Exchange Commission, "Key Points about Regulation SHO", *supra* note 384 at IV.
[854] US Securities and Exchange Commission, "Key Points about Regulation SHO", *supra* note 384 at IV.
[855] IOSCO, *Regulation of Short Selling Final Report, supra* note 394 at paras 1.3, 1.5, 1.6, and 3.18.2.

with the required disclosure of long positions, including the timing for such disclosure and when updates are required."[856] Similar calls for regulatory changes have been made in Canada.

As outlined above in Section 4, the EU is the only jurisdiction we reviewed in this paper that requires individual disclosure of positions on a non-market-aggregated, non-anonymous basis. The reasons stated for such disclosure are:

- to provide regulators with early warning signs of a build-up of large short positions;
- to provide regulators with increased capacity to monitor circumstances and recognize potentially abusive behaviour, and that without such disclosure, the identification of significant short positions would require significant resources;
- to assist in identifying unusual short selling activity and the ability to determine whether intervention is required; and
- to assist in the goal of achieving a measure of behavioural change by constraining aggressive large-scale short selling, which may involve unacceptable risks of abuse or disorderly markets.[857]

Each of the regulatory considerations noted above – except the last – are present in all of the jurisdictions we reviewed, and have been addressed by other means of transparency.[858] With respect to the need to impose individual non-anonymous disclosure for the purpose of creating behavioural change, we do not accept the premise of the goal. We have seen no evidence, including from EU regulatory authorities, to support that large-scale short selling by an individual increases systemic risk more than short selling by market participants broadly or is directly correlated to illegal activity. In reviewing the EU's rules, it is important to keep in mind that it imposes disclosure obligations for short selling entirely on investors on an individual basis, as opposed to on dealers, and does not disclose short sale volumes. This may explain the need to address systemic risk issues related to short selling by compelling the individual disclosure of significant positions.

Nevertheless, we do see the benefit of individual disclosure, primarily for the reasons outlined in the NASDAQ Letter. However, it is for one of the principal reasons articulated in the NASDAQ Letter – that there should be parity in long and short position reporting – that we have come to the conclusion that the reporting of individual short positions is unwarranted in Canada.

Unlike in the US,[859] long position individual reporting in Canada, other than in respect of insiders, is only required upon the acquisition of beneficial ownership or the control or direction of 10% or more of the outstanding securities of a class of voting or equity securities of a public company.[860] The primary reason for such disclosure was due to the belief that the accumulation of a holding of 10% or more could impact control:

> The early warning system contained in the securities legislation of most jurisdictions requires disclosure of holdings of securities that exceed certain prescribed thresholds

[856] Letter from Edward S. Knight (Executive Vice President, General Counsel and Chief Regulatory Officer of NASDAQ) to Brent J. Fields (Secretary of SEC), "Petition for Rulemaking to Require Disclosure of Short Positions in Parity with Required Disclosure of Long Positions" (7 December 2015) at 1, online (pdf): *US Securities and Exchange Commission* <www.sec.gov/rules/petitions/2015/petn4-691.pdf>.
[857] CESR, *Model for a Pan-European Short Selling Disclosure Regime*, *supra* note 462 at paras 31, 60–64.
[858] See Sections 4.2, 4.3 and 4.4.
[859] In the US, a party that acquires, directly or indirectly, beneficial ownership of more than 5% of a voting class of a company's equity securities must report: see *Securities Exchange Act of 1934*, *supra* note 382 at 15 USC § 78m, § 13 cl (d)(1).
[860] *National Instrument 62-104 Take-Over Bids and Issuer Bids*, (2016) 39 OSCB 4225 at 5.2(1), online (pdf): *Ontario Securities Commission* <www.osc.gov.on.ca/documents/en/Securities-Category6/ni_20160505_62-104_take-over-bids.pdf>.

> in order to ensure that the market is advised of accumulations of significant blocks of securities that may influence control of a reporting issuer. Dissemination of this information is important because the securities acquired can be voted or sold, and the accumulation of the securities may signal that a take-over bid for the issuer is imminent. In addition, accumulations may be material information to the market, even when not made to change or influence control of the issuer. Significant accumulations of securities may affect investment decisions, as they may effectively reduce the public float, which limits liquidity and may increase price volatility of the stock. Market participants also may be concerned about who has the ability to vote significant blocks, as these can affect the outcome of control transactions, the constitution of the issuer's board of directors and the approval of significant proposals or transactions. The mere identity and presence of an institutional shareholder may be material to some investors.[861]

In 2013, the CSA proposed that the 10% reporting threshold be reduced to 5% for the reasons noted below:

> We believe this lower threshold is appropriate because information regarding the accumulation of significant blocks of securities is relevant for a number of reasons, in addition to signalling a potential take-over bid for the issuer, such as:
>
> - it may be possible for a shareholder at the 5% level to influence control of an issuer;
> - significant shareholding is relevant for proxy-related matters (for example, under corporate legislation, a shareholder can generally requisition a shareholders' meeting if it holds 5% of an issuer's voting securities);
> - market participants may be concerned about who has the ability to vote significant blocks as these can affect the outcome of control transactions, the constitution of the issuer's board of directors and the approval of significant proposals or transactions;
> - significant accumulations of securities may affect investment decisions;
> - the identity and presence of an institutional shareholder may be material to some investors;
> - a lower early warning reporting threshold will provide all market participants with greater information about significant shareholders and thereby enhance market transparency;
> - a 5% threshold would be consistent with the standard of several major foreign jurisdictions; and
> - changes in corporate governance practices have increased the need for issuers to communicate directly with beneficial owners. A lower threshold would provide

[861] *CSA Notice and Request for Comment – Proposed Amendments to MI 62-104 Take-Over Bids and Issuer Bids, NP 62-203 Take-Over Bids and Issuer Bids, and NI 62-103 Early Warning System and Related Take-Over Bid and Insider Reporting Issues*, (2013) 36 OSCB 2675 at 2676, online (pdf): *Ontario Securities Commission* <www.osc.gov.on.ca/documents/en/Securities-Category6/mi_20130313_62-104_take-over-bids.pdf>.

> reporting issuers with greater visibility into their shareholder base and a greater ability to engage with significant shareholders earlier. It would also allow shareholders to communicate among themselves earlier. [862]

Some of the above factors, such as the impact on investment decisions and the enhancement of market transparency, are equally applicable for disclosure regarding significant individual holdings of short positions. Ultimately, the CSA determined not to move forward with the lower threshold for the reasons stated below:

> We originally proposed to reduce the early warning reporting threshold from 10% to 5%. We considered this lower reporting threshold to be appropriate because information regarding the accumulation of significant blocks of securities can be relevant for a number of reasons, in addition to signalling a potential take-over bid for the issuer.
>
> However, a majority of commenters raised various concerns about potential unintended consequences of reducing the early warning reporting threshold from 10% to 5% in light of the unique features of the Canadian public capital markets, including the large number of smaller issuers as well as limited liquidity. These commenters noted the potential risks of reducing access to capital for smaller issuers, hindering investors' ability to rapidly accumulate or reduce large ownership positions in the normal course of their investment activities, decreased market liquidity and increased compliance costs. Taking into account these concerns, we have concluded that it is not appropriate at this time to proceed with this proposal. We are of the view that the intended benefits of the enhanced transparency are outweighed by the potential negative impacts of implementing the lower reporting threshold.
>
> A number of commenters also suggested that the lower reporting threshold should not apply to certain issuers or certain investors. As a result, the CSA explored alternatives for creating a reduced early warning reporting threshold for only a subgroup of issuers or investors. In considering the policy rationale for the early warning system, the complexity of applying a lower threshold to only certain issuers or investors and the associated compliance burden, we concluded that the reporting threshold should remain at 10% for all issuers and investors. [863]

The CSA determined that the benefits of individual disclosure for reasons other than issues related to the impact on control of a public company were outweighed by the costs of complying with the new rules and the likely impact on liquidity, which is critical for the Canadian markets, especially for venture stocks.[864] Each of these factors would also be important in any analysis as to whether individual short positions should be disclosed in Canada. More importantly, however, the sole remaining policy rationale for early warning reporting (i.e. the possible impact on control) is simply not applicable to the disclosure of short positions and therefore the strongest argument in favour of such disclosure – establishing parity between long position and short position reporting – is not applicable.

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[862] *Ibid* at 2677–2678.
[863] *CSA Notice of Amendments to Early Warning System: Amendments to Multilateral Instrument 62-104 Take-Over Bids and Issuer Bids and National Instrument 62-103 The Early Warning System and Related Take-Over Bid and Insider Reporting Issues and Changes to National Policy 62-203 Take-Over Bids and Issuer Bids*, Ontario Securities Commission (25 February 2016), 39 OSCB 1747, online (pdf): *Ontario Securities Commission* <www.osc.ca/documents/en/Securities-OSCB/20160224_oscb_3906_toc.pdf>.
[864] *Ibid.*

Finally, we also note that the SEC did not require individual funds to disclose short positions.

Accordingly, we do not see a basis for recommending the disclosure of short positions on an individual non-anonymous basis from a policy or public interest perspective.

7.3 Dearth of Regulatory Enforcement Action

IOSCO Principle 3 states that short selling should be subject to an effective compliance and enforcement system that ensures an effective and credible use of inspection, investigation, surveillance and enforcement powers.[865] In Canada, there is a dearth of cases from IIROC or any other Canadian regulatory authority imposing sanctions in connection with prohibited short selling. In the rare event that regulators take action, the short selling activity is typically coupled with one or more other serious acts of misconduct contrary to UMIR or securities regulations.[866] This is in direct contrast to the US, where the SEC has been relatively active in sanctioning dealers for prohibited short selling activities.[867]

This lack of regulatory action has a significant impact on investor confidence and is no doubt responsible for the view held by many that there is widespread naked shorting and other significant illegal activity associated with short selling in Canada.[868] It is critical that these concerns be addressed.

