

# NECESSARY GUIDANCE: ONTARIO CAPITAL MARKETS TRIBUNAL PROVIDES KEY INSIGHTS ON THE ‘NECESSARY COURSE OF BUSINESS’ EXCEPTION IN *KRAFT (RE)*

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Directors and officers frequently find themselves making swift decisions in connection with corporate transactions. While the rapid exchange of information, including to those outside of the company, is crucial for effective and efficient decision-making, it also introduces risks associated with the inappropriate sharing and use of material non-public information (“MNPI”). On October 20, 2023, the Capital Markets Tribunal of the Ontario Securities Commission (the “Tribunal”) provided guidance in *Kraft (Re)*<sup>[1]</sup> (“*Kraft*”) on how the selective disclosure of MNPI ought to be handled by insiders. For the first time, the Tribunal considered the application of the “necessary course of business” exception (the “NCOB Exception”) to the prohibition against tipping under Section 76(2) of the *Securities Act (Ontario)* (the “Act”), and in doing so, provided practical guidance on when insiders can rely on the NCOB Exception when selective disclosure of MNPI occurs.

## Key Takeaways

The Act does not provide a definition of the phrase “in the necessary course of business”, nor does the Act provide specific guidance on the various factors individuals can reference when attempting to rely on the NCOB Exemption.<sup>[2]</sup> That said, the Tribunal outlined a roadmap of best practices for persons in a special relationship with an issuer regarding the handling of MNPI. The key takeaways in *Kraft* are:

- 1. Is the information material?** Materiality is objective and does not need to be in any particular form. The subjective belief of a person who receives MNPI is not relevant in determining whether such information is material and thus subject to the prohibition against tipping and insider trading. Materiality is determined in the context of an issuer’s business and industry, and regulators may readily find information to be material where it is seemingly significant given the circumstances, regardless of whether there is a “market impact analysis” quantifying its effect on the market value of securities. In some cases, knowledge of MNPI may be extended to any reasonable inferences made by the recipient based on the information received.
- 2. Is the disclosure truly necessary?** The word “necessary” imports a higher level of importance than something done in the “ordinary” course of business. The sharing of MNPI must be for a valid business purpose

that is “essential”, “indispensable”, or “requisite”. This determination is objective, and the Tribunal will not rely on the subjective view of the person sharing MNPI regarding whether they believed it was “necessary in the course of business”.

In determining whether the selective disclosure of MNPI is in the “necessary course of business”, the following non-exhaustive factors may be relevant:

- a. the business of the issuer;
- b. the relationship between the tipper and the issuer;
- c. the relationship between the tipper and the tippee;
- d. the nature of the MNPI that was disclosed;
- e. the relevance of the MNPI to the relationship between the tippee and the issuer, and whether such relationship necessitates disclosure;
- f. the tipper’s reason for making the selective disclosure to the tippee; and
- g. the credibility of the tipper seeking to establish the NCOB Exception.

**3. Is there evidence that demonstrates a necessary reason for disclosure?** To successfully rely on the NCOB Exception, providing evidence that a tipper made the selective disclosure of MNPI in the necessary course of business may contribute to substantiating a valid purpose for such disclosure made. The evidence can take various forms such as discussions at the board or management level considering the need for the selective disclosure of MNPI, documents (e.g., retainer agreements, minutes, and memos) specifying the purpose for making selective disclosure of MNPI, and confidentiality agreements with instructions to the intended recipient regarding the use of MNPI. While entering into a confidentiality agreement is not a precondition to being able to establish the NCOB Exception, the Tribunal in *Kraft* stated that this is advisable as a best practice and is potentially relevant to the determination of whether selective disclosure of MNPI is being made in the necessary course of business. Insiders ought to work with legal counsel to ensure robust evidence is in place in order to confidently rely on the NCOB Exception.

