2019 Canadian Capital Markets Report

DAVIES

DAVIES

About Davies

Davies is a law firm focused on high-stakes matters. Committed to achieving superior outcomes for our clients, we are consistently at the heart of their largest and most complex deals and cases. With offices in Toronto, Montréal and New York, our capabilities extend seamlessly to every continent. Contact any of our lawyers to talk with us about your situation.

Visit us at dwpv.com

Contents

Key Decisions in 2018

Regulatory Developments

U.S. Update

Overview

The year 2018 witnessed ongoing volatility in global markets, fuelled by geopolitical uncertainty, rising trade tensions and slowing world economies. In Canada, emerging market sectors continued to gain steam, most notably the cannabis industry, which experienced a dramatic uptick in investment and M&A activity as the country became the first major economy to legalize recreational use. Several other notable trends came to light, including a resurgence of reverse takeovers and evolving industry standards regarding fairness opinions. On the regulatory and judicial fronts, significant developments clarified and expanded disclosure obligations, and a landmark ruling by the Supreme Court of Canada stood to mark a turning point for securities regulation in parts of the country.

It is against this backdrop that we explore the following issues and developments of importance to capital market participants and offer our insights on what to expect in 2019 and beyond.

Emerging Industries

- Canada made international headlines in 2018 as the first major economy to legalize recreational cannabis use. In the months leading up to legalization, the sector was dominated by a wave of consolidation and cross-border investments. In 2019, cannabis continues to generate buzz as the focus of licensed producers shifts from domestic acquisitions to next-generation products and international expansion strategies. Read the latest updates in this fast-growing sector in **Cannabis Industry Continues to Roll**.

- Despite cannabis remaining illegal under U.S. federal law, many Canadian cannabis producers have set their sights on establishing a foothold in the potentially lucrative U.S. market. Learn how TSX-listed companies maintained their early-mover status without running afoul of TSX requirements in **TSX-Listed Cannabis Issuers Creatively Preserve U.S. Opportunities**.

- Blockchain technology continued to attract mainstream attention and that of regulators in 2018. Regulatory pronouncements and enforcement actions provided greater clarity on the legality of initial coin offerings (ICOs) and cryptoasset exchanges, while security token offerings emerged as a compliant alternative to ICOs. Learn what players seeking to enter this space need to know in **Crypto Crackdown: Will Blockchain Remain Relevant in 2019?**

Notable Trends

- Canadian capital markets have proven to be fertile ground for the financing of issuers in the cannabis industry, many of which have gone public by way of reverse takeovers. We examine the reasons for the resurgence of these takeovers and explore their relative advantages and disadvantages compared with traditional IPOs in **The Return of the Reverse Takeover**.

- The Ontario Court of Appeal's decision in *RBC Dominion Securities v Crew Gold Corporation* provides important guidance on the structuring of M&A engagement letters and suggests that courts will be loath to find a financial adviser entitled to a success fee for a transaction in which it played no role. Read the key takeaways for advisers drafting engagement letters in **Success Fees in Advisory Agreements: Financial Advisers (and Their Clients) Take Note**.

- Two years after the Yukon Supreme Court's decision in *InterOil Corporation v Mulacek*, the standard for fairness opinions in M&A transactions continues to evolve. Learn what issuers and their financial advisers need to know about the role of fairness opinions in Canada in **Playing Fair in a Post-*InterOil* World: Market Practice in Fairness Opinions**.

Key Decisions in 2018

- In Ontario, two rulings – *Wong v Pretium Resources* and *Paniccia v MDC Partners Inc*. – appeared to set a new standard for determining materiality in secondary market misrepresentation claims under the Ontario *Securities Act* (OSA). In both cases, the court applied the U.S. "reasonable investor" test in assessing materiality, as opposed to the "market impact" test mandated by the OSA. Read the implications in **Good Laws Gone Bad: Continued Confusion over the Standard for Materiality in Civil Misrepresentation Actions**.

- In November, the Supreme Court of Canada in *Reference re Pan-Canadian Securities Regulation* upheld the constitutionality of a national cooperative capital markets regulatory system, removing a major roadblock to Canada's long-sought effort to harmonize Canadian securities regulation in at least some of the provinces. Find out more about this seminal decision and what may happen next in **Supreme Court of Canada Paves Way for a National Securities Regulator**.

Regulatory Developments

- The Canadian Securities Administrators proposed for the first time a set of rules to govern non-GAAP and other financial measures. The rules will require issuers to adhere to specific disclosure requirements when publicly disclosing non-GAAP financial measures, including in postings on websites and social media. Learn how to **Mind the GAAP: Avoid Getting Tripped Up by New Non-GAAP Disclosure Requirements**.

- The TSX continued to adopt significant policy and practice refinements in its staff notices in 2018. Included among these was new guidance regarding securityholder approval requirements in significant issuances and the pricing of offerings after the disclosure of material information. Read the details of **Important Developments in TSX Policy in 2018**.

U.S. Update

- South of the border, the U.S. Securities and Exchange Commission (SEC) approved final rules to modernize the SEC's mining property disclosure requirements. The new rules, which are generally similar to Canada's National Instrument 43-101, will provide investors with more comprehensive and detailed information regarding a registrant's material mining properties and level the playing field between U.S. and foreign registrants. Learn more in **The SEC Modernizes Mining Disclosure**.

For more information on any of the issues raised in this report, contact one of our experts listed under "Key Contacts" at the end of the report.

Emerging Industries

CHAPTER 01

Cannabis Industry Continues to Roll

The cannabis industry has been one of Canada's most talked-about sectors over the past 24 months, headlined by a handful of significant M&A transactions and cross-border investments. We expect cannabis will continue to make headlines in 2019 as cannabis issuers seek to develop next-generation products and implement international expansion strategies.

Proposed and actual liberalization of U.S. cannabis laws has led to increased appetite for exposure to the U.S. cannabis market, and investments by alcohol and tobacco players have legitimized a nascent industry. With these factors in mind, we expect to see the capital markets' "cannabis frenzy" continue throughout 2019.

United States Legalizes Hemp

On December 20, 2018, U.S. President Donald Trump signed into law the so-called Farm Bill (*Agriculture Improvement Act of 2018*), which removed industrial hemp from the definition of “marihuana” under the federal *Controlled Substances Act*. This action created a federally legal environment for the cultivation, distribution and sale of industrial hemp in the United States and made hemp an ordinary agricultural commodity. The significance of this enactment stems from the presence of the non-psychoactive cannabinoid, cannabidiol (CBD), which is found in industrial hemp and purported to have a range of therapeutic benefits. CBD derived from “marihuana” will continue to be federally illegal, and hemp-derived CBD will be subject to state regulation.

Canadian licensed cannabis producers Canopy Growth Corporation (Canopy) and Tilray Inc. (Tilray) have already sought to take advantage of the liberalized U.S. hemp laws. On December 17, 2018, Tilray announced that it had entered into a letter of intent to purchase hemp-derived CBD isolate from LiveWell Canada Inc., which will be sourced from both the United States and Canada and processed by Tilray for distribution in wellness and medical products across both countries. Canopy, meanwhile, has taken a step toward establishing a direct presence in the United States. On January 14, 2019, Canopy announced that it had been granted a licence by New York state to process and produce hemp. Canopy intends to invest US$100 million to US$150 million in large-scale production facilities dedicated to hemp extraction and product manufacturing within the United States. To facilitate its U.S. hemp endeavours, earlier this year Canopy announced the acquisition of AgriNextUSA, an organization noted as being at the forefront of hemp advocacy in the United States.

Although estimates of the potential market for hemp-derived CBD vary greatly, ranging from US$2 billion to US$22 billion, the consensus appears to be that a significant opportunity exists in the U.S. hemp-derived CBD market.

United States Moves Closer to Liberalizing Federal Cannabis Laws

On June 7, 2018, Senators Cory Gardner and Elizabeth Warren introduced the *Strengthening the Tenth Amendment Through Entrusting States* (STATES) Act in Congress, which would amend the *Controlled Substances Act* to exempt individuals and corporations from prosecution for federal cannabis offences if they comply with relevant state cannabis laws. However, the STATES Act would not remove cannabis as a Schedule I narcotic, meaning that cannabis would remain federally illegal. With this distinction in mind, it remains unclear what impact the STATES Act, if passed, may have on the willingness of U.S. stock exchanges and federally regulated banks to participate in the U.S. cannabis industry.

Likely of more import to U.S. federally regulated banks is the *Secure and Fair Enforcement* (SAFE) *Banking Act*, the passage of which would allow banks to service cannabis companies that comply with state laws. Currently, federally regulated banks are prohibited from servicing cannabis companies because any funds would be considered proceeds of crime.

Due to the slow progress of the STATES Act in the House and Senate, on December 17, 2018, Senator Cory Gardner introduced an amendment to a broader criminal justice bill before the Senate that mirrored the language of the STATES Act. However, the amendment was not accepted. It remains unclear whether the STATES Act will be passed into law; however, many have speculated that liberalization of federal U.S. cannabis laws is merely a matter of time. The SAFE *Banking Act*, on the other hand, was approved by the U.S. House Financial Services Committee on March 28, 2019, and is under review by the House and Senate.

Canopy to Acquire U.S. Cannabis Company upon U.S. Federal Legalization

On April 18, 2019, Canopy announced that it had entered into a definitive agreement to acquire all of the shares of Acreage Holdings, Inc. (Acreage), the largest vertically integrated, multi-state owner of cannabis licences and assets in the United States. Under the terms of the transaction, Canopy will pay a US$300-million upfront premium to certain classes of Acreage shareholders in exchange for an option to acquire all of the outstanding shares of Acreage.

Canopy's call option has a term of 90 months from the date of issuance. Canopy will be required to exercise the call option once the U.S. federal laws change to permit the general cultivation, distribution and possession of cannabis or to remove regulation of these activities from the U.S. federal laws. Upon exercise of the call option, each Acreage share will be exchanged for 0.5818 of a common share of Canopy, for total consideration (including the upfront premium described above) to Acreage shareholders of US$3.4 billion, representing a 41.7% premium over the 30-day VWAP of Acreage shares on the Canadian Securities Exchange (CSE) ending April 16, 2019.

The transaction represents the first outright acquisition of a U.S. cultivator by a TSX-listed Canadian licensed producer and gives Canopy immediate access to the U.S. cannabis market upon federal legalization. The deal is not without its critics, however, as Marcato Capital Management LP (Marcato), a 2.7% holder of Acreage shares, announced its intention to vote

On December 20, 2018, U.S. President Donald Trump signed into law the so-called Farm Bill (*Agriculture Improvement Act of 2018*), which removed industrial hemp from the definition of "marihuana" under the federal *Controlled Substances Act*.

As of the date of this writing, 160 cannabis-related issuers list on the CSE alone, many of which have exposure to the U.S. cannabis industry.

against the proposed transaction, citing, among other things, an insufficient premium that undervalues the potential value of Acreage upon federal legalization of cannabis in the United States. By the time Marcato announced its intention, Canopy's shares had risen 15.2%, while Acreage's share price had dropped 6% since the deal was announced. Acreage shareholders will vote on the proposed transaction on June 19, 2019.

Restructuring and Spinout Transactions Gain Popularity as Appetite for U.S. Exposure Increases

As a result of the TSX and TSXV policy prohibiting listed issuers from engaging or investing in activities that violate U.S. federal law, listed cannabis issuers have structured creative transactions to retain exposure to what many expect to be a lucrative U.S. cannabis market while remaining compliant with exchange listing requirements.

For example, in spring 2018, Aurora Cannabis Inc. (Aurora) spun out its U.S. assets in a new company, Australis Capital Inc. (Australis), which listed on the CSE. The CSE has adopted a disclosure-based approach to U.S. cannabis investments or activities and will permit listed issuers to engage in such activities. Aurora retained a back-in right to reacquire an interest in Australis upon the legalization of cannabis at the U.S. federal level.

Similarly, in October 2018, Canopy and Canopy Rivers Inc. (Canopy Rivers), the venture capital arm of Canopy, restructured their respective investments in TerrAscend Corp. (TerrAscend), a CSE-listed cannabis company, so that TerrAscend could pursue opportunities in the United States. By way of plan of arrangement, Canopy Rivers and Canopy exchanged their common shares and warrants in TerrAscend for non-participating, non-voting exchangeable shares that may be exchanged for common shares only on the federal legalization of cannabis in the United States.

U.S. Cannabis Issuers Flood North

Although regulated by many U.S. states, cannabis remains federally illegal in the United States; accordingly, no pure play U.S. cannabis companies will be found listed on federally regulated major U.S. stock exchanges. However, the disclosure-based approach of Canada's more junior exchanges, such as the CSE and NEO, has resulted in an influx of U.S. cannabis issuers listing north of the border. As of the date of this writing, 160 cannabis-related issuers list on the CSE alone, many of which have exposure to the U.S. cannabis industry.