Additionally, IIROC has shown a reluctance to assist complainants in actions taken to recover damages against short campaigners or ascertaining their identities.[869]

Any argument to the effect that there is no activity worthy of enforcement action would appear to be blatantly untrue. It may be suggested that a system built to be more lenient is more likely to have fewer breaches of the law. In fact, since naked short selling is not technically illegal, such activity and other related conduct is less likely to be the subject of regulatory scrutiny.

7.4 Analysis of IIROC Studies

From 2006 to 2011, IIROC conducted four studies[870] to gather data on short sales and failed trades in Canada, and to determine whether amendments to UMIR were necessary. Through these studies, IIROC concluded that the "Canadian market has not had the problems with short sales, particularly naked short sales, and failed trades that may have been evident in other jurisdictions."[871] Two of the

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[865] IOSCO, *Regulation of Short Selling Final Report*, *supra* note 394 at 16.
[866] See for example, *Re W Scott Leckie* (July 19, 2005), SA 2005-005, where a trader using a short selling strategy was unable to borrow shares to cover his client's short position and engaged in a wash trade using an account at a second dealer to cover his outstanding short position. He was fined $100,000 for engaging in the wash trade.
[867] See section 4.2.
[868] See for example, Pete Evans, "Canada needs to toughen short selling rules to weed out abuse, market watchers say" (11 February 2019), online: *CBC* <www.cbc.ca/news/business/short-selling-abuse-1.5009871>.
[869] *Harrington Global Opportunities Fund S.A.R.L. v. Investment Industry Regulatory Organization of Canada* 2018 ONSC 7739.
[870] See Market Regulation Services, *Statistical Study of Failed Trades on Canadian Marketplaces* (April 2007), online (pdf): *Investment Industry Regulatory Organization of Canada* <docs.iiroc.ca/DisplayDocument.aspx?DocumentID=743406BF02D54C7796C89D1507400B6F&Language=en> [*Failed Trade Study*]. See also Investment Industry Regulatory Organization of Canada, *Recent trends in trading activity, short sales and failed trades* (February 2009), online (pdf): *Investment Industry Regulatory Organization of Canada* <docs.iiroc.ca/DisplayDocument.aspx?DocumentID=DE2E6F9F4AE442F5BC0AE75A9E812FE5&Language=en>. See also Investment Industry Regulatory Organization of Canada, *Price movement and short sale activity: The case of the TSX Venture Exchange*, (25 February 2011), online (pdf): *Investment Industry Regulatory Organization of Canada* <docs.iiroc.ca/DisplayDocument.aspx?DocumentID=72B43F7B362043FF945E4401A11CD1FF&Language=en >. See also Investment Industry Regulatory Organization of Canada, *Trends in trading activity, short sales and failed trades*, (February 2011), online (pdf): *Investment Industry Regulatory Organization of Canada* <docs.iiroc.ca/DisplayDocument.aspx?DocumentID=CEE8BC8CA63944DEBCFCF2E499676F43&Language=en > [Trends Study].
[871] *Rules Notice – Technical – UMIR – Price Movement and Short Sale Activity: The Case of the TSX Venture Exchange*, IIROC Notice 11-0077 (25 February 2011) at 2, online (pdf): *Investment Industry Regulatory Organization of Canada* <www.iiroc.ca/Documents/2011/2360b592-c485-47d2-bc1d-d666bd9f1cc3_en.pdf>.

studies are particularly important: (i) the Failed Trade Study, which examined trades from August 4, 2006 to August 11, 2006, and was published by RS in April 2007, and (ii) the Trends Study, which examined trades for the period from May 1, 2007, to April 30, 2010, and which IIROC published in February 2011 (the Failed Trade Study and the Trends Study are collectively referred to as the "**IIROC Studies**"). The Failed Trade Study analyzed surveyed data from Participants and provided key insights that IIROC relied upon for years to follow. The Trends Study combined the data collected in the studies conducted by IIROC from 2007 to 2010, and provided a comprehensive analysis on short sales and failed trades.

We examined the methodology and results of each study and believe that they highlight the need for further research on the relationship between short sales and failed trades in the Canadian marketplace.

7.4.1 Failed Trade Study

The Failed Trade Study[872] was conducted "to gather statistical information on the prevalence of, and the reasons for, failed trades on Canadian marketplaces".[873] While RS acknowledged the existence of naked short sales, the Failed Trade Study found that they were not a "widespread phenomenon in Canada".[874] IIROC proposed certain regulatory changes in 2008 based on the conclusions of the Failed Trade Study, including the definition of "Short Sale Ineligible Security"[875] and the timing requirement for EFTRs.[876] IIROC also used this study as a basis for concluding that, given most trade failures result from administrative errors, "hard" close-out provisions were not appropriate.[877] Similarly, in IIROC's view, historic low trade failure rates made it unnecessary to impose general locate or pre-borrowing requirements.[878]

7.4.1.1 Methodology

RS selected 25 Participants[879] of varying sizes, business types and geographic locations, who represented on average 73.5% of the volume of the overall marketplace – the TSX, TSXV and CNQ – for August 2006.[880] The study was conducted over five consecutive business days and five Participants were each randomly assigned one day to provide information regarding failed trades.[881]

7.4.1.2 Failed Trade Study Observations

Over the study period of five trading days from August 4, 2006, to August 11, 2006, Participants reported a total of 1,078 failed trades, which accounted for 0.27% of total trades.[882] A comparison by marketplace showed that securities listed on the TSXV and CNQ were at a greater risk of failure than securities listed on the TSX.[883] Moreover, approximately 24% of total trades by the Participants were short sales, with only 6% of failed trades resulting from those short sales.[884]

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[872] *Failed Trade Study, supra* note 870.
[873] *Ibid* at 3.
[874] *Ibid* at 13.
[875] *IIROC Notice 08-0143, supra* note 59 at 10.
[876] *Ibid* at 3.
[877] See *IIROC Notice 11-0075, supra* note 150 at 36, 48.
[878] *Ibid* at 49.
[879] The 25 participants included six participants that were owned by the major Canadian chartered banks: see *Failed Trade Study, supra* note 870 at 4.
[880] *Failed Trade Study, supra* note 870 at 4.
[881] *Ibid* at 5.
[882] *Ibid* at 7.
[883] 0.22% of trades on TSX failed to settle (838 fails out of 379,211 trades); 0.9% of trades on TSXV failed to settle (239 fails out of 26,509 trades); and 2.22% of trades on CNSX failed to settle (one fail out of 45 trades): see *Failed Trade Study supra* note 870 at 7.
[884] *Trends Study, supra* note 870 at 6.

RS also collected further information on a subset of 5% of the reported failed trades, or 373 trades. Each Participant was asked to provide a detailed analysis for each failed trade (a "**Detailed Report**") on a random sample of only 5% of its reported failed trades.[885] The Detailed Report consisted of the following: (i) the reasons for the failure to settle the trade, (ii) a copy of the trade ticket and (iii) the details of any action taken to rectify the failed trades.[886]

In the Detailed Reports, the Participants indicated that the primary reason for failed trades was "administrative" (approximately 51% of failures) and the second most prominent reason was "[the] other side failed to deliver shares"[887] (approximately 18% of failures). However, RS noted that to the extent that the "other side" in the studied trades were not participants of the study, the causes of the failures were not known.[888] Interestingly, despite the indeterminate cause of failure, RS made the presumption that "there is no reason to believe that the reason(s) the counterparties failed to deliver [would] be different from the causes experienced by the [Participants]."[889] Essentially, RS presumed that a majority of the failures resulting from counterparty failed trades were due to "administrative" issues experienced by the counterparty.[890]

The Detailed Reports also provided information on "closing out" the failed trades. Cumulatively, approximately 88% of these failed trades settled within five days of the expected settlement date and 98% were settled within 15 days.[891] On average, failed trades were rectified within 4.2 days of the expected settlement date.[892] This finding was interpreted to mean that the duration it took to rectify a failed trade was the same, regardless of the stock exchange on which the security was listed, and thus the primary reason for trade failure was "administrative" across the market. However, this interpretation is at odds with the conclusion drawn in the study that securities listed on more junior stock exchanges were at a greater risk of trade failure.[893] Without sufficient explanation, it is difficult to reconcile the interpretation that the reasons for failure were the same across the markets in light of the fact that the occurrences of failure were different.

7.4.1.3 UMIR Rule Amendments

The empirical evidence in the Failed Trade Study played a significant role in shaping the amendments to UMIR in 2008 and in later years. For example, because the results of the Failed Trade Study indicated that short selling was not the primary reason for failed trades, IIROC adopted a more flexible approach in designating a "Short Sale Ineligible Security".[894] The designation would be made after IIROC finds that "short selling [activity] is exacerbating" over a period of time.[895] IIROC opined that the need to make such a designation would be a relatively rare occurrence in Canada.[896] In addition, IIROC established the reporting requirements for EFTs based on the Detailed Reports of 373 trades, determining that it was appropriate for an EFTR to be filed if a failed trade is not resolved within 10 trading days following the settlement date.[897]

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[885] *Failed Trade Study, supra* note 870 at 5-6.
[886] *Ibid.*
[887] *Ibid* at 6, 11.
[888] *Ibid* at n 19.
[889] *Ibid.*
[890] *Ibid.*
[891] *Ibid* at 6.
[892] See *IIROC Notice 08-0143, supra* note 59 at 3. Notably, RS did not distinguish this data by seniority of the security.
[893] *Failed Trade Study, supra* note 870 at 8.
[894] It is further explained, "IIROC is of the view that there are greater risks to market integrity if a series of dealers experience prolonged trade failures for a relatively minor number of shares of security that is illiquid than from the failure of a single block trade (due possibly to administrative problems or delays at a custodian) in a highly-liquid security": see *IIROC Notice 08-0143, supra* note 59 at 10.
[895] *Ibid* at 10–11.
[896] *Ibid* at 10.
[897] *Ibid* at 3.

