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Making a Profit Is Not Illegal: Capital Markets Tribunal Dismisses Enforcement Proceedings Finding Borrowed Free Trading Shares Remain Unaffected By Pledge of Restricted Shares

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The Ontario Capital Markets Tribunal (Tribunal) recently dismissed enforcement proceedings brought against several respondents by the Ontario Securities Commission (Commission) in *Cormark Securities Inc (Re)*. The Commission alleged that settling a short sale with free-trading shares borrowed under a stock loan, collateralized by shares of the same company that were issued pursuant to a private placement and subject to a hold period, was a distribution of securities that triggered the requirement to file a prospectus. The Tribunal resoundingly rejected all of the Commission's allegations and dismissed the proceedings against all respondents in its entirety.

Key Takeaways

- In a rare victory for respondents to enforcement proceedings, the Tribunal found, on November 6, 2024, that the respondents did “nothing wrong” by participating in a series of transactions (the Transactions) whereby shares of Canopy Growth Corporation (Canopy) were purchased under a private placement (Restricted Shares) and posted by the buyer as collateral to borrow previously issued and publicly traded shares of Canopy (Free-Trading Shares) to settle a short sale.
- The Tribunal also recognized that settling shares of a company sold short with shares that were borrowed against collateral in the form of shares of that same company (even if recently issued under a private placement and subject to a hold period) is not an illegal distribution of securities, even if the hold period has not yet expired. It is also not a distribution of the Restricted Shares by virtue of the “extended definition” of a distribution.
- The Tribunal declined to find that its public interest jurisdiction was engaged in the circumstances, reasoning that hedging and managing risk are normal and accepted practices; the Transactions did not undermine hold periods or threaten the efficient operation of or public confidence in capital markets. Moreover, there is nothing wrong with registrants using their knowledge and skills and benefitting from their efforts, which is “expected of market participants and registrants.”
- A decision to the contrary could have resulted in significant consequences for hedging activity and could have generated uncertainty concerning the legality of common trading strategies, including short selling securities borrowed using collateral in the form of other securities of the same company.
- The Commission appears to have pursued this proceeding in an effort to engage in “legislation by enforcement.” Indeed, the Tribunal characterized the allegations as an “overreach,” and recognized that “[t]he unfortunate consequence is that the respondents have incurred significant costs due to this proceeding, both financial and reputational, which they cannot recover.”
- It will be interesting to see whether the Commission elects to enact any rules or guidance arising from this decision.

Background

Overview of the Transactions

On March 17, 2017, TSX-listed Canopy was added to the TSX Composite Index which was expected to generate increased demand for Canopy's common shares. Cormark Securities Inc. (Cormark) developed the following structure for a series of transactions to capitalize on this expected demand:

- Canopy issued 2.5 million of its common shares to Saline Investments Ltd. (Saline) by way of a private placement, with the Restricted Shares being subject to a four-month hold period.
- Saline borrowed 2.5 million previously issued, Free-Trading Shares from an insider of Canopy (Goldman Holdings) under a securities loan agreement.
- Saline pledged the Restricted Shares to Goldman Holdings as collateral for the loan of the Free-Trading Shares.
- Saline sold short 2.5 million common shares of Canopy on the TSX, using the Free-Trading Shares to settle the short sales.

The Commission's Allegations

The Commission alleged that:

- The Transactions resulted in an illegal distribution of Canopy shares.
- The respondents' conduct engaged the Tribunal's public interest jurisdiction.

The Tribunal rejected all of the allegations made by the Commission and entirely vindicated the respondents. The respondents included Cormark, Cormark's former Head of Equity Capital Markets (William Jeffrey Kennedy), Saline, and the principal of Saline (Marc Bistricher).

Key Findings

No distribution of canopy shares

The Commission alleged that the Transactions amounted to an indirect offering of securities to the public without a prospectus. The Commission argued that the private placement to Saline, the securities loan and pledge between Goldman Holdings and Saline, and Saline's short sales of Canopy shares were part of a series of transactions involving purchases or sales "during or incidental to a distribution," thereby caught by the so-called extended definition of "distribution" and triggering the prospectus requirement.