Altria's investment in Cronos marks the first major investment by a tobacco company in the Canadian cannabis industry and, coupled with its investment in Juul, a significant bet on the growing "vape" product category.

Canadian Cannabis Companies Begin Listing on Nasdaq and NYSE

As noted above, U.S. cannabis companies are prohibited from listing on major U.S. stock exchanges. However, Nasdaq and the NYSE have accepted listings from Canadian cannabis companies that operate exclusively in Canada and other jurisdictions where cannabis is legal for medical and/or recreational purposes.

Cronos Group Inc. (Cronos) became the first U.S.-listed Canadian cannabis company – listing on Nasdaq in February 2018. Tilray completed its IPO on Nasdaq shortly thereafter in July 2018, bypassing a Canadian stock exchange listing altogether.

Canopy became the first Canadian cannabis company to list on the NYSE in May 2018, but has since been joined by Aurora, Aphria Inc. (Aphria) and CannTrust Holdings Inc. HEXO Corp. (HEXO), which has a market cap of approximately $1.3 billion, was approved for listing on the NYSE American on January 17, 2019.

Big Tobacco Arrives on the Scene

In March 2019, Altria Group Inc. (Altria), one of the world's largest producers and marketers of tobacco products, made an investment of approximately $2.4 billion in Cronos by way of private placement. Altria acquired both common shares, which represent an approximate 45% ownership interest in Cronos, and warrants, which, if exercised, would result in Altria owning some 55% of Cronos.

Just two weeks after the announcement of its investment in Cronos in December 2018, Altria announced a US$12.8-billion investment in Juul Labs (Juul), the dominant player in the e-cigarette space.

Altria's investment in Cronos marks the first major investment by a tobacco company in the Canadian cannabis industry and, coupled with its investment in Juul, a significant bet on the growing "vape" product category.

Alcohol Players Continue to Invest in Cannabis

The Cronos/Altria deal was structured in a similar fashion to the largest investment in the Canadian cannabis space to date: Constellation Brands' (Constellation's) $5-billion investment in Canopy. After investing $245 million for a 9.9% interest in Canopy in 2017, Constellation injected an additional $5 billion into Canopy in summer 2018, to bring its ownership to approximately 38%. Constellation also acquired warrants that, if exercised, would bring its position in Canopy above 50%.

On December 20, 2018, Health Canada released draft regulations governing cannabis edibles, extracts and topicals, which are expected to come into force on or before October 17, 2019.

However, Constellation is not the only alcohol player entering the cannabis space. In August 2018, Molson-Coors Canada and HEXO announced a joint venture under the name Truss to develop non-alcoholic, cannabis-infused beverages for the Canadian market. Molson-Coors Canada has a 57.5% controlling interest in Truss, with HEXO having the remaining ownership interest. In December 2018, Anheuser-Busch InBev, the world's largest brewer, announced a partnership with Tilray to research non-alcoholic beverages containing THC and CBD. Each party intends to invest up to $50 million in research, with the objective of having beverages ready for sale when they become legal in 2019.

Shoppers Drug Mart Receives Cannabis Sales Licence

On December 8, 2018, Shoppers Drug Mart (Shoppers) was granted a licence by Health Canada to sell medical cannabis online. According to Shoppers' website, it is currently servicing customers in Ontario only. Shoppers has indicated that it has no intention of producing cannabis and has disclosed that it has entered into supply agreements with a number of licensed cannabis producers, including Tilray, Aurora, Aphria, Emblem Corp., WeedMD Inc., The Flowr Corporation and Starseed Medical Inc.

Edibles Regulations Are on the Horizon

On December 20, 2018, Health Canada released draft regulations governing cannabis edibles, extracts and topicals, which are expected to come into force on or before October 17, 2019. The draft regulations were subject to a 60-day consultation period.

The draft regulations prescribe maximum THC and CBD limits for edible or topical products and require that such products be packaged in plain packaging, similar to that required for currently legal forms of cannabis. The draft regulations also prohibit certain forms or types of edible products. For example, the draft regulations prohibit (i) edibles that require refrigeration or freezing; (ii) extracts that contain added sugars, sweeteners or sweetening agents; (iii) packaging and labelling of cannabis extracts that list flavours that appeal to youth; and (iv) the use of non-dried meat, poultry and fish.

Although the consultation period has ended, it remains to be seen what the final draft of the regulations on edibles, extracts and concentrates will look like. One area that generated a significant amount of commentary during the consultation period was the proposed rule that regular food products and edible cannabis products could not be produced in the same facility. The capital cost associated with establishing a separate facility may limit the ability of existing food processors to participate in the industry. Additionally, the draft regulations also

While much of the media focus has been on the participation of alcohol companies, it remains to be seen whether traditional consumer packaged goods manufacturers will enter the edibles space.

prohibit representations on cannabis product packages that would associate the cannabis product with an alcoholic beverage, suggesting that existing alcohol companies will not be permitted to utilize their brands in the cannabis space.

While much of the media focus has been on the participation of alcohol companies, it remains to be seen whether traditional consumer packaged goods (CPG) manufacturers will enter the edibles space. In November 2018, Canadian licensed producer Newstrike Brands Ltd. announced that it had entered into a joint venture with Neal Brothers Inc., a Canadian specialty foods company, to develop edible cannabis products. Although Coca-Cola had been rumoured to be investigating opportunities in the Canadian cannabis industry in early 2018, those rumours have not resurfaced since and no major CPG or confectionery players have been linked to the Canadian cannabis space. This is an area we will be keeping an eye on in 2019.

Short Seller Reports Permeate Cannabis Industry

Amid rising valuations premised primarily on perceived potential and production capacity, the cannabis industry has been a prime target for short sellers. In the last 12 months, Canadian cannabis producers Aphria, Cronos, Tilray, Aurora and Namaste Technologies Inc. have each been the subject of short-seller reports citing valuation issues ranging from deficient disclosure to improper accounting measures and insider dealing.

While the short-seller reports have generally resulted in only a temporary dip in the subject's share price, a report published by *The Globe and Mail* on January 23, 2019, indicates that cannabis companies remain some of the most shorted stocks, with Aurora, Aphria and Canopy ranking in the top 20 by percentage of shares on loan as of January 21, 2019.

Aphria Comes Under Fire and Faces Takeover Bid

Arguably the most talked-about short-seller report, published by Hindenburg Research and Quintessential Capital Management on December 3, 2018, targeted Aphria and alleged that a recent series of Latin American and Jamaican acquisitions, totalling approximately $425 million, were the product of insider dealing and involved the purchase of assets that were largely worthless. Aphria's share price fell nearly 30% in the wake of the report from its pre-report share price of $10.51, but has since rebounded to $11.50 per share as of April 15, 2019.

On January 11, 2019, Aphria announced that Vic Neufeld, the company's CEO, and Cole Cacciavillani, the company's co-founder and VP of Growing Operations, would be stepping down from their roles. Subsequently, on January 23, 2019, Green Growth Brands (Green Growth) launched a takeover bid for Aphria after publicly announcing its intention to do so on December 27, 2018.

On May 8, 2019, Health Canada announced significant changes to its policies for the review of cultivation, processing and medical sales licence applications under the *Cannabis Act*.

The Green Growth bid contemplated an all-share transaction valued at $2.8 billion. However, the value ascribed by Green Growth was premised on a $7 per share price of Green Growth stock, despite Green Growth having never traded above $6.20 on the CSE and closing at a price of $5.81 on the day it announced its bid. Green Growth had previously announced that it would complete a $300-million financing at $7 per share to lend credibility to its valuation; however, it was announced that half of such financing would be purchased by a related party of Green Growth. On April 15, 2019, Green Growth and Aphria came to terms, resulting in an early termination of Green Growth's hostile bid, a mutual 12-month standstill period and an agreement to enter into discussions involving potential commercial arrangements.

Big Banks Continue to Get Comfortable with Cannabis

The major Canadian banks have been slow to enter the cannabis space, though recent activity has evidenced increased comfort for some. BMO Capital Markets has been the leader in the space, having co-led bought deal financings for Canopy, Cronos and Auxly Cannabis Group Inc. (then Cannabis Wheaton Income Corp.) in early 2018 and providing a $200-million credit facility to Aurora in June 2018.

CIBC Capital Markets entered the fray in the summer of 2018, acting as agent on a private placement for Canopy Rivers in connection with its reverse takeover listing on the TSXV and underwriting a $63.5-million bought deal for Canopy Rivers in February 2019. On January 7, 2019, BMO (as lead lender), CIBC and Concerta Bank agreed to provide up to $80 million in secured financing to PharmHouse Inc., a joint venture in which Canopy Rivers is a partner. Subsequently, BMO and CIBC teamed up again to offer a $65-million secured term loan to Cronos Group and a $65-million secured term loan to HEXO.

We expect to see the other major Canadian banks enter this space as the Canadian cannabis industry continues to mature. Scotiabank acted as financial adviser to Aphria in the unsolicited takeover bid by Green Growth Brands. Meanwhile, on March 19, 2019, RBC entered into a construction loan facility with Eve & Co Incorporated in the amount of $18.7 million to fund the construction of a cannabis greenhouse.

Changes to *Cannabis Act* Licensing Process

On May 8, 2019, Health Canada announced significant changes to its policies for the review of cultivation, processing and medical sales licence applications under the *Cannabis Act*. Such applications will only be considered for licensing if the applicant has in place "fully built" facilities that comply with all regulatory requirements.

Previously, cannabis licensing applicants were able to advance their applications and obtain some level of comfort regarding licensing before spending capital on production facilities. Many applicants have been able to raise substantial capital for build-out purposes on the basis of a pending licence. We expect Health Canada's new approach will mark a turning point in the development and maturity of Canada's cannabis ecosystem, including capital markets activity. The change will benefit well-capitalized issuers that are prepared to invest in the development of regulatory-compliant facilities without any licensing assurance from Health Canada. We also expect it will divert investment capital to issuers that have a demonstrated track record of building and licensing facilities. Whether this change alleviates supply shortages and wait times for existing applicants that are ready or nearly ready to begin commercial operation remains to be seen.

What's in Store

Looking forward, we expect to see Canadian cannabis issuers continuing to actively deploy capital, with the focus shifting from expanding domestic production capacity to gaining exposure to the U.S. market and developing next-generation products, such as edibles and vapes. Furthermore, on the heels of the investments by Constellation and Altria and with the regulation of edibles expected to come into force in the fall, we will be watching to see if a major consumer packaged goods player enters the Canadian cannabis space.

CHAPTER 02

TSX-Listed Cannabis Issuers Creatively Preserve U.S. Opportunities

While cannabis legalization in Canada captured international headlines in 2018, many cannabis issuers continued to pursue business opportunities in the competitive and vastly more lucrative U.S. market, despite cannabis remaining illegal under U.S. federal law. Given this continued legal uncertainty, the Toronto Stock Exchange (TSX) effectively prohibits its listed issuers from engaging in U.S. cannabis activities. In response, TSX-listed cannabis issuers wishing to maintain their listing and preserve early-mover status south of the border continue to seek creative structures to preserve their entry into the U.S. market. Although these structures serve their immediate compliance purpose, any assessment of their longer-term implications is complicated for both the issuer and the investee company, given that the time horizon to U.S. federal legalization remains murky at best.

TSX Prohibition

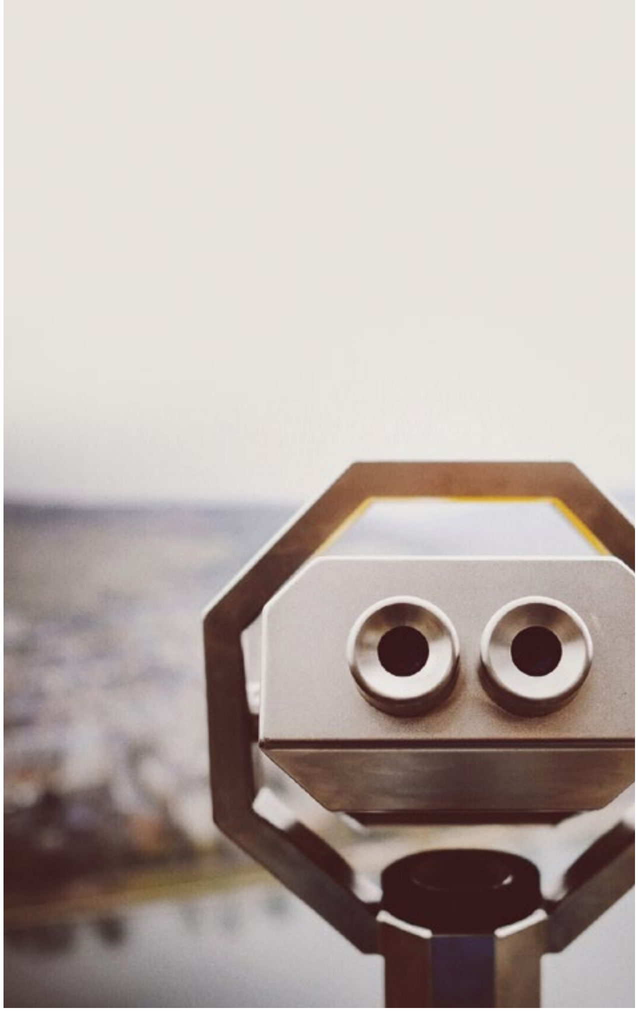
In October 2017, the TSX issued a staff notice[1] warning that listed issuers "with ongoing business activities that violate U.S. federal law regarding marijuana are not complying" with applicable listing requirements. Furthermore, the notice made clear that the concept of "ongoing business activities" would be interpreted broadly to include, in order of importance,

- direct or indirect ownership of, or investment in, any entity engaging in activities related to the cultivation, distribution or possession of cannabis in the United States (a "U.S. Cannabis Business");
- commercial interests or arrangements with a U.S. Cannabis Business that are similar in substance to ownership or investment;
- providing services or products that are specifically designed for, or targeted at, a U.S. Cannabis Business; or
- commercial interests or arrangements with entities providing such services or products to a U.S. Cannabis Business.

