

Strategies for Issuers with Cannabis-Related Activities in the U.S.

September 13, 2017

On August 17, 2017, the TMX Group issued a [statement](#) announcing that it has engaged with the Canadian Securities Administrators regarding the clearing of securities of issuers with cannabis-related activities (including assets and operations) in the U.S. Although the TMX Group's general position on companies engaging in such activities has been a source of speculation and uncertainty for some time, the announcement highlighted specific uncertainty about whether the TMX Group, which is the parent company of The Canadian Depository for Securities Limited ("CDS"), might make the securities of issuers with cannabis-related activities in the U.S. ineligible for clearing and settlement through CDSX. Although no such action has been taken or articulated, such action could materially impede the ability to trade in the securities of issuers with cannabis-related activities in the U.S. and thus have a chilling effect on the listing and financing of such issuers.

What is the general position of the TMX Group and other market participants?

The TMX Group has for some time signaled concerns about listing cannabis companies with U.S. exposure on the Toronto Stock Exchange (the "TSX") and the TSX Venture Exchange (the "TSXV"), given the regulatory and legal landscape for cannabis in the United States. As described in more detail in our previous [post](#), while medical and adult-use cannabis have been legalized in a number of U.S. states, cannabis remains illegal federally in the United States. Although the federal government under President Obama adopted a non-interventionist approach to local cannabis-related law enforcement, under the Trump Administration the federal government's position has become increasingly unclear¹ raising concerns that engaging in U.S.-related cannabis activities (including aiding or abetting such activities) could lead to broad civil and/or criminal exposure.

The TSX and TSXV retain significant discretion when it comes to approving and maintaining listings, and compliance with laws in the jurisdiction in which a company operates is a factor in the exercise of that discretion. While some issuers have expressed frustration at the seemingly inconsistent application of that discretion to date (see for example, [this](#) Globe and Mail report on this topic), in general the TSX and TSXV appear not to be listing securities of issuers with U.S. cannabis assets as they consider such businesses to be operating illegally.

On the other hand, the Canadian Securities Exchange (the "CSE") has taken a more supportive approach to listing issuers with cannabis-related activities in the U.S. Instead, the CSE has invited cannabis companies with U.S. assets or operations to list on its exchange subject to companies satisfying the

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exchange's disclosure and other requirements, including complete risk disclosure². The result has been that a large number of issuers on the CSE are cannabis companies.

Apart from the issue of what exchange an issuer might be permitted to list on (or remain listed on), a policy change that affects eligibility for CDS could prohibit the clearing, settlement and, consequently, the trading of securities of issuers with U.S. cannabis-related assets and operations more generally, regardless of the exchange.

What is CDS and how would a policy change be implemented?

Through CDS Clearing and Depository Services Inc., CDS owns and operates CDSX, a clearing and settlement facility through which trades in eligible exchange traded and over-the-counter debt, equity and money-market transactions are processed. CDS is in turn owned by the TMX Group. Responsible for processing approximately 1.6 million exchange trades daily³, CDS has become an integral part of Canada's capital markets and is responsible for clearing and settling trades on the TSX, the TSXV and the CSE.

If CDS decides to make a change to the eligibility of securities of issuers with cannabis-related activities in the U.S., this change could be implemented by CDS in a number of ways: (1) through the exercise of the discretion of the CDS Board of Directors; (2) through housekeeping amendments ("Housekeeping Amendments") to the CDS Participant Rules (the "Rules"); or (3) through material amendments ("Material Amendments") to the Rules.

First, under the Rules, which govern the operation of CDS' clearing and settlement services, securities must be "eligible" to be settled through CDS. While Rules 1.6.2 and 11.3.1 of the Rules provide guidance on what constitutes an eligible security, the Rules appear to confer significant discretion on the Board of Directors of CDS to determine what securities are "eligible". As a result, it is possible that a prohibition by CDS of the clearing and settlement of trades for issuers with cannabis related activities in the U.S. could be effected through the board's discretion alone, subject to possible intervention by relevant securities commissions.

Second, CDS could effect this change by making Housekeeping Amendments to the Rules. Housekeeping Amendments describe amendments required to ensure consistency or compliance with existing rules or other regulatory requirements, which could include, as in this case, compliance with U.S. federal law. While implementation of such Housekeeping Amendments has a relatively low bar, such amendments are still subject to public comment and the Ontario Securities Commission (the "OSC") can disagree that an amendment is merely a Housekeeping Amendment and require CDS to instead treat an amendment like a Material Amendment.