The UMIR amendments were adopted to "provide IIROC with additional tools to address potential abusive short selling and failed trade activity."[898] Given the very limited sample size of failed trades and the self-reported Detailed Reports, it is interesting that IIROC relied on the Failed Trade Study when developing the UMIR amendments. This is particularly surprising in light of the fact that the rules adopted were relatively lenient compared to other jurisdictions. In deciding to deviate so far from the rules in other similar capital markets, it would have been better to have more statistical data to support the conclusions reached.

7.4.2 Trends Study

The Trends Study[899] examined trading activity and short sales in the Canadian marketplace[900] from May 1, 2007, to April 30, 2010 (the "**Study Period**"). IIROC undertook the study to explore the relationship between short selling and failed trades, and to consider whether regulatory measures taken by securities regulators in other jurisdictions in respect of short sales "would be appropriate in the context of the Canadian market".[901] IIROC concluded that it was unlikely that a relationship between short selling and failed trades existed in the Canadian market.[902]

7.4.2.1 Methodology

IIROC collected information on trading activity[903] for the Study Period from a number of Canadian exchanges, including the TSX and TSXV.[904] IIROC also aggregated its own data on short sale activity in the marketplaces for the Study Period, derived from "the internal audit tracking systems" maintained by IIROC.[905] Additionally, CDS also provided IIROC with certain information in respect of failed trades, including (i) the value of securities eligible for continuous net settlement and the value of cumulative net fails (outstanding trade failures that did not settle on T+3) for each trading day between March 2005 and April 30, 2010,[906] and (ii) the number of initial failure "buy-in" notices received during the Study Period.[907]

7.4.2.2 Trends Study Observations

The Trends Study showed that short sales during the Study Period gradually increased in relation to total trading activity on the TSX and TSXV. The number of short sale trades, volume of shares short sold and value of shares short sold increased as a percentage of the total number of trades,[908] total traded volume[909] and total traded value[910] of securities on the exchanges.

With respect to the rates of trade failures, the Trends Study showed that the value of accumulated fails as a percentage of the value of trades eligible for continuous net settlement declined steadily

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[898] *Ibid* at 1.
[899] *Trends Study, supra* note 870.
[900] The analysis included trade information from TSX, TSXV, CNSX, Match Now, Pure Trading, Omega, Chi-X and Alpha: see *ibid* at 6-7.
[901] *Ibid* at 1.
[902] *Ibid* at 32.
[903] "Trading activity" refers to data on the number of trades, the value of trades and the volume of trades provided to IIROC by the exchanges participating in the study: see *Trends Study, supra* note 870 at 14.
[904] *Ibid* at 6-7.
[905] *Ibid* at n 16.
[906] *Trends Study, supra* note 870 at 8. During the Study Period, Canada operated on a T+3 settlement cycle before moving to a T+2 settlement cycle in 2017 following amendments to NI 24-101.
[907] *Ibid.*
[908] *Ibid* at Appendix Table 7 – Short Sales as a Percentage of Trades. At the start of the Study Period (May 2007), short sales constituted 24.0% of trades on the TSX and by April 2010 this had risen to 33.9%, with a period average of 34.4%.
[909] *Ibid* at Appendix Table 8 – Short Sales as a Percentage of Volume. At the start of the Study Period, short sales constituted 19.3% of the total volume of the TSX, and this rose to 23.5% by the end of the study period, with a period average of 24.8%.
[910] *Ibid* at Appendix Table 9 – Short Sales as a Percentage of Value. At the start of the Study Period, short sales constituted 24.8% of the value of trades on the TSX and this rose to 32.9% by the end of the study, with a period average of 28.1%.

throughout the Study Period, from 2.69% in May 2007 to 1.62% in April 2010.[911] IIROC noted that the decline in the value of accumulated fails could be attributed to a general decline in the length of time that a failed trade remains outstanding and/or to a general decline in the rate of trade failures.[912]

IIROC's data showed that while the value of short sales as a percentage of total traded value increased over the Study Period, the value of accumulated fails as a percentage of total traded value decreased.[913] From this trend, IIROC concluded that "[the] relationship displayed [between the value of short sales and the value of accumulated fails] throughout the Study Period is consistent with the finding in the Failed Trade Study that a short sale is less likely to fail than a trade generally and casts doubt on whether the relationship between short sales and failed trades that is perceived in the [US] is applicable in the Canadian context."[914]

IIROC surmised that part of the reason for the general decline in the value of failed trades may have been because of the introduction of NI 24-101,[915] which came into force prior to the Failed Trade Study on April 1, 2007.[916]

This view appears to have been shared by the AMF. In a speech on April 14, 2009, the Superintendent of the AMF stated in part as follows:

> On the settlement side, the CSA adopted in 2007 National Instrument 24-101 … which provides a general framework for ensuring more efficient and timely settlement processing of trades. Registered dealers and advisers are required to establish, maintain and enforce policies and procedures designed to achieve trade matching as soon as practical after the trade has been executed, and in any event no later than 12:00 p.m. on the day after the day on which the trade was executed. The current rule will also require, starting July 1, 2010, that trade matching be done before midnight on trade date (T). In addition, NI 24-101 requires dealers to establish, maintain and enforce policies and procedures designed to facilitate the settlement of trades by the standard settlement date prescribed by an SRO or a marketplace. We believe that NI 24-101 contributed to the decline in value of accumulated fails as a percentage of traded value, which has been declining steadily in the past two years from 2.7% to less than 1%.[917]

As noted in the Trends Study and as explained below, the declining trend in failed trade percentage rates would not last, and therefore it is not clear that NI 24-101 should provide any comfort to regulators that low failed trade rates in Canada are sustainable.

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[911] *Ibid* at Table 18 – Value of Accumulated Fails. This table contains data on the value of accumulated fails as a percentage of trade value, calculated from the data provided by CDS.
[912] *Ibid* at 28.
[913] *Ibid.*
[914] *Ibid* at 32.
[915] *Ibid* at 28–29.
[916] Sections 3.2, 3.4 and Parts 4 and 6 of NI 24-101 came into force on October 1, 2007: see *National Instrument 24-101*, (2007) 30 OSCB 2609, online (pdf): *Ontario Securities Commission* <www.osc.gov.on.ca/documents/en/Securities-Category2/rule_20070323_24-101_trade-matching.pdf>.
[917] Louis Morisset, "Notes pour un discours prononcé par Monsieur Louis Morisset Surintendant des marchés de valeurs de l'Autorité des marchés financiers" (16e Conférence canadienne des négociateurs de valeurs mobilières, 14 August 2009) at 9, online (pdf): *Autorité des marchés financiers* <lautorite.qc.ca/fileadmin/lautorite/grand_public/salle-de-presse/discours/2009/discours-morisset-csta-14-08-09.pdf>.

In August 2016, the CSA issued a consultation paper regarding shortening the settlement period from T+3 to T+2 (the "**CSA Consultation Paper**"[918]), in which it reviewed CNS failed trade data from May 1, 2007, to March 31, 2016, thereby extending the period of the Trends Study. It was noted that following the Study Period of the Trends Study, "the declining trend in CNS fail rates appears to have abated, with cumulative CNS fails remaining relatively stable and generally below 2% of the aggregate value of trades".[919] Following the Study Period, there were spikes in CNS fails, with variances of up to 46% above the average for the May 1, 2007, to March 31, 2016, period for which data was reviewed.[920] Not surprisingly, a spike in failed trades was also seen in the Trends Study in September 2008.[921]

To accurately assess whether a relationship exists between short selling and trade failures, it is important to consider the duration that a failed trade remains outstanding and the underlying reasons for failure.[922] However, in the Trends Study, IIROC collected data on neither the duration nor the reasons for trade failure. [923] Such data would have allowed IIROC to better understand why there had been a general decline in the value of failed trades and to better assess whether a relationship between short selling and failed trades exists. Instead, IIROC relied on the findings in the Failed Trade Study together with the general decline in the value of trade failures, which was short-lived, to support its conclusion.[924] As noted earlier, the Failed Trade Study was conducted on a limited set of participants over five trading days in August 2006; it is likely problematic to assume without justification that the data is representative of the broader Canadian markets or that the duration of outstanding fails and the reasons for failure remained the same over the Study Period.

7.4.3 Overall Observations

7.4.3.1 A New Independent Study is Needed

In light of the deficiencies noted above regarding both of the IIROC Studies, we believe it is important that a third party expert be retained to conduct a new study.

The Failed Trade Study looked at trade data for only five trading days, with only five Participants providing information for each trading day, which calls the reliability of the study into question. Further, the Detailed Reports collected in connection with RS's analysis of trade failures only included 5% of the failed trades reported by Participants of the study. Making any inference in respect of the Canadian markets as a whole from such a small subset of failed trades is likely misleading.

The Trends Study showed that the value of trade failures as a percentage of total traded value had declined, while the value of short sales as a percentage of total traded value had increased over the Study Period. However, the decline had abated following the Study Period and spikes in failed trades continued to be significant. In addition, there are concerns regarding the disclosed failed trade rates from all studies. For example, we note that in a November 16, 2016 comment letter pertaining to the CSA Consultation Paper, a leading Participant noted that it had failed trades rates of between

[918] Canadian Securities Administrators, *Policy Considerations for Enhanced Settlement Discipline in a T+2 Settlement Cycle Environment,* CSA Consultation Paper 24-402 (18 August 2016), online (pdf): *Alberta Securities Commission* <www.albertasecurities.com/-/media/ASC-Documents-part-1/Regulatory-Instruments/2018/10/5313054-Consultation-Paper-24-402.ashx> [*CSA Consultation Paper 24-402*].
[919] *Ibid* at 25.
[920] *Ibid* at n 75 and at 20.
[921] *Ibid* at 24.
[922] For example, if the average length of a failed trade increased from the RS study's initial findings and a greater proportion of trade failures were due to a failure to deliver securities, this may suggest some relationship between short selling and failed trades, despite a decline in the overall value of trade failures while the value of short sales increased.
[923] *Trends Study, supra* note 870 at 28.
[924] *Ibid* at 32.

