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Can beaten-up junior miners fight illegal short-selling?

STOCK MARKET | Thinly traded sector seen as vulnerable to manipulation

BY ALISHA HIYATE

Terry Lynch began to notice unusual price movements in **Power Nickel** (TSXV: PNP; US-OTC: PPNF)'s stock (then called Chilean Metals) years ago.

The shares consistently traded down at the end of the day, regardless of news, with late day trades often made anonymously.

Now the stock is stuck in a range of 25¢ to 30¢ — despite a recently released initial nickel-sulphide resource for the company's optioned Nisk project in Quebec.

It's not unusual for a junior mining CEO to be unhappy with his share price, but Lynch says Power Nickel isn't alone and something is amiss in the junior sector. The disconnect between the commodity markets and the junior mining-heavy TSX Venture Index, which is at an all-time low, has reached its widest point.

"When I first started talking about this, people thought, Terry, you should have a tinfoil hat on your head. They thought I was a crazy conspiracy theorist," he told *The Northern Miner* in early December. "But you know what? I got proof. Man, this is really happening and I'm not the only one that sees it."

In search of answers to the sector's woes, he formed the Save Canadian Mining group in 2019, recruiting big names like Eric Sprott, Rob McEwen and Sean Roosen as supporters. Now, he can point to exactly what's bleeding the junior market dry: Predatory short-selling.

"We're in a market where the governments to their credit, federally and provincially, have put out some amazing incentives for miners to actually get out there and explore and develop mines," he said. "So really, we should be in our glory years and we're instead about to go extinct."

Short selling is a legal way for traders to profit from a falling stock price. Traders sell borrowed shares in the hope of buying them on the market at a lower price. It serves an important function in helping the market discover the true value of a company's shares and has even helped uncover frauds like Enron. But it can also be done illegally, if traders don't "cover" their position — meaning the trader is selling shares they haven't borrowed, located, or confirmed are available for them to buy.

Lynch and others say "naked" shorting is a widespread and destructive problem in the junior mining sector. Last week he filed a formal complaint with the Canadian Investment Regulatory Organization (CIRO) and FINRA (Financial Industry Regulatory Authority) in the United States asking them to act on illegal short selling and restore investor confidence in the market. (see explainer)

'Neverending bear market'

Any sector with declining values will attract short selling, which plays an important role in ensuring overvalued stocks don't stay that way.

But veteran junior mining investors say that the removal of the "tick test" restrictions on short selling in 2012 have unleashed algorithmic trading programs onto the market that prey on both companies and retail investors. The "tick test" or uptick rule prohibited short sales at a lower price than the last sales price of a security.



Junior miners say that illegal short selling is depressing their stock values. ADOBESTOCK/VALIANTSIN



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— TERRY LYNCH
CEO OF POWER NICKEL

Often this activity happens in the shadows, in places only institutions like banks and their clients can access, says long-time junior mining analyst John Kaiser of Kaiser Research Online.

"Banks and professional traders are selling stock they don't even have a means to borrow," he said in December. "With no downtick rule to get in the way, they just lean into the bid and then everybody's who's been a 'long,' they get this feeling of despair and they sell."

Kaiser said these traders take advantage of the share volume rise that happens when companies release news, depressing any rallies.

Any new investors are left with nothing but buyers' regret — and juniors are stuck in a "neverending" bear market.

Kaiser says a lot of this trading must be predatory because junior mining stock is not easy to borrow.

"None of it's high enough to be marginable and margin accounts probably don't own this sort of stuff," he says. And large shareholders aren't likely to make stock available to short-sellers.

"Properly covered short selling, if that was enforced, would not be that big a problem."

Meanwhile, junior mining CEOs, many of whom are geologists with a distaste for or lack of knowledge of the capital markets, have proven hapless and helpless.

John Feneck, an Arizona-based technical analyst and consultant who helps mining companies raise their profiles, says many CEOs believe they can let their drill results speak for themselves. But that hasn't been the case for the last couple of years.

"Our sector is really thinly traded," he explained in a phone interview in early December. "Certain stocks are susceptible to larger moves based on their daily trading volume — many trade less than 100,000 shares a day."

Feneck says better disclosure could help market transparency. He notes that in the U.S., FINRA requires short-selling information to be reported only twice a month.

The long gap allows for potentially deceptive activities to take place.

"It's whatever happens between those reports that's frustrating people," he said.

What are the regulators doing?

Regulators have looked at the issue of naked short-selling many times over the past decade. But they've found scant evidence that there's a widespread problem.

In August 2022, CIRO predecessor IROC did clarify that naked short selling is in fact illegal in Canada. Guidance issued at the time stated that entering into a short order without "reasonable expectation" the trader will be able to access enough securities to settle it within two trading days is prohibited, and considered manipulative and deceptive behaviour.

CIRO's latest review concluded in November without recommending any regulatory changes.

But it does expect to publish new proposals outlining how it can further "clarify and support" the reasonable expectation requirement in early 2024.

Finally, CIRO and the Canadian Securities Administrators are forming a working group early in the year to study short selling in Canada, including an analysis of stronger requirements to settle trades when they're due. (see explainer) It will also look more closely at suggestions raised in the previous consultation, including the imposition of "pre-borrow" requirements before a short sale can be entered, and whether short selling of junior stocks should be treated differently. In a response to emailed questions, a CIRO spokesperson confirmed there would also be discussion around suggestions it received to bring back the tick test.