The TSX advised listed issuers to proactively address any compliance issues in light of the foregoing.

Evacuate for Now but Plan for Entry on U.S. Federal Legalization...

The simplest approach to comply with the TSX rules is to divest all interests in entities with U.S. activities, cease the pursuit of any new opportunities and terminate any commercial relationships with service providers to U.S. businesses; however, as a consequence, when (or if) cannabis is legalized at the U.S. federal level, the cost of entry to the U.S. market presumably would be substantially greater given the associated reduction of regulatory risk. Accordingly, TSX-listed cannabis issuers may preserve substantial value if they structure U.S. investments in a manner that satisfies TSX requirements while maintaining the ability to enter the market on reasonable terms if legalization occurs in the United States. The following examples are some of the methods deployed to date:



- **Divestiture with Contingent Right to Reinvest.** In two separate cases, TSX-listed issuers divested their interests in entities pursuing U.S. cannabis activities, in one case by spinning out its interest to its shareholders and in another case by selling its interest to third parties. In each case, the TSX-listed issuer retained the right to reinvest in the entity if certain conditions were satisfied – the principal condition being U.S. federal legalization of cannabis. In one case, the period to reinvest was 10 years under warrants granted by

In October 2017, the TSX issued a staff notice warning that listed issuers "with ongoing business activities that violate U.S. federal law regarding marijuana are not complying" with applicable listing requirements.

1 TSX staff notice 2017-0009.

A common theme in each approach is that the TSX-listed issuer retains the ability to secure the full benefits of its investment upon U.S. federal legalization of cannabis.

the divested entity; in the other case, the issuer was granted a five-year right to repurchase the shares from the third-party buyers.

- **Conversion of Equity into a Non-Participating Interest with Contingent Exchange Right.** A TSX-listed issuer held a significant investment in a publicly traded cannabis issuer listed on the Canadian Securities Exchange (CSE) that wished to pursue opportunities outside Canada, including in the United States. In this case, the TSX issuer exchanged its common shares for a new class of non-voting and non-participating shares of the CSE issuer that are exchangeable into common shares on certain conditions, with the principal condition being U.S. federal legalization of cannabis. The CSE issuer agreed that during the period that the exchangeable shares are outstanding and subject to a maximum term of 10 years, it would, among other things, not declare or pay dividends.

- **Acquisition of a Contingent Interest.** In two other separate cases, a TSX-listed issuer acquired an option to acquire an interest in an entity pursuing U.S. opportunities. In one case, the issuer acquired warrants exercisable into common shares on conditions that included U.S. federal legalization of cannabis; in the other case, the issuer paid a cash premium to existing shareholders and secured the right to acquire the shares themselves upon U.S. federal legalization of cannabis. In the first case, the warrants have a term that expires 2 years after U.S. federal legalization of cannabis, subject to a maximum term of 15 years; while in the second, the right to acquire the shares expires in 90 months.

… But How Long Should the Right Last and at What Cost?

A common theme in each approach is that the TSX-listed issuer retains the ability to secure the full benefits of its investment upon U.S. federal legalization of cannabis. The uncertainty of the potential time horizon adds an interesting dynamic when a proposed restructuring is evaluated, with key issues to be considered by both the TSX issuer and the investee company, including the following:

- **What is the appropriate time horizon for the investor's right to realize on its investment?** From the TSX issuer's perspective, ideally it would prefer to maintain its contingent investment for as long as it takes for cannabis to be federally legalized in the United States. At the same time, the TSX issuer also needs to consider its own shareholders' desire for value creation and to carefully assess how long it would be willing to retain a non-participating investment. For the investee company, it is important to consider the impact of a potentially indefinite overhang, including the effect, if any, of the overhang on the ability to access additional financing or make additional changes to its capital structure.

- **What is the appropriate price at which the investor should be permitted to invest?** Recognizing that the novel structuring of the indirect investment in U.S. cannabis is being driven by forces outside the control of the TSX issuer, one could argue that the price of the investment should reflect the valuation of the enterprise at the time the contingent right is structured. At the same time, one could also argue that the longer the time horizon to realizing on the investment, the greater the possibility that such pricing would allow the TSX issuer to capture benefits from growth in the intervening period that it arguably had little hand in producing.

- **Could the structure function as a "poison pill," foreclosing M&A opportunities?** For investee companies that are themselves publicly traded, particularly in a nascent and fast-growing industry such as cannabis, part of the attraction to investors may be the prospect of exiting the investment in a change of control transaction at a significant premium. In that regard, appropriate safeguards should be considered to ensure that bona fide third-party bids for the company are not hindered by the potential overhang of a significant contingent equity interest.

- **Does the structure result in any other unintended consequential effects?** Any novel structure can create a number of accounting, tax and other issues, all of which need to be carefully considered, particularly when the investment involves entities with activities on both sides of the border. From a capital structure perspective, other shareholders in the investee company could experience potential future dilution (for instance, when the contingent right takes the form of warrants or other options to purchase) or may see their voting and participating interests proportionately increased (such as when an equity interest is converted to a non-participating interest). In either case, the dynamic among the remaining shareholders can be dramatically altered depending on the distribution of voting and equity interests following the restructuring.

On Our Radar

Given the consequences of failing to comply with the TSX listing rules and the time that has elapsed since the notice was first issued, it is likely that most issuers have by now addressed any compliance gap; however, we continue to witness novel structures for new contingent entries into the U.S. market. In an emerging industry with continued legal uncertainty, it is possible to envision that similar capital markets compliance issues could arise in the future and cause industry participants to grapple anew with structuring challenges. Accordingly, issuers and investors alike would be well-advised to make an appropriate assessment of the associated risks to ensure informed decision-making. While the risk appetite for cannabis investors, regardless of structure, remains seemingly endless and robust, we will be watching to see how these structures stand the test of time in the event that U.S. political uncertainty persists for a sustained period.

CHAPTER 03

Crypto Crackdown: Will Blockchain Remain Relevant in 2019?

Following blockchain's meteoric ascent to relevance in the second half of 2017, many predicted that blockchain, the technology underlying bitcoin, would spur massive innovation and disrupt numerous industry sectors. But while 2018 was welcomed in as the "Year of the Blockchain," it proved to be a turbulent period for the nascent technology. Cryptoassets across the board were marred by sharp declines in price, and regulators worldwide ramped up enforcement actions. Despite these struggles, blockchain continues to receive mainstream attention and increased acceptance. Canadian and U.S. regulatory pronouncements and enforcement actions in 2018 provided greater clarity on the approach to assessing the legality of initial coin offerings (ICOs), cryptoasset exchanges and other blockchain-based activities. As regulators have intensified their scrutiny of ICOs, security token offerings (STOs) have emerged as a compliant alternative.

Set out below is a summary of recent developments and key considerations relevant to those looking to start or continue developing businesses based on this enigmatic technology.

Token Offerings: ICOs in Decline; STOs on the Rise

- **Securities Laws Apply to ICOs.** Previously, token issuers sought to deny the applicability of securities laws by characterizing their ICOs as sales of "utility tokens" (that serve a specific function on a blockchain network and facilitate access to a product or service) rather than "security tokens" (that represent ownership in an underlying asset, similar to traditional securities). In 2018, Canadian and U.S. securities regulators repeatedly rejected this notion, taking the position that the majority of utility tokens – despite their functionality – constitute "investment contracts" to which securities laws apply.

- **"Sufficiently Decentralized" Tokens Are Not Securities.** The U.S. Securities and Exchange Commission's (SEC's) director William Hinman raised the possibility that a token could change its characteristics over time so that it would no longer constitute a security. The distinction centred on whether the network on which a token is to function is "sufficiently decentralized" so that there is no longer any third party whose efforts are a key determining factor in the enterprise. Hinman pointed to the Ethereum blockchain as an example of a network that no longer relied on the efforts of a centralized authority that would have warranted the application of securities laws.

- **ICOs Remain Clouded by Uncertainty.** To date, only limited guidance on the attributes of a sufficiently decentralized and fully functional network have been provided by regulators. ICO issuers that are raising capital to fund the network's continued development and continue to exercise some level of control over their respective platforms have yet to find a way to avoid the application of securities laws. However, the practical utility of the token, development of a robust ecosystem and reliance on the efforts of others for profit will be key considerations in determining when a token may transform from a security to a non-security.

- **Regulatory Crackdown Continues.** U.S. regulators have increased enforcement actions against ICO issuers and promoters of unregistered ICOs. Despite the emphasis on the utility of tokens issued by Paragon and Airfox, the SEC focused on the creation of an expectation of profit, including through marketing activities in social media, blogs and digital communications. Of particular importance were statements that the purpose of the offerings was to raise capital to fund further development of existing businesses. As part of its enforcement actions, the SEC imposed significant monetary penalties for the first time on ICO issuers and promoters – even without allegations of fraud or misrepresentation.

- **STOs Becoming Compliant with Securities Laws.** As Canadian and U.S. regulators have intensified their scrutiny of ICOs, STOs have emerged as a compliant alternative. STOs are offerings of digital tokens that treat tokens as a "security" under securities laws and are undertaken subject to all the rules applicable to traditional, non-tokenized securities. For token issuers seeking to raise funds and wishing to avoid the

The practical utility of the token, development of a robust ecosystem and reliance on the efforts of others for profit will be key considerations in determining when a token may transform from a security to a non-security.

A Simple Agreement for Future Tokens (SAFT) is a written instrument entered into prior to release of a blockchain platform that provides its holder with the right to fully functional tokens, delivered once the platform is completed.

costly and time-consuming process of issuing under a prospectus or registration statement, exemptions from applicable securities laws are available. However, currently available exemptions typically contain limitations on the amount raised, subject issuers to some form of ongoing reporting or do not result in tokens that are freely tradable.

- **STO Platforms Gaining Acceptance.** In 2017, we discussed the Ontario Securities Commission's (OSC's) approval of a token offering by Token Funder Inc., which is developing a platform to facilitate the offering of legally compliant blockchain-based securities. Over the past year, several companies have launched similar platforms to facilitate the issuance of compliant security tokens. In 2018, tZero, the blockchain-centric subsidiary of Overstock that is developing a trading platform for security tokens, raised more than US$100 million in its own STO. As the security token market continues to grow, we expect that more companies will turn to STOs to raise capital.

- **SAFT Model Being Revived.** A Simple Agreement for Future Tokens (SAFT) is a written instrument entered into prior to release of a blockchain platform that provides its holder with the right to fully functional tokens, delivered once the platform is completed. Designed to be sold to investors on a prospectus-exempt basis as a means of raising capital in compliance with securities laws, SAFTs declined in popularity following criticisms that artificially dividing the scheme into multiple events does not change the fact that purchasers acquired tokens for an investment purpose. Nor does it guarantee that the tokens, when issued, will not be securities. While the SEC has not opined on SAFT offerings, the notion that tokens initially issued as securities could evolve into non-securities provided renewed optimism in the SAFT model. Whether tokens issued upon conversion of a SAFT are sufficiently decentralized will ultimately depend on the facts and circumstances at the time of such conversion.

Exchanges: Decentralized or Not, It's Time to Comply

- **Regulators Targeting Exchanges.** The launch of "Operation Cryptosweep" – a multijurisdictional campaign aimed at investigating "cryptocurrency-related investment products" – by North American securities regulators has resulted in 200 inquiries and nearly 50 enforcement actions against blockchain businesses. Notably, investigations have not been limited to ICO issuers, with inquiry letters delivered to many prominent crypto exchanges. Regulators are concerned about the lack of controls in place to protect investors. In addition, many of these crypto exchanges list tokens that are likely to be characterized as securities, without satisfying the requirements to operate as a securities exchange (or being exempt therefrom).

