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The Cannabis Frenzy

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While the Canadian capital markets were volatile in 2017, market activity in the Canadian cannabis sector has achieved unprecedented highs. The \$245-million investment by Constellation Brands, a NYSE-listed producer of beer, wine and spirits, in TSX-listed Canopy Growth in the fall of 2017 sparked interest across North America in the Canadian cannabis industry.

Since the Constellation Brands investment, capital markets activity in the cannabis space has soared. In the first quarter of 2018 alone, over \$1.4 billion of equity was raised by cannabis companies listed on Canadian stock exchanges.

Against this backdrop, we have summarized below some of the significant developments in the cannabis sector and expected trends for 2018.

Second Reading Passes

After much speculation and debate, the federal *Cannabis Act*, which will legalize access to recreational cannabis and regulate the growing, production and distribution of recreational cannabis in Canada, was passed by a 44-to-29 vote on March 22, 2018, at second reading in the Senate of Canada. This marks an important milestone for the Canadian cannabis industry, as many feared that the Act would get bogged down in the Senate.

Currently, the *Cannabis Act* is being reviewed by five Senate committees (Aboriginal Peoples; Legal and Constitutional Affairs; National Security and Defence; Foreign Affairs and International Trade; and Social Affairs, Science and Technology), with the aim of having it receive Royal Assent by July 2018.

The *Cannabis Act* assigns significant responsibility for the legal framework of recreational cannabis to the provinces and territories. As a result, the provinces and territories have requested a sufficient period of time between Royal Assent and enactment of the new law in order to allow for the orderly transfer of cannabis products from federally licensed producers to provincially or territorially authorized distributors and retailers. The Government of Canada has indicated that it will accommodate this request by providing for an 8-to-12-week transition period.

Health Canada Proposes *Cannabis Act* Regulations

To support the implementation of the *Cannabis Act*, regulations will need to be enacted. On November 21, 2017, Health Canada published a consultation paper and launched a 60-day public consultation to solicit input on the regulatory approach. Health Canada received 3,218 online and 450 written submissions on the consultation paper. Most of the comments centred on packaging and labelling, security and facilitating access to the industry by "micro-cultivators."

Health Canada does not intend to pre-publish draft regulations for public comment. The final regulations will be published as soon as possible following Royal Assent to the Act.

The "Sessions Effect"

In January 2018, U.S. Attorney General Jeff Sessions rescinded three memos, collectively referred to as the Cole Memorandum, that were adopted in August 2013 under the Obama administration. The Cole Memorandum signalled a shift of government priorities away from strict enforcement of federal laws regulating cannabis and toward a more lenient approach in states that had enacted laws legalizing

cannabis and implemented strong and effective regulatory and enforcement systems to control the cultivation, distribution, sale and possession thereof.

Within days of Sessions rescinding the Cole Memorandum, the Canadian Securities Administrators (CSA) issued a notice advising market participants that it was considering whether the existing disclosure-based approach for issuers with U.S. cannabis-related activities, set out in an October 2017 CSA notice, remained appropriate. In February 2018, the CSA provided further guidance on staff's disclosure expectations for issuers with U.S. cannabis-related activities. The February notice reiterated the original guidance provided in October 2017 but included additional disclosure requirements, including the requirement to quantify an issuer's balance sheet and operating statement exposure to U.S. marijuana-related activities and disclosure regarding whether an issuer has obtained legal advice regarding compliance with applicable U.S. state regulatory frameworks.

Opening of the U.S. Equity Markets

The Sessions Effect did not cool U.S. investors' appetites for cannabis stocks. On February 27, 2018, shares of Cronos Group began trading on Nasdaq, becoming the first Canadian cannabis company to be listed on a U.S. stock exchange. Shortly after listing on Nasdaq, Cronos announced a \$100-million cross-border bought deal offering, co-led by GMP Securities and BMO Capital Markets. This was the first cross-border offering by a cannabis company conducted pursuant to the multijurisdictional disclosure System adopted by the United States and Canada and only the second public offering led by a Canadian-bank-owned dealer.

Given the uncertain regulatory environment in the United States and the legal impediments facing U.S. cannabis companies, we expect many U.S. investors to continue to look to Canadian cannabis companies as advantageous investment opportunities. As a result, we anticipate more Canadian cannabis companies listing on U.S. stock exchanges in order to facilitate capital raising efforts in the United States.

