

CAPITAL MARKETS TRIBUNAL DECISION CONFIRMS LEGALITY OF HEDGING TRANSACTIONS DESPITE PUBLIC INTEREST CONCERNS

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Canada's capital markets operate within the "closed system" intended to protect the general investing public and to ensure regulatory control over the issuance and trading of prospectus-exempt securities. The mandatory hold period of four months – applicable to newly issued securities that are issued pursuant to a prospectus exemption – is a central component of the system. This safeguard ensures that the investing public has access to an issuer's disclosed updated financial and operation information before the restricted shares become freely tradeable in the secondary market. However, what happens when sophisticated parties leverage complex hedging strategies to navigate these rules without overtly breaching them?

This scenario is examined in a recent ruling by the Capital Markets Tribunal (the "**Tribunal**") of the Ontario Securities Commission (the "**Commission**"). The *Cormark* decision^[1] underscores the inherent tension between investor protection and the goals of market efficiency and fostering capital formation.

Overview

Canopy Growth Corporation ("**Canopy**") graduated from the TSX Venture Exchange to the Toronto Stock Exchange (the "**TSX**") in 2016 and was subsequently added to the TSX's composite index on March 17, 2017. Prior to its inclusion to the index, Cormark Securities Inc. ("**Cormark**"), a registered investment dealer, proposed a series of transactions (the "**Transactions**") to Canopy to capitalize on the anticipated increased demand for Canopy shares (the "**Canopy Shares**"), in which Canopy agreed to participate.

William Kennedy, a senior executive at Cormark, developed the structure for the Transactions, which involved Cormark's clients, Marc Bistricher and his company Saline Investments Ltd. ("**Saline**"), as well as Murray Goldman, a shareholder and director of Canopy. The Transactions took place around the time Canopy was added to the index. The key components of the Transactions were:

1. Canopy sold 2.5 million Canopy Shares to Saline in a private placement. These Canopy Shares were subject to a four-month hold period (the "**Restricted Shares**");

2. Saline borrowed 2.5 million freely-trading Canopy Shares (the “**Free-Trading Shares**”) from Goldman Holdings (the “**Loan**”) through a securities loan agreement (the “**Loan Agreement**”);
3. Saline provided the Restricted Shares to Goldman Holdings as collateral for the Loan; and
4. Saline sold short 2.5 million Canopy Shares on the TSX and used the Free-Trading Shares to settle the short sales (the “**Short Sales**”).

The Restricted Shares, which carried a legend indicating that they were subject to a four-month hold period, remained in Goldman Holdings’ account at Cormark until the end of the hold period and were ultimately retained by Goldman Holdings in satisfaction of Saline’s obligations under the Loan Agreement.

The Tribunal’s Decision

The Commission’s allegations included, among other things, that the Transactions constituted an illegal distribution of Canopy Shares, and that the actions and conduct of Cormark and the other respondents engaged the Tribunal’s public interest jurisdiction. However, the Tribunal ultimately determined that the Commission failed to prove any of its allegations.

Analysis

1. The Transactions did not Constitute an Illegal Distribution

The Commission argued that the Transactions amounted to an illegal “distribution” of Canopy Shares to the public without a prospectus or an exemption from the prospectus requirement, as required by the *Securities Act* (Ontario) (the “**Act**”). To support its claim, the Commission relied on the “extended” definition of distribution under the Act, which includes “any transaction or series of transactions involving a purchase and sale or a repurchase and resale in the course of or incidental to a distribution.”^[2]

Specifically, the Commission argued that the issuance of the Restricted Shares to Saline pursuant to the private placement, combined with the Loan Agreement and Saline’s subsequent Short Sales of the Free-Trading Shares, collectively formed a single *distribution*. However, the Tribunal rejected this interpretation, concluding that the Transactions did not effectively convert the Restricted Shares issued under the private placement into Freely-Trading Shares borrowed under the Loan Agreement, and thus the extended definition of distribution did not apply.

2. The Restricted Shares and Free-Trading Shares are Distinct Securities

Further, the Tribunal did not agree that the Transactions – particularly the Loan and Short Sales – were incidental to the issuance of the Restricted Shares under the private placement. The Tribunal concluded that the Restricted Shares and the Free-Trading Shares were *distinct* securities. There were two important features

to support this position: (i) the Restricted Shares bore the resale restriction legend required by applicable securities laws; and (ii) the Restricted Shares had a different CUSIP number than the Free-Trading Shares.

