

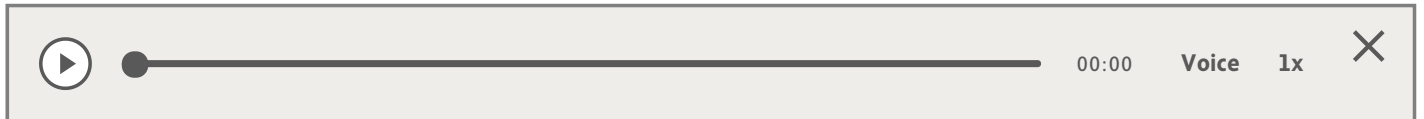
Regulations to rein in short-sellers must not overlook the good they do

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'Short-sellers' actions can be a corrective force for when bad apples slip through the accounting and auditing cracks – look, for example, at how Sino-Forest Corp. and Valeant Pharmaceuticals were brought to light,' Al Rosen, head of forensic-accounting firm Rosen & Associates Ltd., said.

DEBORAH BAIC

A thick hide is a necessary qualification for the job of activist short-seller. When Spruce Point Capital Management released a negative report on Canadian Tire Corp. Ltd. in late 2019, it prompted Yvan Allaire, the executive chair of the Institute for Governance of Private and Public Organizations, to fire back in the

Financial Post: “What one never finds in these short-seller hatchet jobs is concern for anything other than a quick profit.” This was followed with several suggestions for reining in short-sellers.

Mr. Allaire is not the only one proposing restrictions – indeed, there appears to be an upswing in such calls from a number of sources recently. The danger here is that the urge to impose new regulations could go too far and choke off the good things that academic studies have found short-sellers provide to financial markets.

Only seven campaigns were launched in Canada by activist short-sellers in 2019, according to financial data firm Breakout Point. This was the lowest tally since financial analytics firm Activist Insight began keeping records in 2015: In most of those years, the number of new campaigns ranged from 19 to 22. It appears some short-sellers may have gone to the sidelines during 2019 to wait out the bullish tide flowing through the stock market.

Activist short selling campaigns launched against Canadian companies in 2019



COMPANY	SHORT SELLER
Aurora Cannabis Inc.	Night Market Research
Canadian Tire Corp.	Spruce Point Capital
FSD Pharma	White Diamond
Hexo Corp.	The Friendly Bear
Trulieve Cannabis Corp.	Grizzly Research
Tucows Inc.	Kerrisdale Capital
Village Farms International	Citron Research

Data source: Breakout Point. Notes: Some positions may now be closed

Even though Canada’s activist short sales plunged last year, the count was still higher than in other countries, excluding the United States. Indeed, Canadian firms have been disproportionately targeted for several years: From 2015 to late 2019 there were 76 campaigns, compared with 17 in Australia and 57 in the European Union.

ACTIVIST SHORT-SELLERS ON THE ROPES

Perhaps the most notable of recommendations to curtail-short sellers came in a November report released by law firm McMillan LLP. It claimed that the regulatory framework in Canada for short-sale trades was “out of step” with other countries and some tightening up was needed to make it more difficult to engage in abusive transactions, particularly naked short-selling (which can result in illegal situations where the number of short sales exceeds the actual number of tradable shares).

The regulator in charge of trading rules, the Investment Industry Regulatory Organization of Canada, however, has pointed out that its studies have found little evidence of abusive short-selling in Canada. Moreover, assessments of IIROC's regulatory framework by the International Monetary Fund and World Bank concluded that it met international standards.

Several other sources have forwarded their own proposals. They include bringing back the uptick rule (short sales can only be made on an uptick in share price), giving companies civil remedies to combat "short and distort" campaigns, and having institutional investors cut back on lending securities to short-sellers. (Companies can currently sue short-sellers on a criminal basis but civil remedies would be preferable because of their lower burden of proof.)

LET'S KEEP SHORT-SELLERS IN THE FIGHT

The McMillan report and other critical commentary appear to overlook a key explanation for why Canada has attracted more than its share of activist short-selling campaigns – namely, it likely has more to do with the way financial results are reported in this country. If so, that would entail a different set of conclusions.

"We have the easier-to-manipulate IFRS accounting framework and auditors that have been relieved of legal liability toward investors by a Supreme Court ruling," Al Rosen, head of forensic-accounting firm Rosen & Associates Ltd., said in an interview. "Along with minimal oversight and prosecutions, this arrangement gives Canadian companies more leeway in presenting financial results in a favourable light to mask operating problems, unethical practices and fraud."

"Uneconomic companies can continue raising money in financial markets for a longer time than they otherwise should, diverting capital away from more productive uses," Mr. Rosen continues. "Short-sellers' actions can be a corrective force for when bad apples slip through the accounting and auditing cracks – look, for example, at how Sino-Forest Corp. and Valeant Pharmaceuticals were brought to light."

Adds Mark Rosen, head of independent investment-research firm Accountability Research Corp.: "Academic studies find that short-selling plays an important role in providing liquidity to financial markets. It also assists with price discovery – meaning it serves as an offset to the preponderance of bullish viewpoints arising from the dearth of independent research in Canada. It would be inadvisable to restrict short-sellers to the point where these benefits are diluted."

Short-sellers are sometimes accused of conducting "short and distort" campaigns that spread false information to manipulate the market. But these are likely to be isolated cases, argues Stephen Bainbridge, a professor at the UCLA School of Law in Los Angeles. As he writes on his blog: "The risk of liability – coupled with the risk of the company's stock not falling – should encourage the shorts to make sure that they have a strong case."