Third, CDS could effect this change by implementing a Material Amendment. A Material Amendment is any amendment that would have a material effect on a CDS participant. Prior notice to the OSC, as well as a

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formalized review process, would be required if CDS anticipates the amendments would result in a significant change in its policy, would affect a significant number of Rules or may be the subject of significant public comment as a result of publication.

What strategies can issuers adopt in this uncertain environment?

Both current and prospective issuers can expect to be impacted by a change in eligibility for issuers with cannabis-activities in the U.S. While a change does not appear to be imminent, companies should take steps to proactively develop a meaningful strategy that optimizes its business goals and objectives while ensuring regulatory compliance. A number of options and strategies are presented below:

Prospective Issuers

If you are a company with cannabis-related activities in the U.S. that is considering going public, the TSX and TSXV are not, at the moment, appropriate exchanges on which to list. Listing on the TSX or TSXV may be contingent on ceasing U.S. cannabis-related activities or providing an undertaking not to engage in business activities in the United States.

Nevertheless, for the time being, the CSE remains an option for current or prospective issuers with cannabis-related activities in the U.S. That said, issuers must take care to ensure to provide full, complete, and continuous disclosure that includes all risks, including information about the legal framework for cannabis in the U.S.

Current Issuers

Current issuers on the TSX or TSXV with cannabis-related activities in the U.S. may be asked or be required to comply with requests to divest U.S. assets or cease operations in order to remain listed. While different issues may arise on a case to case basis, issuers in this position must develop appropriate strategies to anticipate and adapt to such requests. Current issuers on the CSE can expect the status quo for the time being, and should continue providing full, complete and continuous disclosure about their companies.

All Market Participants

A policy change adopted by CDS that prohibits the clearing and settlement of securities of issuers with cannabis-related activities in the U.S. could have significant implications for the capital markets. Although the TMX Group is consulting with the Canadian Securities Administrators, it is uncertain what the result of such consultations will be. While we recommend a wait-and-see approach, there may be options available for issuers to ensure clearing and settlement of their securities in the event that such a prohibition is implemented:

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- 1. Direct Registration System.** The Direct Registration System ("**DRS**") allows registered securities to be held in electronic form without having a physical security certificate issued as evidence of ownership. Securityholders, through their financial intermediary, can securely sell and transfer electronically held securities using the information from the DRS. This service is offered by Computershare Investor Services Inc. and TSX Trust Company in Canada.
- 2. Dealer-Centric Settlement.** Market participants can explore an approach in which a sponsoring dealer could hold shares, as nominee, on the books of the transfer agent. Trades would be effected within the dealer's position, between dealers with accounts, similar to current "upstairs market" trades. While there are complexities associated with implementing this approach, it is an option that issuers may consider in the event that CDS prohibits the clearing and settlement of securities of issuers with cannabis-related activities in the U.S.
- 3. Blockchain-Enabled Settlement.** Market participants could consider moving securities to a permissioned blockchain system. Since blockchain is an immutable database, there is no need to use stock certificates and clearing agencies when transferring a security. Such an approach would use a combination of digital currency, wallets and smart contracts to secure share transfer for both parties. As an example, the NASDAQ has a platform that uses blockchain ledger technology, [Linq](#), designed to cater to private securities transactions. A current platform for this type of trading and settlement does not exist, in Canada, but developments in the world of blockchain may soon fill this void. This approach, when available, may be easier for current closely held, private companies that are looking to go public.
- 4. Provide Feedback.** As discussed above, with a proposed change in CDS Rules, whether a Housekeeping Amendment or a Material Amendment, the public would be provided with an opportunity to provide feedback and voice concerns or objections about such policy change. Market participants should anticipate providing feedback that addresses specific concerns about how such a change would affect the public markets.

For additional guidance and specific advice, please a member of our cross-disciplinary [Cannabis](#) or [Securities](#) Groups.

¹https://www.washingtonpost.com/news/wonk/wp/2017/08/04/is-jeff-sessions-planning-to-crack-down-on-legal-pot-this-letter-suggests-he-might-be/?utm_term=.4dca9db51759

²<http://thecse.com/en/about/publications/cse-news/cse-confirms-position-on-us-cannabis-listings>

³<https://www.cds.ca/>