– **Crypto Exchanges Vetting Tokens.** While there is a regulatory regime that applies to securities exchanges, it is not clear what other rules apply specifically to trading cryptoassets outside of that regime. Although industry best practices have arisen to manage the ambiguity and reduce the likelihood of enforcement action by regulators, some Canadian and U.S. crypto exchanges have implemented stringent vetting procedures to avoid listing tokens that may be characterized as securities in the hopes of avoiding an obligation to register as a securities exchange. Recently, however, prominent crypto exchanges have publicly announced applications or plans to apply for licences to operate an Alternative Trading System, which would allow such exchanges to offer blockchain-based securities in compliance with securities laws.

– **QuadrigaCX May Spur Change.** In February 2019, QuadrigaCX – once Canada's largest cryptocurrency exchange – was granted protection by the Supreme Court of Nova Scotia under the *Companies' Creditors Arrangement Act.* The ruling followed the sudden death of QuadrigaCX's founder and CEO, Gerald Cotten. Long plagued with liquidity issues due to disputes with its payment service providers, QuadrigaCX was reportedly unable to locate as much as US$137 million in funds locked up in offline wallets accessible only by Cotten. The story of QuadrigaCX serves as an example of the dangers of unregulated cryptocurrency exchanges, with many critics calling for regulatory oversight to mitigate potential mismanagement or loss of investor funds. The Canadian Securities Administrators and the Investment Industry Regulatory Organization of Canada recently published a proposed framework for the regulation of cryptocurrency exchanges that addresses the heightened investor-protection risks that these platforms present. However, as the focus of the proposed framework is on exchanges trading in securities, it remains to be seen how non-security cryptocurrency exchanges will be affected.

– **Offshore Exchanges Must Register.** We previously discussed the OSC's approval of a settlement agreement with eToro (Europe) limited, a Cyprus-based brokerage firm that operates an online cryptocurrency and stock trading platform. The settlement signals that the OSC will be taking a tougher enforcement position against offshore exchanges and trading platforms that offer securities to Ontario residents without complying with Ontario registration and prospectus requirements. These platforms include those offering blockchain and cryptocurrency tokens that constitute "investment contracts" and "securities" for the purposes of Ontario securities laws.

- **Unregistered Decentralized Exchanges May Be Sanctioned.** The SEC recently settled charges against Zachary Coburn, founder of the popular crypto exchange EtherDelta, for operating an unregistered securities exchange. Interestingly, EtherDelta was touted as a "decentralized exchange" that facilitated orders between buyers and sellers through a smart contract, but it arguably lacked certain indicia of centralization necessary to meet the criteria of a securities exchange. However, EtherDelta listed over 500 ERC-20 tokens, many of which the SEC considered to be securities, and Coburn exercised some control over how the system looked and operated. By targeting a decentralized exchange, the SEC has signalled that attempts to decentralize operations will not absolve those who exercise some level of control from liability for violations of securities laws.

Investment Funds: Not Ready for Prime Time

- **Bitcoin Investment Fund Is Not "In the Public Interest."** On February 15, 2019, the OSC's Director of Investment Funds and Structured Products (Director) refused to issue a prospectus receipt for "The Bitcoin Fund," an investment fund managed by 3iQ Corp. that would invest substantially all of its assets in bitcoin. In refusing to issue the receipt, the Director cited valuation, market manipulation and custodial concerns, and stated that granting a prospectus receipt "would not be in the public interest" due to the lack of regulation for the bitcoin market at this time. The Director also concluded the prospectus was not in compliance with securities law restrictions on funds holding illiquid assets, since bitcoin does not trade on market facilities on which public quotations in common use are widely accepted. The decision raises questions about when bitcoin will be accepted by regulators as the primary underlying asset of a fund. It also highlights the OSC's lack of confidence that the current market for bitcoin is sufficiently robust to justify allowing retail investors to participate. 3iQ Corp. has filed an application with the OSC for a public hearing to review the Director's decision on the basis that the Director applied tougher standards on The Bitcoin Fund than those imposed on funds investing in more traditional asset classes.

The Road Ahead

The legal landscape for cryptocurrency exchanges and token offerings continues to be wrought with uncertainty. These issues will likely remain unsettled for some time as regulators formulate an appropriate framework to address the risks presented.

The tendency for regulators to "regulate by enforcement" is a trend that is expected to continue in 2019. Increased enforcement actions and joint regulatory initiatives will likely produce a wealth of settlements and judgments from government agencies in North America, providing useful but limited insight on the steps necessary to mitigate regulatory risk for blockchain businesses until more comprehensive regulatory frameworks are developed.

Notable Trends

CHAPTER 04

The Return of the Reverse Takeover

Following Canada's legalization of recreational cannabis in 2018, Canadian capital markets have proven to be fertile ground for the financing of issuers in the cannabis industry, both foreign and domestic. Several cannabis issuers have gone public by way of reverse takeovers (RTOs or also called reverse mergers or back-door listings) to access these markets, including Aurora Cannabis, Curaleaf, Zenabis, MJardin, IGC Resources, Pure Global Cannabis and MedMen. Since 2017, a total of 66 cannabis issuers have announced or completed reverse takeovers.

The Canadian Stock Exchange (CSE) has been a particularly active marketplace for RTOs in the cannabis space because its rules allow for the listing of cannabis companies with U.S. domestic operations, whereas the TSX and the TSXV restrict listed issuers from engaging in or investing in U.S. cannabis cultivation and distribution operations, and certain ancillary activities.

How Does an RTO Work?

An RTO is a transaction whereby a public company (Pubco) whose shares are listed on a stock exchange acquires all the shares of a company (Targetco) that has operating assets or an operating business, but whose shares are privately held. As a result, Targetco shareholders exchange their shares for shares of Pubco, which in turn holds the shares of the operating business (Targetco). An RTO is generally seen as an alternative to the traditional initial public offering (IPO) of shares that mitigates execution risk and results in widened access to Canadian capital markets.

Unlike a traditional IPO, RTO disclosure documents are generally not reviewed by securities commissions, only by the exchange on which they propose to list. Although this reduces the regulatory burden on issuers, it also dispenses with an important element of investor protection.

Structures and sizes vary, but RTOs generally involve Targetco shareholders exchanging all the Targetco shares for Pubco shares, which have a deemed issuance price corresponding to the value of the operating assets or operating business of Targetco. Since the value of the operating assets or operating business of Targetco will generally be substantially higher than the value of Pubco on a pre-transaction basis, Targetco shareholders will ultimately control a substantial majority of the Pubco shares following the reverse takeover.

What Explains the Recent Surge?

The recent RTO trend comes in the wake of a cooling IPO market in Canada and may be explained by the fact that RTOs (i) do not necessarily require a concurrent financing, or (ii) are often preceded by private placement of subscription receipts, allowing private issuers to (a) gauge investor interest before going public and (b) complete their financing before

An RTO is generally seen as an alternative to the traditional initial public offering (IPO) of shares that mitigates execution risk and results in widened access to Canadian capital markets.

Generally, where there is a pre-RTO financing, the proceeds will be held in escrow until the issuer closes the RTO allowing it to list, failing which, investors' funds are returned to them.

going public. Generally, where there is a pre-RTO financing, the proceeds will be held in escrow until the issuer closes the RTO allowing it to list, failing which, investors' funds are returned to them. In either case, the prospect of going public without the need for a financing or going public knowing that your financing is complete significantly reduces the execution risk of the process. This stands in contrast with an IPO, whereby an issuer may incur significant professional fees without any certainty regarding market sentiment and an ultimately successful transaction.

Advantages and Disadvantages of RTOs

As with any transaction structure, an RTO involves several advantages and disadvantages.

ADVANTAGES

- Reduces execution risk by allowing private issuers to go public with certainty that financing is complete or even without financing.
- May be cheaper and faster than an IPO.
- Generally does not involve regulatory review other than by the applicable exchange.
- Provides a lifeline to a dormant Pubco and more liquidity and value for Pubco shareholders willing to exit after the transaction.
- Does not usually involve prospectus liability for the directors, officers and selling shareholders.

DISADVANTAGES

- Involves less market validation of Targetco's business than an IPO.
- Generally requires a Pubco shareholders' meeting.
- Could be stigmatized by scandal (Sino-Forest), and the volume of transactions leading to a "gimmicky" perception.
- Targetco shares are automatically diluted (through the Pubco shares)
- Where no concurrent financing is available, it may be subject to sponsorship or due diligence requirements by stock exchange member organizations.
- May trigger post-transaction tax reorganization and complicated post-transaction corporate restructuring, involving the collapse of the holding and operating company vehicles.

Exchange Sponsored RTO-like Programs

Both the TSX and the TSXV have implemented exchange programs to put in place transactions and structures that functionally have a similar effect to an RTO.

In 2008, the TSX adopted the special purpose acquisition corporation (SPAC) program in order to offer an alternative vehicle for listing on the TSX. The SPAC program is structured as a two-step listing process whereby the SPAC is first listed as a non-operating cash entity, raising a minimum of $30 million. These proceeds must then be used for the qualifying acquisition of an operating company or assets within 36 months of listing.

In the late 1980s, the TSXV adopted the capital pool company (CPC) program in order to offer an alternative vehicle for listing on the TSXV. Similar to the SPAC program, the CPC program is a two-step listing process whereby a CPC is first listed as a non-operating cash entity, following which it raises between $200,000 and $4,750,000. These proceeds must then be used for the acquisition of an operating company or assets within 24 months of listing.

Key Takeaways

The experience of cannabis issuers in their overwhelming use of RTOs to go public serves to highlight three important points regarding RTOs:

- Since RTOs can be completed with financing already complete or without financing, issuers have been able to avoid or minimize market and execution risk on their going-public transactions.
- Because RTOs may be cheaper in terms of professional and other expenses as well as faster than the IPO process, RTOs have been widely adopted by issuers in "hot" industries in order to get to market as quickly as possible.
- Since their initial offering document is not reviewed by securities regulators, RTO issuers may face additional scrutiny from securities regulators on their first prospectus issuance following the RTO.

It remains to be seen whether other industries will adopt RTOs as wholeheartedly as the cannabis industry (and the junior mining industry before it) has done, but for issuers in more speculative or "hotter" markets, it will remain an attractive going-public alternative to the IPO for the foreseeable future.

CHAPTER 05

Success Fees in Advisory Agreements: Financial Advisers (and Their Clients) Take Note

The decision of the Ontario Court of Appeal in *RBC Dominion Securities v Crew Gold Corporation* underscores the importance of clearly delineating the circumstances in which a financial adviser is entitled to a success fee. The decision also suggests that the courts will be loath to find that the financial adviser is entitled to a success fee for transactions unrelated to the work it performed. In particular, parties should consider specifying whether or not a "causal link" between the adviser's activities and the transaction must be present in order for a success fee to be payable.

The Advisory Mandate in *Crew Gold*

In 2009, Crew Gold Corporation (Crew) engaged RBC to assist it in evaluating strategic alternatives. Under the engagement agreement, RBC was entitled to a success fee for a "Transaction" that was completed during the term or within 12 months thereafter, whether or not the purchaser was solicited by RBC.

The agreement defined "Transaction" as a potential transaction involving the direct or indirect sale or disposition of Crew and stated that a Transaction may involve (i) a sale of all or a substantial portion of the shares, business or assets of Crew to a third party; (ii) an investment by a third party in Crew that resulted in its change of control; or (iii) an amalgamation, arrangement or other business transaction involving Crew and a third party to effect such sale or disposition.

Pursuit of the Strategic Transaction

During the course of RBC's mandate, Crew restructured its outstanding debentures, and Crew's board considered several strategic alternatives presented to it by RBC. Following the debenture restructuring and while the board was considering the strategic alternatives presented to it by RBC, a shareholder of Crew (that had obtained its shares as a result of the debenture restructuring) sold its block of shares to Endeavour Financial Corporation (Endeavour) without the involvement of either Crew or RBC. As a result of the transaction, Endeavour's stake in Crew increased to 43%. Following this transaction, RBC was "shunted to the side" as Crew focused on a potential transaction involving Endeavour.

Battle for Control of Crew

Within days of Endeavour's purchase of the shares, OAO (Severstal), a Russian mining company, began to increase its interest in Crew. The race was on for the ultimate control and ownership of Crew, and the focus turned to the battle between Endeavour and Severstal. Crew engaged a different financial adviser to advise it with respect to the brewing takeover battle and terminated RBC's advisory engagement. Endeavour ended up selling its 43% stake in Crew to Severstal approximately two months after the termination of the RBC engagement agreement. Severstal took Crew private several years later under a plan of arrangement. RBC claimed that it was entitled to a success fee for the Endeavour/Severstal transaction, which Crew declined to pay, notwithstanding that the transaction was, on its face, clearly contemplated as a Transaction in respect of which a success fee was payable under RBC's engagement agreement.

No Causal Link, No Fee?