2.4% and 3.4% for Q4 2015 through Q3 2016, which is significantly higher than reported in the CSA Consultation Paper and consistent with the rates reported in the US.[925]

Furthermore, unlike the Failed Trade Study, the Trends Study did not provide data on the reasons for trade failures, the duration of trade failures or the differences in value or rates of trade failures based on the stock exchange or security class. Instead, IIROC took the position that the general decline in the value of trade failures confirmed the Failed Trade Study's findings and concluded that short sales were not of concern in Canada.

Moreover, IIROC places much emphasis on the relatively low fail rates in Canada compared to the US. However, the following is noted in the CSA Consultation Paper:

> With respect to average fail rates in markets outside of Canada, different markets apply different methodologies for calculating fail rates, so it is also difficult to draw comparisons with foreign markets. The IIROC Trends Study contains a brief comparative analysis with fails in the [US]. Based on information from the SEC's Office of Economic Analysis, IIROC suggested that "fail rates in the [US] may be somewhat higher than in Canada after taking into account differences in the size of the respective markets".[926]

In a footnote at the end of the above paragraph, it is also noted that "in Australia, the settlement failure rate for cash equities is extremely low, with an average daily settlement failure rate of 0.339% over the December 2013 quarter."[927] Therefore, a key foundation for conclusions reached in the IIROC Studies appears not to be firmly rooted in analysis and facts.

Additionally, IIROC suggested in the Trends Study that the introduction of NI 24-101 in April 2007 may have resulted in a reduction of the number of failed trades and the length of time they remain outstanding.[928] However, as noted in Section 7.4.2.2, the data available publicly does not support this finding, and without further and more recent data and analysis on failed trades, it is difficult to draw any such conclusions.

IIROC has made policy decisions on the basis of these studies. For example, IIROC declined to both implement a "capital charge" on dealers that failed to receive a security and an administrative penalty on dealers that failed to deliver because "studies by IIROC indicated that the majority of trade failures arose out of 'administrative error' and were readily resolved."[929] However, as noted, without a more comprehensive study on trade failures and the underlying reasons for such failures, it is difficult to definitively conclude from the IIROC Studies alone that there is no direct relationship between trade failures and short sales in the Canadian context, and therefore it is problematic to attempt to make policy decisions based on such limited data.

7.4.3.2 Low Fail Trades Across the Market is Not a Defence to Systemic Risk

Although we acknowledge that a new independent study would provide a better foundation for changes to the Canadian short selling regulatory regime, we have significant doubts that the singular focus on market-wide failed trade data by IIROC is worthwhile. As noted above, failed trade

[925] Comment Letter from CIBC World Markets to the Canadian Securities Administrators (CSA) (16 Nov 2016) at 2, online (pdf): *Ontario Securities Commission* <http://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20161116_24-101_cibc.pdf>.
[926] *CSA Consultation Paper 24-402, supra* note 918 at 25.
[927] *Ibid.* at n 78.
[928] *Trends Study, supra* note 870 at 28–9.
[929] *IIROC Notice 11-0075, supra* note 150 at 36.

rates in Australia are dramatically lower than in Canada, and we would not be surprised if other markets also have lower rates. In addition, current failed trade rates cannot be taken as a barometer for future ones in times of financial distress or market shock. In fact, IIROC's and the CSA's own data show that failed trade rates can spike.

Systemic risk usually starts with a sector or a large financial institution and then spreads to the entire market. It is not clear to us what the unique attributes of Canadian markets are that provide regulators the freedom to impose lenient short selling rules without increasing systemic risk. At a minimum, in order to better gauge the impact of short selling, we implore IIROC to study the short selling data around short campaigns against, and financial distress of, key public companies. In particular, short campaigns against significant institutions can lead to "overshooting" on the downside, which could raise issues of systemic risk or lead to insolvency for companies targeted by short sellers. Such results can have serious and long-lasting consequences for Canada and the communities in which we live.

The onus should be on IIROC and the CSA to justify that deviations from accepted standards and regulations adopted by regulatory authorities in similar capital markets and recommended by the OSC and AMF, as part of IOSCO's Technical Committee, are appropriate.

7.5 EFTR

EFTRs are important for three reasons: (i) the basis of the imposition of pre-borrowing obligations, (ii) reporting requirements by Participants and Access Persons to IIROC with respect to EFTs and (iii) reporting requirements after the submission of an EFTR to explain how the failed trade ultimately settled.

Notwithstanding the importance of the designation, it appears that IIROC selected 10 trading days as the trigger for an EFTR based on data from the flawed Failed Trade Study, principally to ensure it received few EFTRs.[930] It is difficult to accept a 10-trading day cure period for a failed settlement as being reasonable or in the public interest. It is untenable to base any analysis on systemic risk with respect to short selling and failed trades on whether someone can close out a trade within 10 trading days of the expected settlement date. The imposition of pre-borrow obligations after an EFT has occurred is an acknowledgement that pre-borrow obligations should, in the view of IIROC, be used as a penalty of last resort, not as a tool to reduce systemic risk. We also understand that IIROC does not track the imposition of pre-borrow obligations, which is not surprising since the requirement was established on the basis that it would rarely ever be required.

We have no doubt that the 10-trading day window for EFTs must be narrowed. Regardless of whether the window is narrowed, it is clear that some of our recommendations – if implemented – would have a significant impact on EFTs. In particular, having a locate or pre-borrow requirement should lessen the importance of, or even the need for, EFTRs.

7.6 Penalties for Failed Trades

In the US, FINRA may impose monetary penalties in connection with failures to close out failed trades (see Section 4.2.8). In the EU, commencing in September 2020, there will be cash penalties and the potential for suspension on participants of CSDs that fail to deliver (see Section 4.3.5). While CDS charges a fee for failures to deliver securities to settle an outstanding CNS position, there are currently no penalties imposed under securities laws in connection with failed trades. Canadian securities regulators should consider whether it would be appropriate to impose a fine for failed trades to

[930] *IIROC Notice 08-0143*, *supra* note 59 at 3.

bring the Canadian regulatory regime in line with some of the comparative jurisdictions we have reviewed.

7.7 Private Right of Action for Short and Distort Schemes

Canada has attracted a significant number of short campaigns. This is not surprising in light of the leniency of our short selling regulations compared to the regulations of other markets. It may also be that Canada has attracted more than its fair share of short and distort schemes due to the limited remedies available to public companies and their shareholders,[931] and the high costs of pursuing such remedies. In addition, the success rate in regulatory actions brought by staff of the various provincial securities regulators against abusive short campaigners is quite poor, suggesting that the threshold for a successful regulatory action – when taken – is quite high.

We note that even if Canadian regulators had a stronger track record in prosecuting actions in connection with short and distort campaigns, stronger regulatory enforcement would only have a deterrent effect – it would do nothing to compensate the target company or its shareholders for their very real losses. As short and distort schemes can have a deleterious impact on public companies and their shareholders, several commentators have asked that the CSA consider introducing a private right of action, whereby shareholders and public companies could recover damages from short campaigners who knowingly – or with reckless disregard – publicly disclose untrue or misleading information for the purpose of driving down stock prices.

7.7.1 Regulatory Intervention

As discussed in Section 5.3.3.8, one of the direct responses a target company can take to address a short campaign is to make a formal complaint to a market or securities regulator. A short and distort campaign could potentially violate both sections 126.1 and 126.2(1) of the OSA.[932] While these provisions give the OSC jurisdiction to commence proceedings, neither of these provisions provide

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[931] For example, a short seller made statements questioning the environmental practices of Badger Daylighting Ltd. and suggested that the company had engaged in illegal toxic dumping. There was evidence that the share price of the company fell 14% on the day the initial allegedly false statement was made, and 14% the week following the initial statement. See Section 5.3.3.8.4(ii). Fairfax Financial Holdings Ltd. ("**Fairfax**") was victim to an alleged short and distort scheme that began in 2003, which involved certain hedge funds and associated parties circulating misinformation, such as negative analyst reports and falsified accounting claims. It was reported at the time that Fairfax alleged that in connection with the short and distort scheme, parties hired by the hedge funds created a research agency for the purpose of disseminating false and misleading information, and brought misleading information to the US Federal Bureau of Investigation in an attempt to initiate an investigation into the company. See Jonathan Stempel, "Fairfax loses $8-billion short-selling lawsuit against Steven Cohen", *The Globe and Mail*, (3 April 2018), online: *The Globe and Mail* <www.theglobeandmail.com/business/article-fairfax-loses-8-billion-short-selling-lawsuit-against-steven-cohen/>. See also Vanessa Lu, "Fairfax loses lawsuit against U.S. hedge funds", *The Star*, (12 September 2012), online: *The Star* <www.thestar.com/business/2012/09/12/fairfax_loses_lawsuit_against_us_hedge_funds.html>. See also *Fairfax Financial Holdings Limited and Crum & Foster Holdings Corp. v SAC Capital Management LLC et al*, L-2032-06 at 7-8 (NJ Sup Ct 2018).

[932] These sections are set out in Section 5, but are repeated here for ease of reference:

> 126.1(1) A person or company shall not, directly or indirectly, engage or participate in any act, practice or course of conduct relating to securities, derivatives or the underlying interest of a derivative that the person or company knows or reasonably ought to know,
>
> (a) results in or contributes to a misleading appearance of trading activity in, or an artificial price for, a security, derivative or underlying interest of a derivative; or
>
> (b) perpetrates a fraud on any person or company.
>
> (2) A person or company shall not, directly or indirectly, attempt to engage or participate in any act, practice or course of conduct that is contrary to subsection (1).
>
> 126.2(1) A person or company shall not make a statement that the person or company knows or reasonably ought to know,
>
> (a) in a material respect and at the time and in the 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
>
> (b) would reasonably be expected to have a significant effect on the market price or value of a security, derivative or underlying interest of a derivative.
>
> (2) A breach of subsection (1) does not give rise to a statutory right of action for damages otherwise than under Part XXIII or XXIII.1.

a target company or its shareholders with direct access to a remedy in connection with a short and distort campaign.