The Tribunal ultimately decided that, even though the Transactions may have been understood to be designed to work together, it did not change the fact that two separate sets of securities were involved. The Restricted Shares stayed within the closed system for the entirety of the four-month hold period and Saline used the Free-Trading Shares to settle its Short Sales. The Tribunal was clear that these were two distinct set of securities – and that the Transactions did not involve the resale of the Restricted Shares. The Tribunal agreed with the respondents that the subjective intentions of the parties in determining whether a distribution occurred is irrelevant, as the hold period (as part of the closed system) established an objective criterion.

3. Cormark was not Acting as an Underwriter

The Tribunal dismissed the Commission's reliance on guidance from Companion Policy 41-101CP *General Prospectus Requirements* ("**Companion Policy 41-101**"). The Tribunal emphasized that factors from Companion Policy 41-101 such as resale timing and purchase price discounts did not apply in this case since the Transactions did not involve the resale of the Restricted Shares to the public. The Commission argued that Saline's purchase of the Restricted Shares and subsequent resale to the public was akin to the role of an underwriter in a traditional public offering. However, the Tribunal disagreed with this categorization, stating that Saline was not acting as an underwriter nor distributing shares to the public when it sold short the Free-Trading Shares which were already previously issued and outstanding and sold in the secondary market through the TSX.

The Commission further relied on the anti-avoidance guidance in Companion Policy 45-106CP *Prospectus Exemptions* and Companion Policy 45-501 CP *Ontario Prospectus and Registration Exemptions*, which prohibits underwriters from selling securities to the public without a prospectus. While acknowledging that this guidance pertains to underwriters reselling prospectus-exempt securities in the secondary market, the Commission argued that it should similarly apply to underwriters purchasing newly issued securities and reselling identical borrowed securities to investors. The Tribunal rejected this argument, clarifying that Saline was not acting as an underwriter, the Free-Trading Shares and Restricted Shares were not identical, and the Transactions were not designed to circumvent prospectus requirements.

4. No Finding of Misleading and Improper Conduct Relating to the Transactions

After a detailed examination of the facts, the Tribunal concluded that Canopy was not Cormark's or Kennedy's client, and as a result, the obligation to deal fairly, honestly and in good faith under Rule 31-505 *Conditions of Registration* was not applicable. The Tribunal also rejected the Commission's claims that Cormark and Kennedy failed to disclose important aspects of the Transactions, including the Short Sales, Saline's risk-reward

ratio, and comparisons to previous deals. Based on the facts, the Tribunal concluded there was no misconduct and determined that Canopy's management and legal counsel had sufficient information about the Transactions, enabling Canopy to make informed decisions.

5. None of the Respondents' Conduct Engaged the Tribunal's Public Interest Jurisdiction

The Tribunal ruled that its public interest jurisdiction under the Act was not engaged when considering the Commission's claims that the conduct of the respondents undermined the investor protection provided by hold periods, avoided disclosure, threatened capital markets efficiency and confidence and failed to meet the high threshold of business conduct expected of market participants and registrants.

After examining the facts, the Tribunal found no evidence of misconduct, affirming that the Transactions adhered to the hold period and that Canopy retained full control over its public disclosures. In addition, the Commission claimed that the Short Sales undermined market efficiency and confidence by potentially causing the price to decline for reasons unrelated to Canopy's investment merits. However, the Tribunal found no evidence to substantiate these claims, noting that short selling is a common trading strategy that contributes to market pricing. The Tribunal also concluded that Cormark, Kennedy and Bistricher acted appropriately within the expectations for market participants, utilizing their knowledge and skills and rejecting the claims that their conduct caused harm to the investing public. The Tribunal deemed the allegations against Cormark and others to be an overreach from the Commission.

Conclusion

The closed system is integral to investor protection in Canada, ensuring that securities issued under prospectus exemptions do not bypass disclosure requirements or resale restrictions. This case illustrates how sophisticated parties might leverage complex hedging strategies to navigate these rules without overtly breaching them. While the Tribunal found no misconduct, it highlighted the fine line between legitimate market strategies and actions that could erode market confidence.

As our capital markets evolve, regulators must evaluate whether the current rules adequately address modern trading practices, including short selling. The real-time disclosure of short sales and trade failures data could provide greater market transparency, empowering regulators and the investing public to detect and deter potentially abusive practices. Ultimately, preserving the integrity of the closed system is essential to maintaining public trust and fostering a stable and efficient capital market.

[1] *Cormark Securities Inc. (Re)*, 2024 ONCMT 26

[2] RSO 1990, c S.5

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A Cautionary Note

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