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Limiting the damage of short-sellers

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Yvan Allaire, PhD (MIT), FRSC
Executive Chair, IGOPP
Emeritus professor of strategy

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When any individual investor or fund comes to the conclusion after careful analysis that a company is over-valued, it may very well sell short the shares of that company. Fair enough. If the analysis proves right, facts on the ground will confirm it eventually and the stock price will drop.

But that's not the game plan of "professional" short-sellers. These funds produce a wholly negative report about a targeted company, which they broadcast widely to media, analysts, and investors in the hope of producing a stampede of shareholders exiting the company's stock. The result usually is a sharp drop in price as a kind of self-fulling prophecy. The short seller then buys the stock back at this much lower price and sails into the sunset with a bundle of cash.

Several countries (Japan, France, Germany, Italy) are considering ways and means to curtail the ability of activist funds to inflict damage to their industrial structure. Japan's huge Government Pension Fund has suspended all loans of shares to short-sellers; if all Canadian institutional funds were to adopt such a policy, it would drive way up the price of borrowing shares to short-sell and make it more difficult to carry such operations profitably.

France is proposing to lower the threshold for reporting holdings of shares in a company from 5% to 3%. (Canada is *a laggard and an outlier* in this respect with a threshold of 10%; USA=5%; UK=3%). Furthermore, in the UK, short sellers must make their position public when it reaches 0.5% of outstanding shares and *must include all derivatives in the computation of that ratio.*

In the U.S., the SEC has clamped down on "naked" short selling, the practice of selling shares but delaying the delivery of the shares for as long as possible in the hope of buying back the shares at a much lower price without incurring the cost of borrowing shares from other holders. The SEC has instituted a "Hard T+3 Close-Out Requirement" imposing a three-day limit on stock delivery after a sale. No such restriction has been put in place in Canada.

Also, short selling could not be carried out if the last transaction had not been executed at a price higher than the previous transaction (the "uptick" rule). This rule was dropped in the U.S. in 2007 and in Canada in 2012. However, *in 2010, the SEC introduced a modified tick test that is triggered for the remainder of the day and all of the following day if the price of a security falls by more than 10 per cent. This modified tick test was never adopted in Canada*. *(Activist short-sellers are increasingly targeting Canadian companies — is Canada ready?* ***Financial Post****,* Barbara Shecter, October 6th 2017

Canada is thus a benign place to practice financial/casino capitalism. The features of this sort of capitalism are in full display at Spruce Point Capital, the American hedge fund and serial aggressor of Canadian companies. This fund practices the dark art of short selling. Barely a year ago in October 2018, Spruce Point Capital launched a virulent campaign against Dollarama. It produced a report to buttress its claim that the stock price of Dollarama should or would drop from $46 to $28; the stock price actually leveled off at $31 in December 2018 from which level it soared back to above $45.

It is fair to assume that Spruce Point Capital bought back shares it had short-sold at $46, making a hefty profit of some $15 per share in a period of some 2-3 months! But what about those shareholders who believed Spruce Point's "demonstration" and sold their shares on the way down only to find that they had been helping (unwittingly) a financial scheme, losing a large amount of money in the process. *Should they not have a claim, a basis for a class action, against Spruce Point Capital?* Why are activist hedge funds permitted to publicly and with impunity disparage any company, to spread innuendoes ("possibly misleading accounting", "potential shenanigans"), and to carry "ad hominem" attacks on officers or board members?

The same process, the same *modus operandi,* is on display at the most recent Canadian target of Spruce Point Capital: Canadian Tire is "*An Antiquated And Structurally Non-Competitive Brick And Mortar Retailer With No Clear Focus And No Competitive Advantage"* claims Spruce Point in a report of 108 unreadable pages made public on the morning of December 5th ("Kicking the tire down the road").

Although there may be kernels of truth in their analysis, the report throws everything but the kitchen sink at the reader and in the process throws mud at an Executive Vice-President and the Chairwoman of Canadian Tire.

What one will never find in these hack jobs is any concern for the environment and the society at large or for stakeholders other than shareholders. Yet, almost all institutional investors have now adopted strategies that put a high priority on Environment and Society, on long-term investment horizon and due consideration for all stakeholders of a company. Given this solemn commitment, why would these institutional investors support and abet the shenanigans of activist hedge funds whose sole focus is on short-term profit?

Large institutional investors with a significant position in a company have, or should have, the analytical wherewithal to assess public claims made by short sellers against this company. *If they find those claims to be ill-founded or even false, they should state so publicly instead of, as is the case now, letting the company fend off the attack by itself.* And these large institutional funds should not lend their shares to short sellers of the Spruce Point Capital ilk.

Canadian securities authorities and institutional fund managers should adopt some ways and means to limit the nefarious activities of activist funds, particularly the short-selling kind: more transparency, better regulations, enhanced constraints, self-discipline by institutional investors.

The author is solely responsible for the opinions expressed in this article.