In its analysis, the Tribunal recognized that the definition of distribution plays a fundamental role in Ontario securities law. Its definition aims to capture the moment of initial distribution, when a security first becomes available to the public and triggers the disclosure obligations designed to protect investors. In the present case, the Transactions did not, however, convert the Restricted Shares issued under the private placement into the Free-Trading Shares borrowed under the securities loan agreement. The two categories of shares were not interchangeable, including because the Restricted Shares bore a resale restriction legend and had different CUSIP numbers. There was no "distribution" because the Free-Trading Shares were previously issued securities.

The Tribunal concluded that the test for determining whether a distribution under a prospectus is only one transaction in a series of transactions in the course of, or incidental to, the ultimate distribution set out in Companion Policy 41-101CP was not met because there was no resale of Restricted Shares in the secondary market. The Tribunal also agreed with the respondents that their subjective intent or understanding of the Transactions was irrelevant to its assessment of whether there was a distribution. The Tribunal also rejected the application of Companion Policies 45-106CP and 45-501CP, which provide guidance on an underwriter's ability to resell securities purchased in an underwriting to investors without a prospectus, because it concluded that Saline was not acting as an underwriter, the shares were not identical securities and the Transactions were not structured to avoid delivering a prospectus for the distribution of securities being made available to the public for the first time.

The Transactions did not engage the tribunal's public interest jurisdiction

The Commission alleged that the Tribunal's public interest jurisdiction was engaged because: (i) Cormark and Mr. Kennedy misled Canopy about various aspects of the Transactions; (ii) the respondents undermined investor protection; (iii) the Transactions were sized to avoid disclosure; (iv) the respondents threatened the efficiency of and confidence in public markets; and (v) the respondents failed to meet the standards of fitness and business conduct expected of market participants.

The Tribunal rejected each of these allegations.

First, the Tribunal concluded that the evidence did not support any of the allegations of misleading conduct on the part of Cormark and Mr. Kennedy. Neither lied about the short selling, concealed Saline's risk-reward ratio in respect of the Transactions or failed to disclose risks to Canopy. In respect of Saline's risk-reward ratio in particular, the Commission alleged that the Transactions were structured such that Saline was able to receive "virtually risk-free" profits. The Tribunal concluded that "[h]edging or managing risk is a normal and accepted part of participating in the capital markets" and that "[m]erely because a structure might reduce or eliminate risk does not make it contrary to the animating principles of the Act." The Tribunal further confirmed that "[i]t is not unreasonable for market participants to have an expectation of profit."

Second, the Commission failed to establish that the Transactions were structured to somehow enable Saline to improperly avoid the hold periods applicable to the Restricted Shares. The Transactions did not convert the Restricted Shares into Free-Trading Shares, and there was nothing to prevent Goldman Holdings from loaning those shares to Saline and Saline using them to settle its short sales. In addition, investor protection was not undermined by what the Commission alleged was an increase in the "public float" of Canopy shares, because no new Canopy shares entered public markets until the end of the hold period applicable to the Restricted Shares.

Third, the Tribunal concluded that the respondents did not breach the requirement for full, true and plain disclosure by failing to file a prospectus, or minimize the timely, accurate and efficient disclosure of information about the Transactions. As the Transactions were not a distribution, there was no requirement to file a prospectus. In addition, structuring the Transactions in a manner that aimed to comply with insider trading rules, as the respondents did, was not contrary to the animating principles underlying those rules.

Fourth, the Tribunal concluded that Saline's short sales did not threaten capital markets efficiency or confidence. The Tribunal recognized that "market participants can and do trade for reasons other than an issuer's merits and that all trading, regardless of the traders' reasons for being in the market, contribute to pricing a security."

Finally, the respondents did not fail to meet the standards of fitness and business conduct expected of market participants. This allegation was based on the incorrect premise that the Restricted Shares were converted or swapped for the Free-Trading Shares. In addition, the respondents' use of their knowledge and skills, and benefitting from their efforts, is "what is expected of market participants and registrants." The conduct of the respondents "was not improper, and we also conclude that there is no evidence that the investing public in this instance suffered from the Transactions."

Davies represented Saline Investments Ltd. in this proceeding.

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