At trial, the court held that RBC and Crew intended that RBC receive a success fee only if there was a "causal link" between RBC's activities and the transaction in question. This is somewhat surprising given that the success fee was expressly payable even if RBC had not introduced the purchaser to Crew or if RBC's

At trial, the court held that RBC and Crew intended that RBC receive a success fee only if there was a "causal link" between RBC's activities and the transaction in question.

involvement was not a material cause of the transaction. The court also found that the engagement agreement was not intended to broadly apply to any sale of shares by a Crew shareholder, even though the definition of Transaction included the sale of a significant portion of Crew shares by either Crew or one of its shareholders.

The Ontario Court of Appeal upheld the lower court's decision. The Court of Appeal held that notwithstanding the plain language in the engagement agreement, the trial judge did not fail to apply proper contractual interpretation principles in interpreting the engagement agreement. The Court of Appeal found that the trial judge's interpretation – that the parties intended the success fee to be linked to some action on the part of RBC – was reasonable based on the engagement agreement in question. With respect to the tail provision in the engagement agreement, the Court of Appeal found that the trial judge correctly interpreted the tail provision as simply providing for payment of a success fee if the "mandate" was carried out after the termination of the engagement agreement. In other words, the transaction for which a success fee was payable must relate to work performed by the adviser before the termination of the engagement agreement.

Lessons from the *Crew Gold* Decision

Financial advisers and their clients alike would be well-advised to take a thoughtful and careful approach to tail provisions and related key definitions in their engagement agreements:

- Financial advisers should consider including express language in their standard form engagement agreements to the effect that no causal link is required for a success fee to be payable during the tail period. They should also consider proposing a detailed and expansive definition of "Transaction" if they want to be entitled to a success fee for a broad range of transactions executed during the tail period.
- Courts will continue to apply a contextual approach to contractual interpretation and will not necessarily render decisions on the basis of the express language in an engagement agreement; however, express language addressing the causal link requirement may help demonstrate to a court that the parties intended the success fee to be payable to a financial adviser in a broad set of circumstances, including where there is no causal link between the transaction and the advisory services provided.
- Although the courts have demonstrated an unwillingness to broadly construe a financial adviser's entitlements during the tail period, parties that engage financial advisers should consider proposing a more limited definition of "Transaction" or excluding certain types of transactions from the definition.

CHAPTER 06

Playing Fair in a Post-*InterOil* World: Market Practice in Fairness Opinions

The provision of fairness opinions in M&A transactions remains an area of evolving practice in Canada following the Yukon Court of Appeal's 2016 decision in *InterOil Corporation v Mulacek*. In that decision, the Yukon Court of Appeal blocked ExxonMobil's acquisition of InterOil Corporation under a plan of arrangement on the basis that the arrangement was not fair and reasonable to the parties whose interests were being arranged, partly due to deficiencies in the fairness opinion obtained by InterOil's board of directors. The Yukon Supreme Court subsequently approved ExxonMobil's second attempt to acquire InterOil through a plan of arrangement after InterOil's board of directors had obtained a more robust, "long-form" fairness opinion. Despite considerable discussion of the potential impact of the *InterOil* decision, the implications of the decision are not fully clear almost two years later. As a result, issuers and their financial advisers continue to need to balance the value of providing a comprehensive fairness opinion to shareholders with the costs of enhanced disclosure in the particular circumstances of each transaction.

The Canadian Approach

Fairness opinions are not legally required to be provided in Canadian acquisition transactions, but are a regular feature of almost all board-supported transactions in Canada. Boards customarily obtain fairness opinions from a financial adviser to help demonstrate that they have satisfied their fiduciary duties in approving a transaction.

In contrast to the approach taken in the United States, where issuers typically provide detailed disclosure of the financial analysis underlying the fairness opinion, market practice in Canada prior to *InterOil* had been to obtain only a "short-form" opinion, with no disclosure of the underlying financial analysis. Further, the financial adviser providing the opinion has generally been compensated through a success-fee arrangement. Disclosure of the underlying financial analysis has only been included in the context of transactions subject to Multilateral Instrument 61-101, *Protection of Minority Security Holders in Special Transactions* (MI 61-101), which mandates the requirement to obtain a formal valuation from an independent valuator in certain circumstances and certain related disclosure.

Judicial and regulatory consideration of market practice relating to fairness opinions predated the decision in *InterOil*. In its 2009 ruling in respect of the proposed transaction between Hudbay Minerals Inc. and Lundin Mining Corporation, the Ontario Securities Commission (OSC) concluded that a fairness opinion prepared by a financial adviser compensated on a success-fee basis did not assist directors in demonstrating compliance with their fiduciary duties.[1]

A year later, the OSC intervened in the reorganization of the capital of Magna International Inc. (Magna) in circumstances in which, among other things, no fairness opinion was obtained by the issuer. The OSC required Magna to provide enhanced disclosure to its shareholders, including additional disclosure concerning the financial analysis of the underlying transaction provided by the issuer's financial advisers.[2]

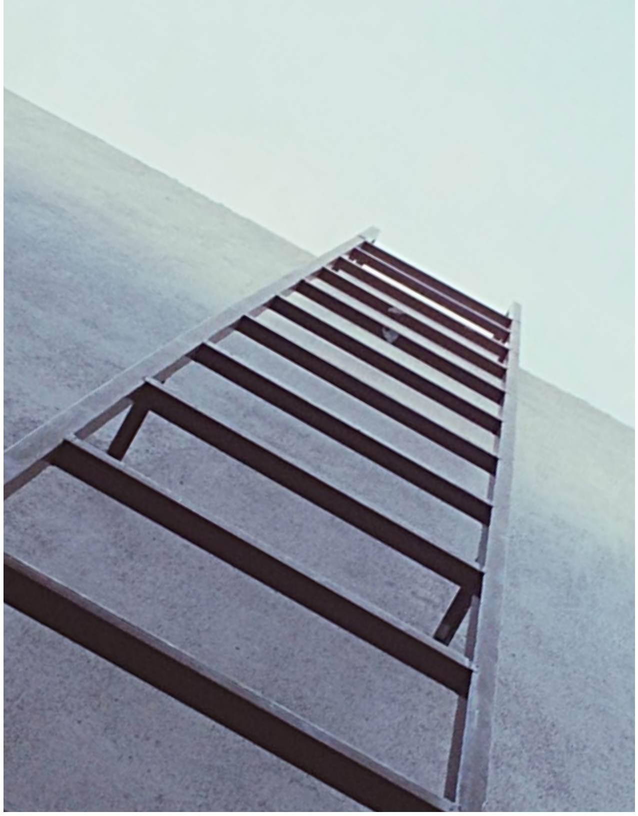
In 2014, the Ontario Superior Court questioned the prevailing practice with respect to fairness opinions by refusing to admit as evidence the fairness opinion filed by Champion Iron Mines Limited on the basis that it did not disclose any meaningful financial analysis.[3] However, in two subsequently released decisions, *Re Bear Lake Gold Ltd*. and *Re Patents Royal Host Inc*., the Ontario courts concluded that there was no reason to depart from the existing disclosure practice in the context of non-contested transactions.[4]

The *InterOil* Standard

In 2016, ExxonMobil agreed to acquire InterOil under a Yukon plan of arrangement. In approving the transaction, the InterOil board obtained a market standard short-form fairness opinion from a leading investment bank that was to be compensated with a success-based fee.

Despite the arrangement receiving the support of over 80% of shareholders, the Yukon Court of Appeal (comprising judges from the B.C. Court of Appeal) held that the arrangement was not fair and reasonable, in part due to deficiencies in the fairness opinion relied upon by the InterOil board. Among other "red flags" in the board-approval process, the Court objected to the success fee of the financial adviser providing the fairness opinion, the failure to disclose the specific amount of the fee, and the fairness opinion included in the circular not providing the financial adviser's underlying financial analysis.

1 *Re Hudbay Minerals Inc*., 32 OSCB. 1082, para 264.
2 *Re Magna International Inc*. (OSC reasons); *Re Magna International Inc*., 2010 ONSC 4123.
3 *Re Champion Iron Mines Limited*, 2014 ONSC 1988, para 17.
4 *Re Bear Lake Gold Ltd*., 2014 ONSC 3428, para 16; *Re Patents Royal Host Inc*., 2014 ONSC 3323.



InterOil continued to pursue the transaction and, ultimately, paid US$4 million for an independent, fixed-fee, long-form fairness opinion. The circular for the second attempt at the transaction contained detailed disclosure about the valuation of InterOil and the consideration payable to shareholders under the arrangement, including the financial adviser's methodologies and a value analysis. The Yukon Supreme Court approved the revised transaction and endorsed a new minimum standard for plans of arrangement to be supported by a long-form fairness opinion obtained on a fixed-fee basis.

Staff Notice 61-302

On July 27, 2017, staff at five of the Canadian provincial securities regulatory authorities issued Multilateral CSA Staff Notice 61-302 (Notice),[5] which clarified staff's expectations regarding the role of special committees in "material conflict of interest transactions" and discussed the standard of disclosure for fairness opinions in these transactions.

The Notice confirms the discretion of the board and the special committee in determining whether or not to obtain a fairness opinion and in determining the compensation arrangements for the financial adviser providing the opinion. However, where a fairness opinion is obtained, the Notice sets out that the circular should disclose the following:

– the compensation arrangement of the financial adviser and its consideration by the board or special committee;

– any other relationship or arrangement between the financial adviser and the issuer or an interested party that may bear on the independence of the opinion;

– a summary of the methodology, information and analysis underlying the opinion; and

– the relevance of the fairness opinion to the board and special committee.

In contrast with the guidance provided by the Yukon courts in the InterOil decisions, the Notice did not mandate fixed-fee compensation for the financial adviser providing the fairness opinion, nor that the specific amount of the fee must be disclosed.

The Yukon Supreme Court approved the revised transaction and endorsed a new minimum standard for plans of arrangement to be supported by a long-form fairness opinion obtained on a fixed-fee basis.

5 Multilateral CSA Staff Notice 61-302, Staff Review and Commentary on Multilateral Instrument 61-101, *Protection of Minority Security Holders in Special Transactions*. See the subheadings "Financial advisors and fairness opinions" and "Fairness opinions." The Notice was issued by staffs at the security regulators in each of Ontario, Québec, Alberta, Manitoba and New Brunswick.

Market Trends Post-*InterOil*

While the *InterOil* series of decisions do not reflect the law on fairness opinions in Canadian jurisdictions other than Yukon and B.C., market practice across Canada is trending toward enhanced disclosure of the financial analysis underlying fairness opinions. Financial advisers should, at a minimum, be prepared to deliver a fairness opinion that includes details regarding valuation methodology in any transaction in which a fairness opinion is used.

In addition, since *InterOil*, there has been a subtle market shift toward fixed-fee compensation arrangements, with a majority of arrangement transactions valued at over $100 million including at least one fairness opinion provided on a fixed-fee basis. A significant majority of issuers continue to elect not to disclose the amount of the fee paid to financial advisers.

In transactions in which a formal valuation under MI 61-101 was not required, but a fairness opinion was nonetheless provided, the trend is toward fairness opinions containing additional analysis of the financial adviser's methodology. These long-form fairness opinions were obtained in the majority of the transactions surveyed.

There are several examples of issuers moving away from the *InterOil* standard of disclosure in fairness opinions toward a "hybrid" form of disclosure including the financial adviser's valuation methodology, while omitting the detailed financial analysis underlying the opinion. For example, in PayPal's 2017 acquisition of TIO Networks, the fairness opinion obtained by TIO Networks contained a detailed discussion of the methodologies employed by the financial adviser, but did not include an *InterOil*-style value analysis. A similar approach was taken in the 2018 acquisitions of Klondex Mines Ltd. by Hecla Mining Company and of Primero Mining Corp. by First Majestic Silver Corp. Given the incremental costs of comprehensive disclosure and second fairness opinions, we expect that many issuers will opt for this more moderate standard of disclosure in non-contested transactions.

Need to Know

The optimal level of disclosure in a fairness opinion and the appropriate compensation structure continue to depend on the circumstances of each transaction, including the perceived existence of conflict in a particular transaction, the robustness of the board approval process, the governing jurisdiction of the particular issuer and the likelihood of a shareholder challenge or interloper offer.

In non-conflicted transactions, it may not be necessary to obtain a long-form fairness opinion from an independent financial adviser that is compensated on a fixed-fee basis. Transparency regarding the financial adviser's compensation structure (but not necessarily the compensation amount) is generally recommended. In each case, the relevant inquiry is whether the disclosure provided to shareholders is fair and appropriate so as to enable an informed shareholder vote.

Key Decisions In 2018

CHAPTER 07

Good Laws Gone Bad: Continued Confusion over the Materiality Standard in Civil Misrepresentation Actions

Civil liability for secondary market disclosure was conceived by securities regulators with the best of intentions. But, left to the courts to develop without supervision by its makers, it has of late become an unruly child.