Investor protection momentum

In early 2023, several small-cap companies in the U.S. announced plans to take legal

action against short-sellers targeting their stocks.

In November, South Korea placed a temporary ban on short selling until next June. The move was supported by the country's powerful lobby of retail investors, who believe big banks are suppressing share values through short selling. Over a quarter of the nation's population invest in the stock market.

And in September, a judge in the Harrington Global Opportunity Fund market manipulation case against CIBC and big banks in the U.S. denied the defendants' motion to dismiss the case. In her decision, she found that banks and brokerage firms can be held liable for their clients' illegal trading, if they fail to provide proper oversight.

Banks have previously argued that they're not responsible for clients' illegal trading.

Lynch is encouraged by the momentum.

During an "emergency" Save Canadian Mining virtual event in late November,

Sprott exhorted junior executives to take action to protect their share prices. "CEOs must realize almost everyone's working against you," he said. "If the price sucks, why don't you wake up and do something about it!"

While Lynch doesn't want to take the banks to court, he wants to let them know industry is willing to go that far.

"Nobody wants to really fight them, but we need to show them, hey, we've got the evidence," he said. "The banks and the regulators, once they decide they want to do something, they can move very swiftly. They can change all these rules overnight."

That could usher in the biggest mining boom in human history, he posited.

To the banks, he offers this message:

"The money on the shorting side of this business is almost done. You've almost killed us. You need to invest in the long side, and then everyone's gonna make out like crazy." ^{TNM}



Winter drilling at Power Nickel's 50%-owned Nisk project in Quebec. The company can earn up to 80% of the project from Critical Elements Minerals. **POWER NICKEL**

Explainer: Naked short selling

Covered vs. naked short selling

"Covered" short selling is a legal way to profit in a falling market. It serves an important price discovery function — i.e. allowing traders who believe a stock is overvalued to try to make a profit from the overvaluation by betting the stock will fall once other investors finally clue in. These traders sell borrowed stock they don't actually own in the hope they can buy it at a lower price in the near future to give back to the borrower. This is considered "covered" if the investor arranges to borrow the shares or in less strict markets like in Canada, has some level of certainty that there are enough shares that can be borrowed.

Predatory or naked short selling, when a trader sells securities without assurance they're available to borrow, is considered a form of market manipulation and is illegal in the U.S., Canada and many other jurisdictions.

What's the problem?

Junior miners say illegal short selling is magnifying sector losses and limiting rallies in individual stocks.

They point to the removal of the "tick test" restrictions in Canada in 2012, which curbed short-selling activity by prohibiting short sales at a lower price than the most recent trade. Since then, they say there's been an explosion of algorithmic trading that pressures losing stocks lower, and is currently targeting their sector. They would like regulators to reinstate the rule.

What evidence is there of a problem?

Illegal short selling is difficult to prove because data that could point to manipulative activity isn't required to be disclosed.

Power Nickel CEO Terry Lynch says that data from Connecticut-based ShareIntel, which helps companies track trades in their stock — including suspicious trading activity — shows that there's a massive and persistent naked short position on Power Nickel shares. That imbalance has grown to at least 9 million shares over the last four months, or about 7% of the junior's outstanding equity, representing shares that were traded but likely never delivered. The problem could be even worse, Lynch says, because even ShareIntel can only access 80% of the trading data.

Power Nickel filed a complaint with Canadian and U.S. regulators CIRO and FINRA (Canadian Investment Regulatory Organization and Financial Industry Regulatory Authority) in December, asking them to investigate brokers that it says hold much fewer shares in their depository accounts than its clients actually own.

What do failed trades have to do with it?

One indicator of naked short selling is failed trades. Fails happen when a security isn't delivered or paid for when due (typically within two days of a trade). There are legitimate reasons for failed trades. But a 2022 study by CIRO predecessor Investment Industry Regulatory Organization of Canada (IIROC) based on data from 2015-2020 showed a higher correlation between high levels of failed trades in the junior market and short sales. In addition, in Canada there's a lack of transparency around failed trades, with no requirement to disclose them, unlike in the United States, Australia and the European Union.

According to Canadian law firm McMillan, IIROC justified this previously by pointing to a 2007 study it conducted that showed failed trades were a small

percentage of trades executed (0.27%). But a 2022 IIROC follow up study using data from 2015-2020 — after the removal of the tick test — suggests as a percentage of total traded volume, failures range from 3-19% depending on the exchange.

How else is Canada out of step with other jurisdictions?

Both the U.S. And EU have pre-borrow or locate requirements for short sales in place. The U.S. has settlement requirements aimed at preventing naked shorting (mandatory close-outs) with the EU is imposing its own (buy-in requirements) in 2025.

What do regulators say?

CIRO says it uses sophisticated algorithms to monitor trading and detect unusual levels of short selling coupled with significant price movements that could point to manipulative trading activity. It says that data shows the frequency of short sales on down ticks is relatively low, and that the rates of such sales are actually lower on exchanges that list junior securities than on other exchanges.

CIRO and the Canadian Securities Administrators plan to form a working group on short selling in early 2024. They say it will look at ways to strengthen requirements that traders secure or locate securities before entering a short sale order, as well as recent suggestions from its latest public consultations.