**4. Have adequate procedures been established to reduce the risks associated with the sharing of MNPI?** While the need for swift information sharing with third parties may be imperative, such information sharing must be exercised with due caution. Regulators have the opportunity to closely scrutinize the reactive actions of directors and officers with the benefit of hindsight, and any finding of improper sharing and use of MNPI can result in long-lasting ramifications to the parties involved. It is important that issuers consult with legal counsel to develop formal processes regarding the handling of material information, including procedures for documenting when and why MNPI may be shared outside of the company, and agreements that restrict the use of any MNPI received by third parties.

## **The Tribunal's Decision in *Kraft (Re)***

*Kraft* concerned the sharing of selective MNPI between Michael Paul Kraft, the Chairman and director of WeedMD Inc. (the "**Company**"), a cannabis issuer listed on the TSX Venture Exchange, and his long-time friend and business associate, Michael Brian Stein. In October 2017, the board of directors of the Company was finalizing the terms of a greenhouse lease and option to purchase property that would mark a significant expansion of the Company's production capacity (the "**Transaction**"). On October 23, 2017, prior to the meeting to vote on the expansion, Kraft sent an email to Stein containing the draft lease and other documents received by the Company in relation to the Transaction. As long-time business associates, Kraft and Stein were in regular contact regarding potential deals and business opportunities, and on October 25, 2017, Stein provided comments on the draft lease, some of which were incorporated into the final version. While Stein had previously been a consultant to the Company in years prior, he was not retained to formally review the draft lease, nor was he compensated for conducting such review. On November 21, 2017, Stein acquired 45,000 shares of the Company. Over the two days following the announcement of the Transaction by the Company on November 22, 2017, Stein sold the shares he purchased on November 21, 2017, resulting in a profit of \$29,345, representing an approximate 43% return on his investment.

## **Illegal Tipping and Insider Trading Under the Act**

Section 76(1) of the Act provides that a person in a 'special relationship' with an issuer is prohibited from purchasing or selling securities of the issuer if that person has knowledge of a material fact or material change about the issuer that is not publicly disclosed. Section 76(2) of the Act provides that a person in a 'special relationship' with an issuer is also prohibited from informing others of a material fact about the issuer that is not publicly disclosed, *other than in the necessary course of business*.

In *Kraft*, the Tribunal found that Kraft was in breach of Section 76(2) by sending Stein the email containing the draft documents. Subsequently, the Tribunal determined that Kraft could not rely on the NCOB Exception as a defence. In addition, the Tribunal established that Stein violated Section 76(1) by engaging in trading based on the MNPI provided by Kraft. While the Tribunal found that an objective test for the NCOB Exception infringes Section 2(b) of the *Canadian Charter of Rights and Freedoms* (the "**Charter**"), such infringement is justified under Section 1 of the Charter.

## **Materiality Does Not Need to be in any Particular Form**

Only the selective disclosure of material information is subject to the prohibition against insider trading and tipping. Materiality is assessed objectively through the lens of a "reasonable investor". The "market impact test" is often used by the Tribunal to determine if certain information is considered material by looking at whether the information would reasonably be expected to have a significant effect of the market price or value of a

security. In *Kraft*, the Tribunal noted that materiality does not need to be in any particular form; furthermore, the Tribunal's view is that a market impact analysis is not required for the Tribunal to determine materiality.

In establishing materiality, the Tribunal outlined several non-exhaustive factors, including: (i) developments in the industry; (ii) the size and nature of the business and its operations; (iii) the specifics of the information disclosed; and (iv) the likelihood of the information materializing. These factors point to the “indicia of interest” in the Transaction, which can be considered in assessing whether a proposed transaction was sufficiently likely or certain to occur such that it was material at the time that the MNPI was disclosed.<sup>[3]</sup>

Throughout 2017 and 2018, the Canadian cannabis industry was experiencing exponential growth, and there was substantial demand for additional production capacity. The Company's proposed expansion represented a large increase in the size of their operations, which investors would have viewed as highly important given the competitiveness of the industry at the time. Furthermore, the amounts contemplated under the Transaction were significant relative to the Company's assets and market capitalization. While certain details of the Transaction were not finalized, the Tribunal found that any outstanding issues or contingencies did not create enough uncertainty that the Transaction would not proceed, and there was no evidence that the Company was pursuing alternative transactions to the same extent. These aforementioned factors led the Tribunal to conclude that the Transaction, including the documents shared with Stein, constituted a material fact that Kraft selectively disclosed.