We note that section 104 of the OSA gives "interested persons" the right to bring an application to the OSC, asking it to enforce compliance with Part XX of the OSA, which governs take-over bids and issuer bids.[933] Should the OSC intervene, section 104(1) gives it broad powers to regulate conduct in a take-over or issuer bid, including the power to restrain the distribution of or to require the amendment or variation of documents or any communications used or issued in connection with the bid, as well as to direct any person or company to comply with a requirement of the OSA or regulations governing take-over bids or issuer bids.

Section 104 of the OSA is potentially a model for a route for target companies and shareholders to seek regulatory intervention in a short and distort campaign. We note that section 104 of the OSA itself offers no relief to the target company or its shareholders in a short and distort campaign because it is limited to Part XX of the OSA. Moreover, there are no specific provisions of the OSA on which a private application to the OSC could be brought to seek its intervention in a short and distort campaign. However, a short and distort campaign potentially violates the provisions of sections 126.1 or 126.2(1). Therefore, one possible remedy for the target company or its shareholders would be to create a new provision in the OSA, similar to section 104, that would allow an interested person to request that the OSC intervene in a short and distort campaign if the OSC considers that the short campaigners – or others responsible for the statements – have acted contrary to sections 126.1 or 126.2(1), and make the following orders:

- restraining the conduct complained of; for example, in the distribution of a document or communication in connection with the short campaign;
- requiring corrective action, such as an amendment, variation or retraction of any document or statement made in connection with the short campaign; and
- directing a short campaigner or other person, such as an analyst, to comply with the OSA and its regulations. (In contrast, the courts have the power to provide compensation and supra-regulatory relief, such as orders rescinding a transaction with an interested person.)[934]

Adding a new provision to the OSA modelled on section 104 would be helpful, but it would still only be a means to enforce compliance. It would not provide the target company or its existing or former shareholders with any direct remedy, let alone compensation for losses they may have sustained as a result of a short and distort campaign.

7.7.2 Existing Compensatory Remedies Do Not Address Short and Distort Campaigns

The OSA currently provides compensatory remedies in limited circumstances. Each of these remedies arises in a specific context and none of them provide a compensatory remedy to a target company or its shareholders for their losses in a short and distort campaign. However, each may provide some guidance in attempting to define a statutory right of action for losses in a short and distort campaign.

[933] *OSA*, *supra* note 13 at s 104.
[934] *OSA*, *supra* note 13 at s 105(1).

7.7.2.1 Section 105 of the OSA

Section 105 of the OSA provides an "interested person" the right to apply to a court in order to seek compensation for losses incurred in connection with a take-over bid or issuer bid under Part XX of the OSA. The court has jurisdiction to order a wide range of remedies if it concludes that a person has not complied with the provisions of Part XX of the OSA. The court may make an interim or final order, as the court thinks fit, including an order:

> (a) compensating any interested person who is a party to the application for damages suffered as a result of a contravention of a requirement of Part XX or the regulations thereunder;
>
> (b) rescinding a transaction with any interested person, including the issue of a security or an acquisition and sale of a security;
>
> (c) requiring any person or company to dispose of any securities acquired under or in connection with a take-over bid or an issuer bid;
>
> (d) prohibiting any person or company from exercising any or all of the voting rights attached to any securities; or
>
> (e) requiring the trial of an issue.[935]

7.7.2.2 Part XXIII – Misrepresentations in a Prospectus

Part XXIII of the OSA provides investors who purchase securities under a prospectus, offering memorandum or take-over bid circular with a right of action for losses caused by misrepresentations in these documents. Part XXIII provides a complete code, in that it sets out the conduct giving rise to the right to seek a remedy,[936] as well as available due diligence defences and limits on the damages that can be recovered. No reference is made in Part XXIII to the more general prohibitions on fraud and market manipulation in section 126.1 of the OSA, or on making a misleading or untrue statement in section 126.2(1) of the OSA. The right of action provided is limited to the circumstances specifically set out in Part XXIII and lies against the issuer and other persons who were responsible for the misleading prospectus, offering memorandum or circular.

7.7.2.3 Part XXIII.1 – Misrepresentations in Secondary Market Disclosure

The OSA also provides investors who purchase securities on the secondary market with a right of action to recover losses caused by misrepresentations in public disclosures and statements. Again, this remedy lies against the issuer and other persons who were responsible for the misleading disclosure or statements. Part XXIII.1 is also a complete code – like Part XXIII, it does not refer to either sections 126.1 or 126.2(1) of the OSA. Rather, it defines when the right of action arises and against whom. It also sets out the defences available, as well as limits on liability and the damages that can be recovered. However, unlike Part XXIII, it includes procedural steps that must be followed before any action can be brought and engages the court as a gatekeeper to plaintiff claims.

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[935] *OSA*, *supra* note 13 at s 105(1).
[936] *OSA*, *supra* note 13 at ss 130(1), 130.1(1), 132(1) and 132.1(1).

7.7.3 A Proposal for a New Statutory Private Right of Action

We are mindful that providing the target company and its existing or former shareholders with a statutory right of action against a short campaigner or other person who appears to be engaging in conduct contrary to sections 126.1 or 126.2(1) of the OSA will require legislative change.[937] In particular, we note that section 126.2(2) expressly contemplates that the only statutory remedies for a misleading or untrue statement contrary to section 126.2(1) are the remedies in Part XXIII or XXIII.1 of the OSA. These remedies lie against an issuer and others for misrepresentations in a prospectus or secondary market disclosure.

What would such a statutory right of action in favour of a target company and its shareholders – or former shareholders – look like? One option to create a statutory right of action would be to simply repeal subsection 126.2(2) of the OSA, which was introduced at the same time as the civil right of action for secondary market disclosures in 2005.[938] Repealing subsection 126.2(2) would be one way to allow an "interested person" to bring an application to court to seek compensation for conduct that has (i) caused financial loss and (ii) violates either or both of sections 126.1 and 126.2(1) of the OSA.

We think that introducing a compensatory statutory remedy based simply on a breach of section 126.2 of the OSA would require careful consideration, since it would reverse a deliberate policy choice made in the creation and drafting of Part XXIII.1 of the OSA. The history of the civil remedy for secondary market misrepresentations has been detailed by others elsewhere[939] and we do not intend to review the origins of Part XXIII.1 of the OSA. We note that the Toronto Stock Exchange Committee on Corporate Disclosure (the "**Allen Committee**") considered the appropriate balance between deterrence and compensation in both its Interim Report and Final Report, concluding in the latter that:

> [i]n designing a civil liability model, the Committee sought to achieve a balance between competing goals and interests. A statutory civil liability model based on deterrence would try to open the door of civil liability only to the extent that the consequences of misleading disclosure would provide effective deterrence without

[937] While section 122.1 of the OSA gives a court power to make compensatory or restitutionary orders if a short campaigner is convicted of an offence under the OSA, this is not a remedy that the target company or its shareholders can pursue independently.

[938] It is not entirely clear why subsection 126.2(2) was added to the OSA. The Ontario Standing Committee on Finance and Economic Affairs noted that Bill 41 (introduced in 2003, but then died on the Order Paper) was intended to address technical defects in Bill 198 (which was not proclaimed as a result). Part XXIII.1 was not yet in force when the Five-Year Review Committee ("**Crawford Committee**") made its recommendations. No mention was made in connection with clarification that section 126.2 should not be seen as creating a general right of action for misrepresentation in disclosure. The Standing Committee on Finance and Economic Affairs similarly made no specific mention of the limitation introduced in section 126.2(2). Rather, echoing the Crawford Committee, the Standing Committee on Finance and Economic Affairs recommended that the relevant portions of Bill 41 be reintroduced and that the civil liability provisions in Bill 198 be proclaimed: see Standing Committee on Finance and Economic Affairs, "Report on the Five Year Review of the Securities Act" (October 2004) at 22–24, online (pdf): *Legislative Assembly of Ontario* <www.ontla.on.ca/committee-proceedings/committee-reports/files_pdf/REV%20OSC%20Rep-Eng.pdf>. See also Ministry of Finance, "Five Year Committee Final Report – Reviewing the Securities Act (Ontario)" (Ontario: 21 March 2003) at 129-133, online (pdf): *Ontario Securities Commission* <www.osc.gov.on.ca/documents/en/Securities/fyr_20030529_5yr-final-report.pdf>. See also *Bill 149, Budget Measure Act (Fall), 2004,* SO 2004, c 31, Sched 34.

[939] See Dana M Peebles, Brandon Kain and Paul Davis, "Developments in Class Action Law: The 2014–2016 Term – Securities Litigation Comes of Age at the Supreme Court of Canada", (2017) 77 SLCR (2d) 1 at 4–18 outlining the evolution of the idea of a secondary market remedy from the 1979 work of Philip Anisman, Warren Grover, and J Peter Williamson, *Proposals for a Securities Market Law in Canada* (Ottawa: Minister of Supply and Services, Canada, 1979). See also Toronto Stock Exchange Committee on Corporate Governance in Canada, *Where Were the Directors? Guidelines for Improved Corporate Governance in Canada* (Toronto: Toronto Stock Exchange, 1994). See also Toronto Stock Exchange Committee on Corporate Disclosure, *Toward Improved Disclosure: A Search for Balance in Corporate Disclosure* (Toronto: Toronto Stock Exchange, 1995). See also Toronto Stock Exchange Committee on Corporate Disclosure, Allen Committee, *Responsible Corporate Disclosure: A Search for Balance* (Toronto: Toronto Stock Exchange, 1997) [Allen Committee Final Report]. The Allen Committee is the Toronto Stock Exchange Committee on Corporate Disclosure, which was established to review and assess the adequacy of continuous disclosure by public companies in Canada. The Final Report of the Allen Committee was issued in March 1997.