Two recent Ontario court decisions – *Wong v Pretium Resources*, 2017 ONSC 3361 (*Wong*), and *Paniccia v MDC Partners Inc.*, 2018 ONSC 3470 (*Paniccia*) – have compounded the confusion over the appropriate standard for assessing materiality for the purpose of granting leave to proceed under the secondary market liability provisions of the Ontario *Securities Act* (OSA). Issuers should be aware of this uncertainty in the case law and should test their disclosure decisions against both the "market impact test" found in the text of the OSA and the lower threshold of the "reasonable investor test."

Wong: To Disclose or Not to Disclose? Consider the "Reasonable Investor"

In *Wong*, the Ontario Superior Court of Justice granted the plaintiff leave to proceed with an action under section 138.3 of the OSA for secondary market misrepresentation against Canadian mining company Pretium Resources Inc. (Pretium).

The allegations in *Wong* related to Pretium's decision not to disclose concerns raised by an external consultant regarding unfavourable mineral sampling results at Pretium's flagship Brucejack Project. Pretium believed that the concerns raised by its consultant were unfounded and that the mineral sampling results were inaccurate. It therefore decided not to disclose the consultant's concerns to the market when they were raised. The plaintiff argued that Pretium's failure to disclose the external consultant's concerns in its press releases, material change reports and MD&A's issued during the relevant period were a misrepresentation by omission.

Despite Pretium's genuine belief that the concerns raised by its external consultant were unfounded, and that Pretium's belief was ultimately proven correct, the Court found there was a reasonable possibility that the plaintiff would succeed at trial and accordingly granted the plaintiff leave to proceed with the action.[1]

The Court found that the consultant's concerns regarding the mineral sampling results were material facts requiring disclosure by Pretium at the time they were raised by the consultant. In assessing the alleged materiality of the consultant's concerns, the Court applied the "reasonable investor test" and found that a reasonable investor would have

The Court found that the consultant's concerns regarding the mineral sampling results were material facts requiring disclosure by Pretium at the time they were raised by the consultant.

1 In determining whether to grant a plaintiff leave to proceed with an action for misrepresentation under section 138.8(1) of the OSA, a court considers the merits of the plaintiff's case and must assess whether "there is a reasonable possibility that the action will be resolved at trial in favour of the plaintiff."

By failing to consider the impact (if any) that Pretium's failure to disclose had on the market price or value of Pretium's securities, the Court moved away from the objective market impact test set out in the OSA and applied a lower threshold for assessing the materiality of the information in question.

considered the consultant's concerns to be important when deciding whether to invest in Pretium, regardless of the company's own views. Critically, in applying the reasonable investor test, the Court made a determination of materiality without appropriate regard to the relevant test for materiality set out in the OSA – namely, whether the information would reasonably be expected to have a significant effect on the market price or value of the company's securities (i.e., the "market impact test").

By failing to consider the impact (if any) that Pretium's failure to disclose had on the market price or value of Pretium's securities, the Court moved away from the objective market impact test set out in the OSA and applied a lower threshold for assessing the materiality of the information in question.

Paniccia: Following in *Wong*'s Footsteps

In *Paniccia*, the Ontario Superior Court of Justice followed *Wong* and applied the reasonable investor test, as opposed to the market impact test mandated by the OSA, while assessing the materiality of alleged misrepresentations in another application for leave to proceed with an action under the secondary market liability provisions of the OSA.

The plaintiff in *Paniccia* alleged that there were numerous misrepresentations in the continuous disclosure of the defendant MDC Partners Inc. (MDC), including that

- MDC did not disclose that the U.S. Securities and Exchange Commission (SEC) had served a subpoena on MDC;
- MDC did not disclose that it had formed a special committee to conduct an internal investigation regarding its internal controls over financial reporting; and
- MDC failed to accurately disclose its CEO's compensation.

In dismissing the plaintiff's motion for leave to proceed, the Court found that there was a "fundamental flaw" in the plaintiff's case – namely, that none of the alleged misrepresentations were material.

In assessing materiality, the Court evaluated whether each piece of information not addressed in MDC's public disclosure constituted a material fact, which is a prerequisite to qualifying as a misrepresentation for purposes of the civil liability provisions of the OSA. The Court canvassed the law surrounding materiality and the definition of material fact under the OSA and, in doing so, correctly recognized that the definition of material fact encompasses "any fact that reasonably would be expected to have a significant effect on the market price or value of the securities of an issuer" (the market impact test). However, the Court also cited the decision in *Wong* in support of the proposition that a fact may be considered material "if there is a substantial likelihood that a reasonable investor would consider it important in deciding whether to invest and at what price" (the reasonable investor test).

Although the Court recognized that the appropriate standard for determining materiality under the OSA is the market impact test, it arguably departed from that standard in applying the reasonable investor test to conclude that the alleged misrepresentations were not material. Fortunately for MDC, the application of the lower threshold for materiality under the reasonable investor test, as opposed to the market impact test set out in the OSA, did not have an effect on the outcome of the case.

Key Considerations

The fundamental issue raised by *Wong* and *Paniccia* is that the reasonable investor test sets a lower threshold for materiality than does the market impact test. That is to say, a reasonable investor may consider certain information important when making an investment decision when that same information would not be reasonably expected to have a significant effect on the market price or value of a company's securities. This critical distinction between the two tests has been confirmed by the Ontario Divisional Court in *Cornish v Ontario Securities Commission*, 2013 ONSC 1310.

Perhaps the solution is for Canadian securities regulators to intervene in secondary market civil liability cases to help guide this unruly child back onto its intended path. Until that happens, issuers should bear *Wong* and *Paniccia* in mind and ensure that their disclosure meets both the statutory market impact test and the judicially imposed, lower threshold of the reasonable investor test.

Further, Canadian issuers should be aware of the following:

- When assessing materiality, courts will not defer to the business judgment of executives in making an assessment as to whether public disclosure is required.
- Materiality is not assessed with the benefit of hindsight. As demonstrated in *Wong*, the fact that an issuer is later proven to be correct may not be considered a relevant factor in assessing the materiality of the information at the relevant time.
- The primary goal of the OSA is investor protection and the application of the law on materiality will be viewed through this lens.

Supreme Court of Canada Paves Way for a National Securities Regulator

On November 9, 2018, the Supreme Court of Canada (SCC) unanimously ruled in *Reference re Pan-Canadian Securities Regulation*[1] that the federal government's second attempt to create a national securities regulator is constitutional. Specifically, the Court held that the proposed cooperative system (i) does not improperly fetter the provinces' sovereignty; and (ii) falls within Parliament's general powers to regulate trade and commerce under subsection 92(1) of the *Constitution Act*, *1867*. The SCC's decision overturns the Québec Court of Appeal's 2017 ruling that found the proposed regime unconstitutional and clears the path for a voluntary, national securities regulation regime. While the legal roadblocks to a cooperative national securities regulator have now been cleared, it remains to be seen if sufficient political will exists to make a cooperative regime successful in Canada.

1 *Reference re Pan-Canadian Securities Regulation*, 2018 SCC 48. Full text of decision located here: https://scc-csc.lexum.com/scc-csc/scc-csc/en/item/17355/index.do.

Background

In 2011, the SCC rejected the federal government's attempt to create a national securities regulator. In *Reference Re Securities Act*, the SCC held that the federal government's proposed *Securities Act* was not a valid exercise of the federal government's power to regulate trade and commerce in Canada because the proposed Act impermissibly interfered with the provinces' jurisdiction over property and civil rights. However, the SCC left open the possibility that a voluntary federal regulatory scheme could be constitutional.

Heeding the SCC's ruling, the federal government and the governments of Ontario, British Columbia, Saskatchewan, New Brunswick, PEI and Yukon entered into a *Memorandum of Agreement Regarding the Cooperative Capital Markets Regulatory System* (MOA) in 2014 to create a cooperative pan-Canadian securities regulator (Cooperative System). Seven jurisdictions, including Québec and Alberta, have not joined the Cooperative System.

The Cooperative System proposed by the federal government has four components:

- A national securities regulator called the Capital Markets Regulatory Authority (CMRA).

- The *Capital Markets Act* (Model Provincial Act), a standardized provincial and territorial statute to be administered by the CMRA. The Model Provincial Act would address the day-to-day aspects of securities regulation and each participating province would enact a statute that mirrors the Model Provincial Act.

- The *Capital Markets Stability Act* (Draft Federal Act), a complementary federal statute that would regulate systemic risk in Canada's economy.

- The CMRA and its board of directors would operate under the supervision of a Council of Ministers chosen from the cabinet of each participating province and the federal Minister of Finance. The Council of Ministers would propose amendments to the Model Provincial Act.

Judgment of Québec Court of Appeal

Québec, which did not sign the MOA, had concerns about the constitutionality of the proposed Cooperative System and referred two constitutional questions to the Québec Court of Appeal (QCCA):

1. Does the Constitution authorize the implementation of pan-Canadian securities regulation under the authority of a single regulator, according to the model established by the most recent publication of the *Memorandum of Agreement Regarding the Cooperative Capital Markets Regulatory System*?

2. Does the most recent version of the Draft Federal Act exceed the authority of the Parliament of Canada over the general branch of the trade and commerce power under subsection 91(2) of the Constitution?

On the first question, the QCCA held that the proposed Cooperative System was unconstitutional for two key reasons: (i) it unduly fettered the provinces' legislative authority by delegating authority to amend the Model Provincial Act to the Council of Ministers; and (ii) the Council of Ministers' role in approving regulations made under the Draft Federal Act conflicted impermissibly with the principles of federalism.

On the second question, the QCCA held that while the pith and substance of the Draft Federal Act is to manage systemic risk related to capital markets in Canada, which was within federal powers, the Draft Federal Act exceeded Parliament's authority to regulate trade and commerce. The QCCA made clear that unless the power granted to the Council of Ministers to approve regulations made under the Draft Federal Act was removed, the Cooperative System as a whole would be unconstitutional.

Judgment of the Supreme Court of Canada

The SCC revisited the same reference questions that were before the QCCA.

Overturning the QCCA's decision, the SCC unanimously held that the proposed Cooperative System is constitutional and that the Draft Federal Act falls within the federal government's trade and commerce powers under section 91(2) of the Constitution. However, the SCC emphasized that although the Cooperative System is constitutional, each province and territory must decide for itself whether to join the Cooperative System.

QUESTION ONE: THE COOPERATIVE SYSTEM DOES NOT FETTER PROVINCIAL SOVEREIGNTY

The SCC held that the Model Provincial Act does not improperly fetter the provincial legislatures' sovereignty nor does it create an impermissible delegation of law-making authority. A key constitutional principle, parliamentary sovereignty ensures that only the legislature can pass, amend or abolish laws. The SCC held that because the proposed Cooperative System does not force provincial and territorial legislatures to pass the Model Provincial Act and the Model Provincial Act does not have the force of law within a province unless it is enacted by the province's legislature, the Cooperative System does not unduly intrude on parliamentary sovereignty.

Moreover, the proposed Cooperative System does not create an impermissible delegation of law-making authority. Provincial legislatures are prohibited from delegating primary legislative authority with respect to matters over which they have exclusive jurisdiction to a legislature of another level of government. The SCC held that although the Council of Ministers would have the power to approve amendments to the Cooperative System, the MOA is clear that the Council of Ministers would not actually have the power to unilaterally amend the provinces' securities legislation. Because the Council of Ministers remains subordinate to the will of provincial legislatures, the proposed Cooperative System will not result in an impermissible delegation of authority.

The SCC emphasized that although the Cooperative System is constitutional, each province and territory must decide for itself whether to join the Cooperative System.

QUESTION TWO: THE DRAFT FEDERAL ACT IS *INTRA VIRES*

The SCC held that the Draft Federal Act falls within Parliament's general powers to regulate trade and commerce under the Constitution. Parliament can use its trade and commerce power to make laws concerning truly national issues, meaning those issues that provinces and territories cannot deal with on their own. The SCC held that the pith and substance of the Draft Federal Act is to control material adverse systemic risks in Canada's economy and promote stability in Canada's capital markets.

The SCC noted that although provinces have the ability to legislate with respect to systemic risk in their own capital markets, they do so only from a local perspective. The Draft Federal Act addresses matters of genuine national economic importance that transcend provincial borders.

Further, the SCC specifically considered the constitutionality of certain provisions of the Draft Federal Act that allow the federal government to delegate authority to make regulations to the CMRA under the supervision of the Council of Ministers. The Court held that the provisions are constitutional because they are consistent with the legislature's broad authority to delegate administrative powers.

Where Do We Go From Here?

Although Canada is the only country in the G20 not to have a national securities regulator, the SCC's decision is likely to be controversial given the resistance to the concept in some provinces. With the launch of the Cooperative System, there will certainly be challenges in reaching consensus on the broad variety of issues that will need to be addressed. In particular, since Québec and Alberta remain opposed to the Cooperative System, it is unclear whether the Cooperative System will be able to create a truly harmonized securities regulatory regime.

The signatories to the MOA have already taken key steps to ensure that the development of the Cooperative System progresses. An expert board of directors and chief regulator of the CMRA have been appointed, and draft prospectus and related registration exemptions have been released for comment. However, when and how the Cooperative System will be introduced remain unknown.