### **The NCOB Exception**

The NCOB Exception is embedded in the prohibition against tipping in Section 76(2) of the Act and can be used as a defence in certain circumstances. In *Kraft*, the Tribunal determined that Kraft's communication with Stein was not in the “necessary course of business” within the meaning of the Act, despite Kraft's argument that the intent of such communication was to seek advice on the draft lease. The Tribunal's analysis in reaching this conclusion provides important guidance to insiders, as this is the first time the Tribunal considered the application of the “necessary course of business” provision under Section 76(2) of the Act.

### **Test for Establishing the NCOB Exception**

The Tribunal determined that an objective standard applies to the NCOB Exception based on the plain meaning of the wording of Section 76(2) of the Act, and the onus of establishing the exception lies with the respondent. In reaching this determination, the Tribunal considered the Legislature's deliberate, clear and unambiguous intent behind the provision. As such, the Tribunal will not rely on the subjective beliefs of the tipper when determining whether the selective disclosure of MNPI was done in the “necessary course of business”.

The Tribunal emphasized that the NCOB Exception to the prohibition against tipping must be interpreted and applied reasonably narrowly to ensure that the purpose of the legislation is not undermined. To qualify for the NCOB Exception, the Tribunal further clarified that there must be a business rationale for the selective disclosure of MNPI, and that such disclosure must be tied to a business or business purpose within the context of the issuer's business. The Tribunal noted that this determination is a question of mixed fact and law, and the particular facts and circumstances of each case will inform such determination.

In *Kraft*, the Tribunal concluded that the sharing of the draft lease from Kraft to Stein was not provided in the "necessary course of business". As such, Kraft was unable to rely on the NCOB Exception to Section 76(2) of the Act. The Tribunal reached this conclusion by looking at the circumstances of Kraft's action, namely the fact that Kraft hastily forwarded an email containing MNPI, with little instruction, to Stein (who was a personal friend) for his own personal reasons and did so without any prior discussion with the management or the board of the Company about his intentions or the reasons necessitating such disclosure.

#### **Guidance for Insiders – Don't be Careless**

In determining that the NCOB Exemption was not available, the Tribunal did not mince its words while deciding against Kraft. Specifically, the Tribunal noted that Kraft "hastily forwarded an email containing MNPI, with little instruction, to a personal friend reflexively and out of habit and for his own personal reasons. He did so without any prior discussion with management or the board of WeedMD about his intention to make the disclosure or the considerations necessitating that he do so. Such action was careless."<sup>[4]</sup>

The disclosure must truly be necessary in order to rely on the NCOB Exemption. Further, *Kraft* demonstrates the importance of not being careless with respect to the analysis and the requirement to formalize and document the decision-making process and procedures related to MNPI, especially when multiple insiders are involved. Although not strictly required, the Tribunal noted that a confidentiality agreement is advisable as a best practice and "certainly potentially relevant to the question of whether the selective disclosure is being made in the necessary course of business."<sup>[5]</sup>

In short, exceptions from securities law need to be carefully considered when one is deciding whether an exception is available or not. *Kraft* provides key insights for making this determination.

If you have any questions regarding illegal tipping and insider trading, members of McMillan's Capital Markets Group would be pleased to assist you.

[1] *Kraft (Re)*, 2023 ONCMT 36.

[2] *Ibid* at 265.

[3] *Kitmitto (Re)*, 2022 ONCMT 12.

[4] *Supra* note 1 at 282.

[5] *Supra* note 1 at 317.

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### **A Cautionary Note**

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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