BMO Enters the Fray

Financing of the Canadian cannabis industry has generally been dominated by the independently owned investment banks. This changed in 2018 when BMO Capital Markets co-led bought deal offerings for each of Canopy Growth and Cronos Group. The other Canadian, U.S. and global bank-owned dealers appear to be sitting on the sidelines – for now. We expect to see other Canadian-bank-owned dealers, even those with U.S. operations, jumping into the fray once recreational cannabis is legal.

Migration North?

Given the legal uncertainty in the United States, several cannabis companies with U.S. operations have listed on the Canadian Securities Exchange (CSE). Unlike the TSX or the TSX Venture Exchange, the CSE does not restrict issuers with U.S. cannabis-related activities from trading on the exchange. In March 2018, the shares of Cannex Capital Holdings Inc., a cannabis company based in Washington State that claims to be the biggest in that state, began trading on the CSE. Cannex is one of 63 CSE-listed cannabis companies, including over 14 companies with U.S. operations.

Big Pharma Wants In

The race is on to secure supply of cannabis products in advance of the enactment of the *Cannabis Act*. Many pharmacies, including Shoppers Drug Mart and Pharmasave, have applied to become licensed sellers of cannabis products and have entered into supply agreements in anticipation of the opening up of the recreational market. Even though most provincial distribution frameworks will be controlled by government-owned subsidiaries, provinces like Alberta and British Columbia have proposed a private retail framework, which could prove to be lucrative to pharmacies with operations in those provinces.

Another growing industry trend is the entry of Big Pharma. Since 2016, CannTrust Holdings Inc. has been partnering with Apotex Inc. to develop new products that will make it easier for patients to use medical cannabis. In March 2018, privately owned Tilray Inc. announced a strategic alliance with Sandoz Canada Inc., a generic drug maker, to develop and sell medical cannabis products carrying both logos.

We expect to see more partnering between national and international Big Pharma and the cannabis industry in 2018, as growing Canadian cannabis companies aim to gain access to the scale, credibility and experience that the pharmaceutical companies have to offer.

Not Out of the Woods Yet

There remains much skepticism regarding the cannabis sector. In an unhelpful turn of events, three Canadian cannabis companies recently came under attack for questionable conduct by insiders.

In February 2018, Maricann Group Inc., a CSE-listed company, announced in the middle of a public offering that the Ontario Securities Commission was conducting a review of the timing and reporting of trades in securities of the company by certain insiders and that a special committee had been appointed to review the matter. The underwriters backed out of the public offering.

In March 2018, the Ontario and Saskatchewan securities commissions, in reasons released in connection with the hostile takeover bid made by Aurora Cannabis Inc. for CanniMed Therapeutics Inc., criticized certain directors of CanniMed for sharing material non-public information with the hostile bidder. The behaviour did result in private litigation, although this was dropped when Aurora and CanniMed came to terms on a friendly deal.

Also in March 2018, a U.S.-based hedge fund raised concerns about Aphria Inc.'s proposed purchase of Nuuvvera Inc. at that time. It was subsequently reported in the media that neither company had disclosed to shareholders voting on the proposed transaction that certain insiders of Aphria held shares in the target company. The disclosure would have been required if the transaction had proceeded by way of a takeover bid, but it was not a mandatory line item in the proxy circular form used for the acquisition. The omission left many questioning whether the disclosure should have been made nonetheless.

Buzzkill?

In March 2018, a German court stopped the government's tender process for 10 cultivation licences tied to long-term contracts for the supply of 6,600 kilograms of medical marijuana, on the basis that the timeline to respond was too short. A number of Canadian companies were shortlisted for the licences, including Aphria, MedReleaf Corp. and Canopy Growth. Although producers can continue to export medical cannabis to the German market in the meantime, the expected impact of the delay on the selection of the successful bidders resulted in reduced price targets for a number of Canadian cannabis companies.

The Canadian cannabis market was dealt another blow by the *Barron's* cover story on March 30, 2018. *Barron's* issued a strong warning that Canadian pot stocks were overpriced, noting that "today's investors are effectively paying 15 times the industry's cash flow five years from now." The article also raised price-forecast concerns, speculating that the rapid build-out of capacity by the 94 licensed producers in Canada created the potential for a supply glut that will drive down prices and, moreover, that recreational users will not be prepared to pay higher prices for premium brands. This news, coupled with the recent German court decision, leaves us to wonder if the cannabis frenzy will subside in 2018, to be replaced with more measured expectations.

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