The SCC made clear that while its decision constitutionally clears the way for the implementation of the Cooperative System, the individual provinces and territories retain discretion to determine whether participation is in their best interests. However, it remains to be seen if sufficient political will exists among the participating jurisdictions to move the Cooperative System forward.

Regulatory Developments

Mind the GAAP: Avoid Getting Tripped Up by New Non-GAAP Disclosure Requirements

The Canadian Securities Administrators (CSA) has, for the first time, proposed a set of rules to govern non-GAAP and other financial measures. These rules, which will replace guidance previously issued by the CSA, will require issuers to adhere to rigid disclosure requirements when publicly disclosing non-GAAP financial measures. The rules will also expand the universe of regulated financial measures requiring supplemental disclosure beyond traditional "non-GAAP financial measures." Although these proposed rules may change before being implemented, issuers should expect that whatever their final form, the new rules will require more detailed disclosure and additional time and resources to ensure compliance.

Because it mandates disclosure through rules rather than guidance, the Proposed Instrument will eliminate issuer flexibility with respect to the presentation and disclosure of non-GAAP and other specified financial measures.

Recap of the Existing Regime

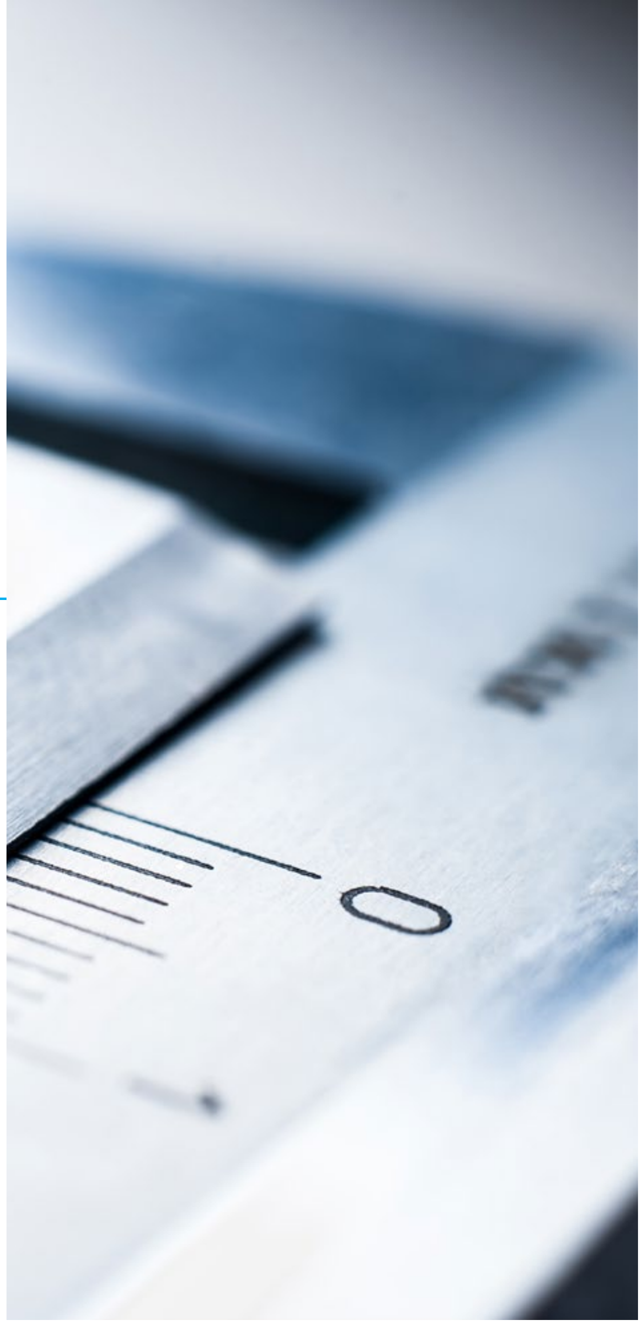
There are currently no Canadian securities regulations specific to the disclosure of non-GAAP and other financial measures outside of an issuer's financial statements. There is only the CSA's guidance in Staff Notice 52-306 (Revised), *Non GAAP Financial Measures* (SN 52-306), which was first issued in 2003 and last updated in 2016. The purpose of this guidance is to help issuers disclose non-GAAP financial measures in a more consistent manner that is transparent and not misleading to investors. To this end, when reporting a non-GAAP financial measure, SN 52-306 provides that issuers should, among other things,

- state that the non-GAAP financial measure has no standardized meaning under GAAP;
- name it in a way that distinguishes it from a GAAP measure and is not otherwise misleading;
- explain why it provides useful information to investors;
- present with equal or greater prominence the most directly comparable GAAP financial measure;
- provide a quantitative reconciliation from the non-GAAP financial measure to the most directly comparable GAAP measure; and
- present the non-GAAP financial measure on a consistent basis from period to period.

Despite these and a number of other seemingly prescriptive requirements, SN 52-306 is regulatory guidance, not binding law. As a result, issuers have some degree of flexibility in how they apply this guidance to their specific circumstances when disclosing non-GAAP financial measures, provided that their disclosure is not misleading to investors.

New Rules-Based Framework

Despite the existing guidance, the CSA has found that disclosure practices still vary materially among issuers. To address this disparity, and in response to ongoing concerns identified by certain investors and other stakeholders, the CSA published Proposed National Instrument 52-112, *Non-GAAP and Other Financial Measures Disclosure* (Proposed Instrument), in September 2018 to replace SN 52-306. The Proposed Instrument would impose mandatory disclosure in respect of non-GAAP and certain other specified financial measures when these are publicly disclosed in writing, including in postings on websites and social media. Because it mandates disclosure through rules rather than guidance, the Proposed Instrument will eliminate issuer flexibility with respect to the presentation and disclosure of non-GAAP and other specified financial measures and enable the CSA to take enforcement action against issuers that fail to comply.



Generally speaking, the requirements imposed by the Proposed Instrument in respect of non-GAAP financial measures are aligned with the current guidance under SN 52-306. However, there are a few notable differences. In some cases, these differences stem from an acknowledgment that a different approach may be appropriate (as a practical or principled matter) in prescribed circumstances. A good example is the Proposed Instrument's exception that allows for a qualitative discussion of certain forward-looking non-GAAP financial measures in lieu of a quantitative reconciliation to a forward-looking GAAP measure.

Unfortunately, some elements of the Proposed Instrument fail to provide appropriate exceptions and impose new disclosure practices that are impractical, unduly burdensome or otherwise unnecessary to ensure the investing public is not misled. For example, the Proposed Instrument requires that when disclosure of a non-GAAP financial measure is made, the "same" non-GAAP financial measure must also be presented for the comparative period. This approach differs from SN 52-306, which requires only that non-GAAP financial measures be consistent from period to period.

As noted in our comment letter to the CSA, in several circumstances it would be impossible or impractical for issuers to present disclosure on exactly the same basis for comparative periods. In these circumstances, absent an express exception (none are currently proposed) or exemptive relief, an issuer would be in breach of the Proposed Instrument even if the issuer were to provide transparent disclosure that ensured investors were not misled. The CSA has suggested that exemptive relief may be available in some of these circumstances; however, even if available, there may be insufficient time to obtain this relief in the context of event-driven or other current disclosure. In our comment letter, we suggested that the CSA reconsider its proposal to deal with these circumstances by exemptive relief, given the costs and delays that it can impose on an issuer.

Another concerning aspect of the Proposed Instrument is the proposed regulation of three "new" categories of financial measures – namely "segment measures," "capital management measures" and "supplementary financial measures." In broad terms, these "other financial measures" are distinct from non-GAAP financial measures but, in the CSA's view, give rise to similar policy concerns if not accompanied by appropriate disclosure. Given that there has never been any regulation of these "other financial measures," or any clear guidance from the securities regulators as to the specific concerns with their use, there is a very real risk of confusion among investors and issuers alike as to the precise meaning of each new disclosure category and the kind of incremental disclosure that is necessary to comply with the Proposed Instrument's requirements. This risk is exacerbated by an absence of clarity in the Proposed Instrument's companion policy as currently drafted.

Finally, the Proposed Instrument would apply to all issuers (including investment funds), with an exception only for "SEC foreign issuers." As a result, an "SEC issuer" reporting in Canada that does not qualify as a "SEC foreign issuer" would need to comply with both U.S. and Canadian disclosure requirements regarding financial measures. Although the regulation of non-GAAP financial measures in the United States and Canada is similar, the regimes are not identical. Furthermore, the Proposed Instrument will apply to other financial measures that are not subject to specific U.S. regulation.

For additional detail on the Proposed Instrument, please see our previous commentary.

What Happens Next?

The comment period for the Proposed Instrument closed in December 2018. The CSA received over 40 comment letters from a variety of market participants who identified a broad range of concerns with the Proposed Instrument. In addition to the concerns noted above, Davies' comment letter also suggests improvements to create a more streamlined and modern disclosure regime.

The Proposed Instrument involves a significant shift in the manner in which disclosure of financial measures is regulated under Canadian securities laws. We expect the CSA will take the time necessary to carefully consider the views and concerns expressed by all the commenters before moving forward with the Proposed Instrument.

Although it is unclear at this time whether any changes will be made to the Proposed Instrument, we expect that the CSA will ultimately implement rules governing non-GAAP and possibly certain other financial measures in one form or another. Accordingly, issuers should be prepared to make changes to their disclosure practices regarding these financial measures. They can also expect that these changes will require the dedication of increased time and resources to ensure compliance.

CHAPTER 10

Important Developments in TSX Policy in 2018

The TSX continued to adopt significant policy and practice refinements in its staff notices in 2018. Included among these were important modifications with implications for both the issuance of securities in connection with acquisitions and the pricing of offerings. Although TSX staff notices are intended to provide guidance to listed companies, this guidance is applied mandatorily by TSX staff, adding an additional layer of substantive requirements that listed issuers need to appreciate.

New Requirements for Significant Share Issuances

In August 2018, the TSX published Staff Notice 2018-0005 (Notice), which replaced previous guidance regarding securityholder approval requirements in connection with the acquisition of a public company in a formal takeover bid, arrangement, amalgamation or similar transaction. Since 2009, the TSX has required issuers to obtain securityholder approval if the number of securities issuable as payment of the purchase price in an acquisition exceeds 25% of the issuer's outstanding securities on a non-diluted basis (Significant Issuance). Under previous guidance, listed issuers were not permitted to subsequently increase the number of securities issuable under the transaction without obtaining further securityholder approval. As a result of the Notice, issuers can now issue an additional 25% of the maximum number of shares previously approved for issuance without obtaining further securityholder approval, but only in connection with an increase in the consideration payable under the transaction.

The disclosure required for a Significant Issuance is largely unchanged by the Notice, as is the requirement to obtain TSX approval for such disclosure. The TSX requirement that issuers disclose in their information circular the maximum number of securities that may be issued for a Significant Issuance also remains unchanged. The only substantive change in the Notice is a new requirement that all listed issuers must now include the following statement in the information circular for their Significant Issuance:

> TSX will generally not require further security holder approval for the issuance of up to an additional [x] [securities], such number being 25% of the number of securities approved by security holders for the transaction.

This requirement applies to all issuers seeking securityholder approval for a Significant Issuance, whether or not the issuer has any intention of increasing the consideration payable in connection with the acquisition. As a result, acquirers using share consideration that would result in a Significant Issuance can no longer rely on the fixed maximum number of securities for which securityholder approval is sought and obtained to discourage further negotiation by target boards or shareholders.

In essence, the TSX has mandated that each issuer using share consideration in such an acquisition must disclose that it has room to negotiate a significant increase in the consideration payable for the acquisition, even after securityholder approval of the acquisition has been obtained, whether or not the issuer desires this ability or its shareholders would have approved the transaction at a higher price. This new requirement may ultimately have unintended consequences and seriously disadvantage certain acquirers and their shareholders by undermining their bargaining position. Other issuers may benefit from being able to increase the consideration payable in their Significant Issuance after shareholder approval has been obtained by increasing the number of shares to be paid in a deal that has been topped by a competitive offer.

While acquisitions involving a Significant Issuance requiring securityholder approval as a result of section 611(c) of the *TSX Manual* were rare in the years after the securityholder approval requirement was originally adopted in 2009, such transactions have become more common and well-accepted in the Canadian marketplace in recent years. Issuers contemplating acquisitions that would involve a Significant Issuance will need to weigh the implications of the Notice and the manner in which it may ultimately affect how the transaction will play out. Any determination to increase the consideration payable in a transaction following shareholder approval for a less expensive deal, as permitted by the TSX in the Notice, may undermine shareholder confidence and goodwill – with unintended consequences.

New Guidance on Pricing Offerings

In March 2018, the TSX published new guidance in Staff Notice 2018-0003 (Pricing Guidance) on pricing prospectus offerings and private placements when an issuer has recently disclosed material information. The Pricing Guidance sets out the TSX's expectations that offerings by listed issuers should be priced five clear trading days after any dissemination of material information to ensure that the market price appropriately prices the impact of the material information that has been disclosed.