> exposing issuers to crippling damage awards, while the model based on compensation would try to compensate anyone who was injured by misleading disclosure. The majority of the Committee favoured a deterrence model.[940]

When the CSA responded to comments on its initial 1998 draft legislation for a statutory remedy for investors for secondary market misrepresentations, it drew a clear distinction between its proposed legislation and remedies available in connection with SEC Rule 10b-5.[941] In its response to comments on the CSA's 1998 draft legislation, the CSA noted that its then proposed legislation, which was largely adopted by the Ontario Legislature in 2002 in Bill 198, "is a specific and comprehensive code whereas [Rule 10b-5] is a general anti-fraud rule which leaves to determination by the courts matters such as the elements of the cause of action and the apportionment of damages."[942] The addition of subsection 126.2(2) is consistent with this foundational choice. It does not create a general anti-fraud remedy for investors similar to Rule 10b-5. We do not want to be taken to suggest that it would be appropriate to repeal subsection 126.2(2) of the OSA, nor are we suggesting that sections 126.1 and 126.2(1) of the OSA should be available to target companies or their shareholders in the same way that Rule 10b-5 is available to investors in the US.

As noted by the CSA in 2000, private enforcement and public regulations complement each other in providing effective incentives to market participants – public companies and others – to ensure that their statements to the investing public are accurate and reliable.[943] There is no reason why private enforcement could not complement public regulation in guarding against abusive short selling and other market manipulation. However, if a statutory right of action for market manipulation and misrepresentation in a short and distort campaign is to focus on compensation and not deterrence, this would be a departure from the underlying philosophy to Part XXIII.1 of the OSA, especially if a new statutory right of action for market manipulation and misrepresentation in short and distort campaigns is created through an additional codified remedy that stands alongside Part XXIII and Part XXIII.1 of the OSA, even potentially introducing it to the OSA as a new part – Part XXIII.2.

It is beyond the scope of this paper to presume to draft a new statutory private right of action to address short and distort schemes. Moreover, creating a statutory private right of action for investors for market manipulation represents a significant change in Canadian securities law – one that will require careful consideration and consultation between regulators and the industry. We note that it took decades for a statutory private right of action for secondary market investors to become law. There is no reason to believe that a statutory private right of action to allow investors to recover losses from those who engage in market manipulation through misleading information, such as a short and distort campaign, will be something that can be drafted and implemented without considerable consultation between regulators and the industry. Nevertheless, we would expect that based on what has been learned from implementing other private rights of action, if it was decided to put in place a new statutory private right of action to allow investors to recover losses from those who engage in market manipulation through misleading information, this could be achieved in a shorter timeframe than that for Part XXIII.1 of the OSA.

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[940] Allen Committee Final Report, *supra* note 939 at 41.
[941] R*egulation SHO*, supra note 393 at § 240.10b-5.
[942] *Report of the Canadian Securities Administrators – Proposal for a Statutory Civil Remedy for Investors in the Secondary Market and Responses to the Proposed Change to the Definitions of "Material Fact" and "Material Change"*, CSA Notice 53-302 (3 November 2000) at 36, online (pdf): *Alberta Securities Commission* <www.albertasecurities.com/-/media/ASC-Documents-part-1/Regulatory-Instruments/2018/10/CSA-53-302-Nov-3-00-Rfor-c.ashx> [*CSA Notice 53-302*]. We note that *CSA Notice 53-302* was withdrawn by *CSA Notice 11-309* on March 3, 2006.
[943] *Ibid* at 4.

As a starting point for further discussion, we have considered the following:

(i) the private right of action under Part XXIII.1 of the OSA,[944] which provides a right of action for secondary market investors who are harmed by issuers and other responsible parties who make misrepresentations in disclosure documents and other statements, or by failure to make timely disclosure; and

(ii) section 1041I of the Australian Corporations Act,[945] which allows individuals who have suffered loss or damages as a result of a breach of various prohibited acts to recover damages. These prohibited acts include engaging in misleading or deceptive conduct, dishonest conduct or "inducing a person to deal" using dishonest or deceptive conduct.[946]

We set out the considerations below with the assumption that the key focus of a private right of action should be deterrence and not compensation.[947] Misrepresentations made by third parties can be as detrimental to the market as those made by issuers and their officers and directors, and the focus of a new private right of action should continue to be market integrity and the reduction of systemic risk, and therefore promoting deterrence by requiring those who profit from abusive short selling to disgorge their gains.

In the hope of advancing an effort to consider and debate the basis and outline for a statutory private right of action to allow investors to recover losses from those who engage in market manipulation through misleading information, we set out below what we believe to be some of the key considerations.

1. Is the frequency of short campaigns in Canadian marketplaces, as well as the risks posed by short and distort campaigns, significant enough to merit intervention and the creation of a new deterrent through a civil right of action for market manipulation?

The Allen Committee's recommendation in its Final Report that a new statutory right of action should be created for investors in the secondary market was based on it concluding that there was a sufficient degree of non-compliance with existing continuous disclosure obligations to cause concern and merit a response.[948] We have no doubt that Canada has attracted a significant number of short campaigners due to the lack of appropriate regulations. We also believe that a lack of regulatory action by IIROC simply compounds the problem. As we urge in Section 7.4.3.1, we think a new independent study is merited, which may assist in determining the extent to which naked shorting occurs in Canadian marketplaces and its correlation to short campaigns. More importantly, we

[944] In particular, section 138.3, which provides shareholders with a right of action against an issuer, its directors and officers, influential persons (as defined) and experts in connection with misrepresentations in the issuer's public disclosures.
[945] Australian Corporations Act, *supra* note 551 at s 1041I(1).
[946] Recently, Rural Funds Management ("**Rural**") launched an action against Bonitas Research ("**Bonitas**") and founder Matthew Wiechert in the Supreme Court of New South Wales with respect to Rural Funds Group (ASX: RFF). Rural is seeking compensation for the alleged loss and damage it suffered from allegations made by Bonitas in a series of reports that alleged that Rural Funds grossly overstated the value of its assets, which include leased-out almond, cattle, vineyard, poultry and cotton farms, and that sent its share price crashing 42% on August 6, 2019. Rural has claimed that sections 1041D, 1041E, 1041F and 1041H of the Australian Corporations Act and section 12DA of the *Australian Securities and Investments Commission Act* were contravened. Bonitas has stated that Australian courts have no jurisdiction.
[947] The Supreme Court of Canada summarized the evolution and function of the secondary market misrepresentation regime in Part XXIII.1 of the OSA in *Canadian Imperial Bank of Commerce v Green*, 2015 SCC 60 at paras 63–69, noting at para 69 that its provisions strike "a delicate balance between various market participants. The interests of potential plaintiffs and defendants and of affected long-term shareholders have been weighted conscientiously and deliberately in light of a desired precise balance between deterrence and compensation."
[948] Allen Committee Final Report, *supra* note 939 at 15.

believe the risks to the capital markets of short and distort campaigns are obvious, particularly from the perspective of increasing systemic risk.

2. Are existing remedies for target companies and their shareholders, in the words of the Allen Committee, "so impractical as to be illusory"?[949]

The Allen Committee also concluded that existing remedies of actions for misrepresentation and deceit were inadequate in providing investors with a meaningful remedy for misleading continuous disclosure.[950] We similarly think that the common law offers target companies and their shareholders, or former shareholders, no effective redress for their losses resulting from short and distort campaigns. Additionally, the staff of securities regulators have not had any success in regulatory actions against short campaigners.

3. What type of conduct is necessary to give rise to a statutory private right of action?

Should a statutory private right of action for market manipulation be based on an entirely new section to the OSA targeted directly at short campaigns, rather than by reference to sections 126.1 and 126.2(1) of the OSA? We view sections 126.1 and 126.2(1) of the OSA as being sufficiently broad to capture the kind of conduct that would be actionable under common law causes of action for negligent misrepresentation and defamation.

We note that a civil liability regime exists in the Australian Corporations Act, which provides investors with a right to recover losses or damages from anyone who engaged in certain prohibited conduct.[951] Civil liability under these provisions is not predicated on the securities regulator taking enforcement proceedings or on a prior conviction of an offence in connection for violating these provisions.[952] Determining who is liable and the basis for ascribing liability depend on specific conduct. For example, losses or damages for false or misleading statements can be recovered from any person or company, so long as they made a statement knowing that it was false or without caring whether the information was true.[953] In contrast, only persons "carrying on a financial services business" are liable for engaging in dishonest conduct in relation to a financial product or service.[954]

- Should a statutory right of action require both an intent to artificially increase or decrease the price of a stock, contrary to section 126.1of the OSA *and* the making of an untrue or misleading statement, contrary to section 126.2(1) of the OSA?

- Should a statutory private right of action be available to address market manipulation or making misrepresentations or untrue statements, regardless of whether the intent was

[949] *Ibid* at 12.
[950] *Ibid*.
[951] Australian Corporations Act, *supra* note 551 at ss 1041E–1041I.
[952] *Ibid*. Violation of sections 1041E through 1041G are also offences that can be prosecuted by the Australian securities regulator:
- Section 1041E of the Australian Corporations Act prohibits making false or misleading statements. This applies to statements where "the statement or information is false in a material particular or is materially misleading." The statement must result in an individual acquiring or disposing a security or impacting the price of a security and the individual making the statement either knows it is false or does not care whether the information is true or false.
- Section 1041F of the Australian Corporations Act prohibits inducing an individual to deal in financial products in certain situations, including making a statement or forecast that is either misleading, false or deceptive; dishonestly concealing material facts; or recording or storing information that a person knows to be false or misleading.
- Section 1041G of the Australian Corporations Act prohibits persons "carrying on a financial services business" from engaging in dishonest conduct.
- Section 1041H of the Australian Corporations Act broadly prohibits engaging in conduct that is meant to mislead or deceive in relation to a financial product or services, such as (but not limited to) publishing a notice in relation to a financial product.

[953] *Ibid* at s 1041E.
[954] *Ibid* at s 1041G.

to artificially increase the price of a stock (in a long sale) or to artificially decrease its price (in a short campaign)?

