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

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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 notice¹ 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 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.

¹TSX staff notice 2017-0009

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