If it is impractical for the issuer to wait five days after the disclosure of material information to launch an offering, the Pricing Guidance provides some latitude for issuers to contact the TSX to seek an exemption. In certain circumstances, the TSX may agree to allow an issuer to rely on a market price calculated using less than five days' trading history, though it has not elaborated on situations in which it may consent to a divergence from its customary market price determination.

Issuers unfamiliar with the implications of the Pricing Guidance run the risk of pricing offerings when such pricing would be prohibited by the TSX or relying on a market price calculation that may not be accepted by the TSX. Either scenario would heighten the risk that the TSX could intervene to require shareholder approval of the offering, a result that would be unfavourable in most circumstances and potentially fatal to the issuer's ability to complete the offering on a timely basis or at all. In addition, issuers should be mindful that the intention to effect an offering itself, depending on its size and surrounding circumstances, may constitute material undisclosed information for the purposes of the TSX regime, which the TSX could in theory require to be disclosed before the offering is priced.

The Pricing Guidance sets out the TSX's expectations that offerings by listed issuers should be priced five clear trading days after any dissemination of material information to ensure that the market price appropriately prices the impact of the material information that has been disclosed.

Our Take

In 2018, the TSX continued to issue significant policy and practice refinements in staff notices that are adopted without the market consultation or input that would arise in connection with a proposed change to the *TSX Manual*. As a result, staff notices do not receive the same level of scrutiny and often fail to garner the publicity warranted by the serious nature and implications of the matters they address.

In the Notice, the TSX is attempting to resolve a problem for issuers that wish to increase the share consideration payable for acquisitions for which they have received securityholder approval. By mandating that all issuers disclose to securityholders that they are entitled to issue up to an additional 25% of the securities approved in an acquisition if the consideration increases, the TSX has solved an administrative problem for such issuers. Although this change will undoubtedly benefit these issuers, it is a blunt instrument and may tactically undermine other issuers that prefer to be constrained from increasing the consideration that they are offering. Even issuers that may be willing to increase the consideration payable in a transaction are likely to be unhappy with the TSX's new mandatory disclosure requirements.

In recent years, the TSX has been increasingly attentive to issues relating to the pricing of offerings by companies that possess material non-public information. All issuers considering raising capital, whether by public offering or private placement, need to be aware of (i) the cumulative impact of recent TSX pronouncements relating to the disclosure of material non-public information prior to offerings and (ii) the implications of these pronouncements on the timing of pricing and announcement of such offerings. Heightened scrutiny of these matters may result in unexpected delays or, more seriously, unexpected securityholder approval requirements imposed on issuers by the TSX.

U.S. Update

The SEC Modernizes Mining Disclosure

In October 2018, the U.S. Securities and Exchange Commission (SEC) approved final rules (the new rules) to modernize the SEC's mining property disclosure requirements. The SEC focused on aligning the new rules with Canada's National Instrument 43-101, *Standards of Disclosure for Mineral Projects* (NI 43-101), and industry standards issued by the Committee for Mineral Reserves International Reporting Standards (CRIRSCO). The new rules, which replace the current mining disclosure requirements in Industry Guide 7 and Item 102 of Regulation S-K, will provide investors with more comprehensive and detailed information regarding a registrant's material mining properties.

The new rules level the playing field between U.S. and foreign registrants, because U.S. registrants were not previously permitted to disclose mineral resources in their SEC filings. Other key changes include requiring that disclosure of exploration results, mineral resources and mineral reserves be based on information and supporting documentation prepared by a "qualified person" and requiring both summary disclosure of a registrant's mining operations as a whole and prescribed disclosure regarding each material mining property.

Complying with the New Rules

All registrants, including foreign private issuers, with material mining operations (which include mining royalty rights) must comply with the new rules for fiscal years beginning on or after January 1, 2021; however, voluntary compliance prior to that date will be permitted once the SEC updates its EDGAR filing system. Canadian issuers that report under the multijurisdictional disclosure system (MJDS) may still comply with NI 43-101 instead of the new rules when using the SEC's MJDS registration statement and annual report forms. Although non-MJDS Canadian issuers will be required to comply with the new rules, the SEC believes that such compliance should not have a material impact on non-MJDS Canadian issuers, given that the new rules are substantially similar to those under NI 43-101. However, it remains to be seen what reconciliations the SEC will require from a MJDS issuer using a registration statement on a non-MJDS form (such as a Form F-4, used in connection with a share exchange acquisition of a U.S. domestic or non-MJDS eligible foreign issuer).

Technical Report Summary Requirements

When registrants disclose mineral reserves or mineral resources[1] on a material property in a registration statement or an annual report for the first time or when there is a material change in the mineral reserves or mineral resources, the new rules require the registrant to file a technical report summary (which is similar to a NI 43-101 technical report) as an exhibit to the relevant SEC filing. The technical report summary must be prepared by a "qualified person,"[2] and must summarize the information reviewed and conclusions

Canadian issuers that report under the multijurisdictional disclosure system (MJDS) may still comply with NI 43-101 instead of the new rules when using the SEC's MJDS registration statement and annual report forms.

1 The definitions of mineral resources and mineral reserves (and their subcategories, proven and probable mineral reserves and measured, indicated and inferred mineral resources) used in the new rules are substantially similar to those used in NI 43-101, which are incorporated from the CIM Definition Standards on Mineral Resources and Mineral Reserves.

2 Under the new rules, a "qualified person" is a person who is a mineral industry professional with at least five years of relevant experience in the type of mineralization and type of deposit under consideration and in the specific type of activity that person is undertaking on behalf of the registrant. Unlike NI 43-101, the new rules do not set out a list of recognized professional organizations to which a qualified person must belong. Instead, the new rules provide the criteria that such organizations must satisfy.

> Unlike NI 43-101, the new rules do not specifically require a qualified person to prepare or supervise the preparation of the scientific and technical information that forms the basis of, or to otherwise approve, the registrant's disclosure in a news release.

reached by that person. The new rules do not prescribe any independence requirements for a qualified person; the SEC indicated that the requirement to disclose the qualified person's affiliated status with the registrant and the potential expert liability of the qualified person should provide adequate safeguards for investors.

Involvement of a Qualified Person in Disclosure

The written consent of each qualified person who prepared a technical report summary must be obtained to file the summary as an exhibit to the registrant's registration statement or annual report, and the written consent itself must be filed as an exhibit to the registration statement.[3] If the technical report summary is included in a registration statement and the qualified person is named as an expert with his or her consent, such qualified person is subject to potential liability under section 11 of the *Securities Act of 1933* for any material misstatements or omissions contained in the technical report summary. However, unlike NI 43-101, the new rules do not specifically require a qualified person to prepare or supervise the preparation of the scientific and technical information that forms the basis of, or to otherwise approve, the registrant's disclosure other than disclosure in a registration statement, an annual report or a technical report summary that is filed by the registrant.

Disclosure of Exploration Results

Under the new rules, disclosure of exploration results and exploration activity for a material property is voluntary and largely within the discretion of the registrant unless such activity and the accompanying results are material for investors, in which case disclosure is required. There is no obligation to file a technical report summary to support any material exploration results, but the disclosure must be based on the findings and conclusions of a qualified person. When disclosing material exploration results, a registrant must provide sufficient information to make the required disclosure not misleading and to allow for an accurate understanding of the significance of the exploration results.

Disclosure of Mineral Resources

The new rules require the disclosure of mineral resources to be based upon a qualified person's initial assessment, which is a preliminary technical and economic study of the economic potential of all or parts of mineralization necessary to determine if there are mineral resources in the deposit that have reasonable prospects for economic extraction. An initial assessment need not contain an economic analysis, but if a qualified person chooses to include an economic analysis, a cash flow analysis must be used.

3 If a third-party firm signs the technical report summary on behalf of the qualified person, the new rules provide that the third-party firm must provide the written consent. However, if the qualified person is an employee of the registrant, he or she must provide the written consent on an individual basis.

The definitions of mineral resources and mineral reserves (and their subcategories, proven and probable mineral reserves and measured, indicated and inferred mineral resources) used in the new rules are substantially similar to those used in NI 43-101.

A registrant must classify its mineral resources into inferred, indicated and measured mineral resources – in order of increasing confidence based on the level of underlying geological evidence – and disclose the classification criteria used.

- An inferred mineral resource is estimated on the basis of limited geological evidence and sampling (which is only sufficient to establish that geological and grade or quality continuity is more likely than not) and cannot be used as a basis to determine mineral reserves, which is consistent with NI 43-101.
- An indicated mineral resource is estimated on the basis of adequate geological evidence and sampling, which establishes geological and grade or quality continuity with reasonable certainty.
- A measured mineral resource is estimated on the basis of conclusive geological evidence and sampling, which is sufficient to test and confirm geological and grade or quality continuity.
- An indicated mineral resource may be converted only to a probable mineral reserve, whereas a measured mineral resource may be converted to a proven mineral reserve or a probable mineral reserve. To prevent confusion, all disclosure of mineral resources by the registrant must be exclusive of mineral reserves.

Disclosure of Mineral Reserves

The disclosure of mineral reserves by a registrant must not be based on an initial assessment, but rather on a qualified person's pre-feasibility study or feasibility study, which must include a financial analysis and evaluate applicable "modifying factors" to establish the economic viability of mineral reserves.[4] While the new rules provide some specific examples of "modifying factors,"[5] the number, type and specific characteristics of the modifying factors applied by a qualified person will depend upon the mineral, mine, property or project.

4 For a mineral reserve to be "economically viable," the qualified person must determine that extraction of the mineral reserve is economically viable under reasonable investment and market assumptions, including assumptions about the prices, exchange rates, interest and discount rates, sales volumes and costs that are necessary to determine the economic viability of the mineral reserves.

5 Examples of modifying factors include mining, processing, metallurgical, infrastructure, economic, marketing, legal, environmental compliance, plans, negotiations or agreements with local individuals or groups, and governmental factors.

A qualified person is required to classify mineral reserves into probable and proven mineral reserves, in order of increasing confidence in the results obtained from the application of the modifying factors to the indicated and measured mineral resources. The new rules explain:

- For a probable mineral reserve, the qualified person's confidence in the results obtained from the application of the modifying factors and in the estimates of tonnage and grade or quality is lower than what is sufficient for a classification as a proven mineral reserve, but is still sufficient to demonstrate that the extraction of the mineral reserve is economically viable.

- A probable mineral reserve can be converted from either an indicated or a measured mineral resource, whereas a proven mineral reserve can be converted only from a measured mineral resource.

Final Thoughts

The new rules are a significant improvement on the current disclosure regime and provide a regulatory framework for SEC registrants with material mining operations that is comparable to the framework for Canadian mining issuers. In drafting the new rules, the SEC was careful not to substantially deviate from the current requirements under NI 43-101 and the CRIRSCO standards. Accordingly, while the new rules may pose a minor compliance problem for Canadian issuers when not using MJDS forms (though it remains to be seen what reconciliations the SEC will require from a MJDS issuer using a registration statement on a non-MJDS form), the new rules were created to be sufficiently similar to current international mining standards so that transitioning to the new disclosure requirements should be relatively understandable and straightforward.

Contributors

Aaron J. Atkinson
Toronto

Jonathan Bilyk
Toronto

Chantelle Cseh
Toronto

Richard Fridman
Toronto

Russell Hall
Toronto

Bob Hu
New York

Brooke Jamison
Toronto

Brian Kujavsky
Montréal

Nicolas Morin
Montréal

Robert S. Murphy
Toronto

Jeffrey Nadler
New York

Daniel Pearlman
Toronto

Patricia L. Olasker
Toronto

Geoffrey L. Rawle
Toronto

Zain Rizvi
Toronto

Sébastien Roy
Montréal

Luis Sarabia
Toronto

Brett Seifred
Toronto

Jared Solinger
Toronto

Veronika Stefanski
Toronto

Robin Upshall
Toronto

David Wilson
Toronto

Key Contacts

If you are interested in receiving more information, please contact us or visit our website at **www.dwpv.com**. The information in this publication should not be relied upon as legal advice. We encourage you to contact us directly with any specific questions.

Robert S. Murphy
Toronto

rmurphy@dwpv.com
416.863.5537

David Wilson
Toronto

dwilson@dwpv.com
416.863.5517

Olivier Désilets
Montréal

odesilets@dwpv.com
514.841.6561

Jeffrey Nadler
New York

jnadler@dwpv.com
212.588.5505

DAVIES

TORONTO

155 Wellington Street West
Toronto ON Canada
M5V 3J7

416.863.0900

MONTRÉAL

1501 McGill College Avenue
Montréal QC Canada
H3A 3N9

514.841.6400

NEW YORK

900 Third Avenue
New York NY U.S.A. 10022

212.588.5500

DAVIES WARD PHILLIPS & VINEBERG LLP