Basing a statutory private right of action on the existing prohibitions against market manipulation in section 126.1 of the OSA *and* against making misleading and untrue statements in section 126.2(1) of the OSA potentially holds accountable and makes liable for resulting losses any person who:

(i) makes a statement – orally or in writing – that can reasonably be expected to be generally disclosed to the public;

(ii) (a) knew that the statement contained a misrepresentation, (b) deliberately avoided acquiring knowledge that the document or public oral statement contained the misrepresentation, or (c) was guilty of gross misconduct in connection with the release of the document or in making the public oral statement that contained the misrepresentation; and

(iii) knew or ought to have known that the statement would contribute to an artificial price for the target company's securities or would reasonably be expected to have a significant impact on the market price or value of the target company's security.

4. Should a statutory private right of action based on conduct contrary to sections 126.1 and 126.2(1) of the OSA distinguish between long sales and short sales?

While we raise the question of a statutory private right of action for market manipulation in the context of short and distort campaigns, there may be no compelling policy reason to limit such a remedy to short sales. Although, we do recognize that, from a practical point of view, it is likely that short sales, rather than long sales, will form the basis of most relief sought.

5. Who should potentially be liable?

We note that sections 126.1 and 126.2(1) of the OSA apply broadly to prohibit a "person or a company" from engaging in the prohibited conduct. This potentially makes persons liable under a new statutory civil remedy, even if they are not otherwise subject to the OSA.

- Should the statutory private right of action be limited to companies or individuals who are already regulated under the OSA, or should it extend broader to any person, whether a registrant or not? This may be appropriate, as it would offer a broad deterrent not only to "registrants" whose conduct is regulated under the OSA, but more broadly to analysts; publishers of market information, such as bulletin boards; and private individuals who may participate in a short campaign, but who are not otherwise accountable to the OSC for their conduct. However, while this would have a broad deterrent effect, it may also go too far and deter or even stifle free speech in connection with the market.

- Need every defendant engage in conduct that contravenes both sections 126.1 and 126.2(1) of the OSA? If not, what level of participation in a short and distort campaign – or other effort to manipulate the market – is required from each defendant to be found liable for damages?

6. Should the court play a gatekeeper role with a responsibility to initially vet a proposed action to prevent vexatious proceedings?

Would it be appropriate to rely on the same test for leave that exists in Part XXIII.1 of the OSA as a prerequisite to any action started under a new statutory private right of action for market manipulation? We note that the Supreme Court of Canada has given guidance on the requirements for the leave set out in section 138.8(1) of the OSA,[955] requiring the court to be satisfied that (a) the proposed action is brought in good faith and (b) there is a reasonable possibility that the plaintiff will be successful. Therefore, the court's gatekeeper function[956] is now well understood and could be a useful element in balancing a right to compensation with encouraging compliance with the OSA and deterring market manipulation through misinformation campaigns.

7. Should there be any reliance requirements?

We note that an offence under section 126.2(1) of the OSA does not require proof that anyone relied on a misleading or untrue misstatement.

- Should a statutory private right of action for market manipulation require the plaintiffs to prove that their losses were incurred as a result of their reasonable reliance on the impugned statements?

- Would it be more appropriate for a statutory private right of action for market manipulation to bear closer resemblance to defamation claims, where liability is based on making a false statement, rather than on negligent misrepresentation claims, where liability is based on a breach of a duty of care and reliance causing losses?

- If it is thought to be desirable to allow these remedies to be pursued by way of class actions to allow smaller investors to seek relief, then it may be more appropriate to not require proof of reliance.

8. Should the plaintiff's knowledge about the truth (or falsity) of a short campaigner's statements be relevant?

As is the case for claims under Part XXIII and Part XXIII.1 of the OSA,[957] should a plaintiff be disentitled to any recovery for his or her losses if he or she had prior knowledge that the statements made by the defendants were untrue or misleading? Is this relevant since it is the market's perception of the veracity of the statement that may determine whether damages are suffered?

9. What are the competing public policy considerations at play in creating a statutory private right of action?

Creating a statutory private right of action may have a chilling effect on free speech, which in itself is vital to any rational, efficient and functioning capital market. Can these concerns be addressed through statutory defences?

- Is there a way to distinguish between intentional misconduct and simply being wrong? Truth will always be a full defence for short campaigners. Investor losses are an inevitable and necessary consequence of a properly functioning capital market. If the target

[955] *Canadian Imperial Bank of Commerce v Green*, *supra* note 947.
[956] *OSA*, *supra* note 13 at ss 138.3, 138.8.
[957] *OSA*, *supra* note 13 at ss 131(4), 138.4(5).

company's shares are overvalued, and the concerns raised by the short campaigner are legitimate and ultimately borne out, shareholder losses are part of the market's self-correcting nature. In other cases, a short campaigner may simply be wrong in its analysis of the target corporation.

- Should a defendant be able to show due diligence by relying on the report of a consenting expert?

- Should a due diligence defence incorporate the defences available to common law claims based on negligent misrepresentation or defamation? For example, can a defendant demonstrate reasonable care similar to showing no negligence as a defence to a negligent misrepresentation claim?[958] Should there be a due diligence defence of fair comment, such as in a defamation action?

- Should corrective disclosure lessen the amount of damages payable in order to provide some inducement to rectify the misrepresentation as soon as possible?

- Should different due diligence defences be available to different defendants? For example, it may be reasonable to allow a publisher to escape liability if it can establish that the document containing a misleading or untrue statement was issued in the ordinary course of its business and that the publisher did not otherwise participate in the scheme. Similarly, it may also be reasonable to provide a professional, such as a lawyer or accountant, who is governed by a professional standard with a defence if he or she publishes information on behalf of a client operating within the rules and regulations governing his or her profession.

10. Should there be statutory limitation of liability?

- If the primary purpose of a new statutory right of action for market manipulation is deterrence, and not compensation, should there be caps on the damages recoverable?

- What would be the underlying policy justification for a damages cap? We note that one of the reasons for imposing damages caps in Part XXIII.1 of the OSA was the concern that damages payable by an issuer in connection to secondary market disclosures would ultimately be borne by long-term investors who did not buy or sell shares during the misrepresentation period. These concerns do not exist in connection with a statutory private right of action related to short and distort campaigns. However, would other public policy considerations, such as not chilling free speech, justify capping or limiting damages?

- Should there be different caps for different defendants? Sections 138.1, 138.6 and 138.7 of the OSA cap damages and make them subject to limitations at different thresholds, depending on whether the defendant was a "responsible issuer" or an "influential person", or a director or officer of either; an expert; or any other person who made a public oral statement. Damages are also assessed according to proportionate responsibility among co-defendants based on their responsibility for the misrepresentation in the issuer's continuous public disclosures.

[958] Due diligence defences are available under Part XXIII and Part XXIII.1: see *OSA*, *supra* note 13 at ss 132.1(1), 138.4(6), 138.4(7).

- Can the goal of deterrence in a new statutory private right of action for market manipulation be achieved by balancing the concepts of compensation and disgorgement of unlawful gains in awarding damages to the target company or its shareholders? For example, could a cap on damages be based on a percentage of the target company's loss of market capitalization and, where the defendant knew that the statements made were misleading or untrue, the amount of any gains realized by the defendant (whether there was a disgorgement of any profits realized on the sale of securities or revenues earned in connection with the defendant's participation in the short campaign).

11. Should there be any procedural rights to address the concern of access to justice?

- Should a statutory private right of action provide a plaintiff a pre-discovery right to receive disclosure of any information that the defendant has about the participation of other individuals in carrying out the manipulative conduct, or in making the misleading or untrue statements? It may be prohibitively expensive or simply not possible for a plaintiff to identify short sellers and their accomplices. Therefore, should a plaintiff be entitled to some type of pre-discovery disclosure? This right, while unusual, is not unknown in civil litigation, and might resemble what is known as a *Norwich Pharmacal*[959] order, or an equitable bill of discovery, which allows a plaintiff to take evidence from third parties who have information about the wrongdoer in order to identify the proper defendants to a civil proceeding. For example, a statutory private right of action could include a provision that would require a defendant to provide a plaintiff with written notice of the information that the defendant has about the identity of any other person who acted in concert with the defendant, and the circumstances related to their participation. A balance would need to be found between making this a meaningful tool, requiring defendants to produce this information on a timely basis, failing which, the court should have the discretion to award a successful plaintiff costs on a full indemnity basis and prevent this right from being used improperly; for example, as a proverbial fishing expedition. Accordingly, should such a procedural tool be available to the plaintiff *only* after the court fulfills its gatekeeping function and grants the plaintiff leave to proceed with the action? Given the relatively unusual nature of such a pre-discovery right to disclosure, there also should be a basis on which a defendant can seek an order of the court excusing it from such a disclosure.

- Should the "loser pays" principle be a meaningful counterbalance to the risk of unmeritorious litigation? The "loser pays" principle generally exists in Canadian civil litigation. The Ontario Standing Committee on Finance and Economic Affairs concluded that the "loser pays" principle was a safeguard against frivolous litigation under the OSA.[960] Are there any reasons why a statutory private right of action for market manipulation should deviate from the ordinary cost consequences?

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[959] These orders are named after the 1974 house of Lords decision in *Norwich Pharmacal Co v Customs and Excise Commissioners,* [1974] AC 133, and have been adopted in Canada as well. The Federal Court of Appeal set out the following four requirements before granting such an order: (1) the person seeking discovery must have a *bona fide* claim against the alleged wrongdoer, (2) the person seeking discovery must have some relationship to the person from whom the information is sought, (3) the person against whom the order is sought must be the only practical source of the information available and (4) the public interest in favour of disclosure is not outweighed by the public interest against compelling disclosure: see *Glaxo Wellcome PLC v Canada (Minister of National Revenue)* (1998), 162 DLR (4th) 433.

[960] Standing Committee on Finance and Economic Affairs, *supra* note 938 at 24.

We are under no illusions that a new statutory private right of action for market manipulation will happen quickly; however, we see no reason why a process cannot be put in place quickly to move this idea forward. We would suggest that the OSC continue its consideration of how to address short and distort schemes by holding a public forum to debate the need and basis for a statutory private right of action to allow investors to recover losses from those who engage in market manipulation through misleading information, and also the broader issues set out herein. A statutory private right of action for misleading continuous disclosure had been recommended over decades before the CSA drafted its 1998 draft legislation. Even then, it took the Ontario government years to proclaim the legislation in force. Certainly, we can move more quickly this time. In any event, we suggest that there are parallels between what the Allen Committee saw as factors justifying the inclusion of a civil remedy for continuous disclosure and what appears to be happening in the Canadian market with short campaigns, as follows:[961]

- There is a sufficient degree of non-compliance in Canadian marketplaces, as evidenced by the increased number of short and distort campaigns in Canada and the clear evidence of naked shorting, to cause concern.

- The current sanctions available to regulators do not appear to provide an adequate deterrent.

- Existing civil remedies available to target companies and shareholders injured by short and distort campaigns are so difficult to pursue as to make them academic.

7.8 Summary

Based on the foregoing analysis, and in order to improve investor confidence and market efficiency while appropriately reducing systemic risk, we would recommend that the following changes be made to the regulations in Canada that govern short selling:

Revisions to UMIR:

1. impose locate or pre-borrow requirements with respect to short sales, subject to limited exceptions;

2. disclose aggregate short position and trade data per issuer daily;

3. disclose failed trade data daily;

4. to the extent EFTs are still considered necessary, lower the failure to settle window; and

5. impose monetary penalties in connection with failures to close out failed trades.

Revisions to securities legislation:

1. CSA to regulate that other Canadian market participants, such as custodians or other institutions that are members of CDS, must disclose daily short trading data; and

[961] Allen Committee Final Report, *supra* note 939 at 10–15. *CSA Notice 53-302*, *supra* note 942 at 4.

2. CSA to require all Canadian trading venues to disclose short trading data per issuer daily.

In addition, we would implore the OSC to increase enforcement activity, and the CSA to consider and evaluate, including by seeking commentary from market participants, whether it is appropriate to create a statutory private right of action to allow investors to recover losses from those who engage in market manipulation through misleading information.

8. CONCLUSION – A NEW PATH FORWARD IS REQUIRED

8.1 Conclusions Derived From Research and Rigorous Debate

It will surprise no one reading this paper that it has evolved through multiple drafts and revisions. Several reviewers of earlier drafts commented on what they perceived as an anti-short – or perhaps, a pro-issuer – bias. To be clear, this is not our intention, nor is it the case. We reviewed the regulatory regime governing short sales in Canada with no preconceptions or conclusion in mind and arrived at our conclusions based on the research undertaken. Similarly, the recommendations we make in this paper are the result of lively discussion and debate of the various competing policy concerns that are engaged in regulating short sales. We recognize the vital role short selling plays in providing liquidity and allowing for price discovery in the Canadian capital markets, as well as the difficulty regulators face in designing rules that balance protection against abusive short selling and ensuring liquidity.

8.2 Canadian Regime is Based on Flawed (or Questionable) Assumptions

It is clear to us that short selling regulations in Canada are out of step with those in other jurisdictions. The Canadian regulatory regime in respect of short selling is inherently weak, as the rules were created based on the results of several IIROC studies that we believe are flawed. IIROC has proceeded from a key assumption – namely, that a historically low rate of failed trades indicates that short selling and naked short selling are not problems in the Canadian markets. We do not see how this assumption is justified. First, it is not clear that Canada has comparatively low failed trade rates. In any event, we do not see how a historically low rate of failed trades provides IIROC with any basis on which to conclude that failed trades will continue to be low. More importantly, it is not clear to us why a historically low rate of failed trades leads IIROC to conclude that short selling does not pose any systemic risk to the Canadian markets. Even if these assumptions could bear the weight placed on them, the IIROC studies are themselves flawed in methodology and we are not convinced that such studies should form the basis of the Canadian regime.

8.3 Canada's Regulations Are (Inexplicably) Inconsistent With Key Aspects of the IOSCO Four Principles

We compared the Canadian regulatory regime in respect of short sales against the regulatory regimes in the US, the EU and Australia, which are jurisdictions that have imposed short sales regulations adhering to the ISOCO Four Principles. In Canada, IIROC has pointed to what it calls the uniqueness of Canadian capital markets to justify deviating from key aspects of the IOSCO Four Principles, including the need for transparency, significant enforcement activity and strict settlement rules.

IOSCO Principle 1 provides that short selling activities should be subject to appropriate controls, such as buy-in provisions or strict settlement provisions, to reduce or minimize potential risks that could affect the orderly and efficient functioning and stability of the capital markets. Despite the fact that the OSC and the AMF were part of IOSCO's Technical Committee that recommended the IOSCO Four Principles, IIROC has steadfastly insisted that the Canadian failed trade experience makes it unnecessary to address the risks identified in and addressed by IOSCO Principle 1. IIROC points to what it calls the unique attributes of the Canadian capital markets as additional reasons why front-end locate or pre-borrow requirements, or back-end compulsory buy-ins, that would address the recommendations in IOSCO Principle 1 are not appropriate in Canada. There is no doubt that certain precautions, such as locate or pre-borrow requirements, would pose significant difficulties in Canadian junior markets – that is, the securities of venture issuers – which tend to have lower liquidity

and higher volatility. However, such issues also exist in other markets, such as Australia, which have followed IOSCO Principle 1. IIROC has yet to draw a clear line linking what IIROC considers the unique characteristics of the Canadian capital markets and the conclusion that IOSOC Principle 1 is inapplicable. The onus should be on the CSA and IIROC to convincingly explain why Canadian short sale regulations should not adhere to each of the IOSCO Four Principles. They have not yet done so.

We would also note that the lack of transparency when compared to other regulatory regimes raises significant issues related to investor confidence and market integrity, and is a deviation from key aspects of the IOSCO Four Principles. The benefits of short selling, such as price discovery, are best achieved with timely disclosure regarding short sales and failed trades, and may well be negated through delays in such disclosure. It is critical that IIROC and the CSA take appropriate steps to improve the frequency of disclosure. We have no doubt that disclosure can be provided on a daily basis, particularly where such information is already available, such as failed trades, gross short positions and the aggregate volume of short sales in a security. Absent a clear policy or public interest rationale, it is not clear to us why less onerous requirements should be imposed on short trades than those imposed on long trades. Short sales have greater potential to inflict harm on the markets and the economy, and transparency through timely disclosure appears to be a logical and constructive means to limit the potential detriments of short selling and enhance its benefits.

8.4 Naked Shorting in Canadian Marketplaces Must Be Better Studied

IIROC has dismissed naked short selling as an issue and takes the view that UMIR prohibits naked shorting. Despite this, when we look to the definition of naked short selling used by regulators in other jurisdictions, it is clear that nothing in UMIR prohibits naked short selling. IIROC's failure to adopt IOSCO Principle 1 facilitates naked shorting in Canadian marketplaces. Naked shorting is perfectly legal and is only prohibited when the short seller has no intention of delivering the shares on the settlement date. This conduct may only become apparent if the seller is unable to settle 10 trading days after the expected settlement date, by which time it should be possible to cover or otherwise undo the naked short. UMIR provides a regulatory regime for short selling in which IIROC simply has no way of knowing the extent to which naked shorting actually occurs in Canada. Similarly, IIROC has no way of identifying, let alone quantifying, the systemic risk naked shorting poses to Canadian capital markets or the consequences that would materialize if market conditions change and those engaged in naked shorting find it impossible or uneconomical to cover their positions.

Statistics from Activist Insight indicate that there are a disproportionate number of short campaigns in Canada compared to the US, the EU and Australia given the size of our capital markets. This suggests that the number of short campaigns in Canada is not merely a coincidence. As such, it is the responsibility of IIROC and the CSA to recognize why this is the case and to understand the systemic risks associated with Canada being a jurisdiction of choice in which to conduct a short campaign.

8.5 Is a New Statutory Private Right of Action Needed?

An increase in the number of short campaigns will inevitably bring increased instances of short and distort schemes. Neither UMIR nor securities laws currently provide a sufficient deterrent to short campaigners engaging in short and distort schemes. With virtually no successful enforcement proceedings in connection with a short and distort campaign, as well as little civil litigation, it is clear that there is currently no effective remedy – whether through compliance or the recovery of damages – for target companies or their shareholders. As such, we recommend that the CSA consider a statutory private right of action. We understand the difficulties of providing such a right

of action, given that there are important countervailing policies brought into play in providing a damages remedy against those who engage in short and distort schemes. There is concern that a statutory private right of action would risk stifling free speech and negatively impact price discovery in the Canadian capital markets. It is premature and beyond the scope of this paper to propose draft legislation, but we have set out a list of factors to be considered. We hope that our recommendations act as a starting point to begin the long public and industry consultation process to determine whether a statutory private right of action can balance these competing policy concerns and provide a means to better address – and deter – abusive short selling.

8.6 Recommendations

In summary, in order to improve investor confidence and market efficiency while appropriately reducing systemic risk, we would recommend that certain changes be made to the regulations in Canada governing short selling. First, we would recommend that the following revisions be made to UMIR:

1. impose locate or pre-borrow requirements with respect to short sales, subject to limited exceptions;

2. disclose aggregate short position and trade data per issuer daily;

3. disclose failed trade data daily;

4. to the extent EFTs are used, lower the failure to settle window; and

5. impose monetary penalties in connection with failures to close out failed trades.

In addition, we would recommend that the CSA:

1. regulate that other Canadian market participants, such as custodians or other institutions that are members of CDS, must disclose daily short trading data; and

2. require all Canadian trading venues to disclose short trading data per issuer daily.

Notwithstanding our recommendations, we do acknowledge that regardless of how IIROC proceeds with regulatory changes, from a practical perspective, it may be necessary for IIROC to retain an independent and qualified third party to undertake a new study as a foundation for changes to the Canadian short selling regulatory regime. Nevertheless, we remain skeptical that a singular focus on market-wide failed trade data will be determinative.

Finally, we implore the OSC to increase enforcement activity. We also strongly encourage the CSA to evaluate (including by seeking commentary from market participants) whether it is appropriate to create a statutory private right of action that allows investors to recover losses from those who manipulate our markets with misleading information.

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