

CANADIAN SECURITIES LITIGATION OUTLOOK

Trends to Watch
for Capital
Markets
Participants

2018 UPDATE

Cassels





TRENDS TO WATCH for Capital Markets Participants

The Cassels Securities Litigation Team is pleased to present our third annual *Canadian Securities Litigation Outlook*, in which we set out our analyses of key securities litigation developments over the past year, and our thoughts on the topics and issues that we expect to see trending in the year to come.

Our feature piece this year focuses on capital market activity, regulatory scrutiny, and expectations in the budding cannabis industry. It also addresses what we expect to see, from a regulatory and litigation perspective, as the industry continues to grow. We assess the considerable uncertainty that continues to exist for market participants following legalization, including as it relates to risk disclosure shortcomings and other challenges that come with paving the way through uncharted territory.

We also examine the recent and rapid evolution of FinTech, along with the enforcement initiatives that have resulted, the uptick in shareholder activism and the shifting corporate governance landscape, current developments in the area of securities class actions, and the continued importance of robust insider trading compliance protections in the face of successful prosecutions and settlements that are often largely based on circumstantial evidence.

We will continue to monitor and report on these and other developments and trends as they unfold.

Please feel free to contact any member of the Cassels Securities Litigation Team to discuss these developments and trends, and their impacts on market participants.

Contents



Trend 1

Hazy Risks and Investor
Highs in Emerging
Cannabis Market

Page 1



Trend 2

Blockchain Blitz: Tackling
the Regulation of
Cryptocurrency

Page 4



Trend 3

New Rules,
New Initiatives, New
Perspectives: Shareholder
Activism in an Ever-
Changing Environment

Page 7



Trend 4

Two Steps Forward, One
Step Back: Continued
Successful Insider Trading
Prosecutions, with a
Notable Exception

Page 11



Trend 5

Class is in Session: Key
Updates to the Securities
Class Actions Landscape
in 2018

Page 15



Cassels

Securities Litigation:
Who We Are and
What We Do

Page 19



1 HAZY RISKS AND INVESTOR HIGHS IN EMERGING CANNABIS MARKET

As of October 17, 2018, Canada became the second country in the world — and the first in the G7 — to legalize cannabis. With the *Cannabis Act* in full force and effect, it is now legal to produce, distribute, sell, possess and consume recreational cannabis nationwide.

The lead-up to legalization incited a flurry of market activity as cannabis-related companies raced to access the Canadian capital markets — and there is no anticipation of a burn out, at least in the short term.

Market excitement has created high expectations: in 2018, cannabis was one of the most active capital market sectors in Ontario and the OSC expects continued growth in the industry.¹ It is also expected that the Canadian legal recreational cannabis market will generate up to

\$4.34 billion in sales within the first year of legalization² and \$6.8 billion by 2020.³

As Canada continues to pave the way through uncharted territory, there remains a haze surrounding what investors can expect to see from this emerging industry. In the year to come, we anticipate:

- Increased market scrutiny from regulators, including increased protective and enforcement measures by the OSC and other Canadian securities regulators;
- Continued capital market activity, including increased merger and acquisition activity, along with increased potential for public financing and debt-financing deals; and
- Increased litigation as a result of regulatory scrutiny and market activity.

Uncertainty and Risks of Investing in the Cannabis Industry

The Canadian Securities Administrators (“CSA”) and provincial regulators have taken note of the rapid growth of capital market activity in the cannabis industry. Since 2015, the CSA has conducted reviews of reporting issuers in the cannabis industry and released a number of statements and notices with respect to investor risk, with the latest having been released just days before legalization.⁴

While explicitly recognizing that accounting and disclosure requirements and best practices are evolving, the CSA has highlighted various specific disclosure deficiencies and provided guidance on disclosure practices as follows:

- The CSA identified that 74% of issuers with cannabis operations in the US have failed to sufficiently disclose risks related to their US cannabis-related activity.⁵ Since US federal law prohibits both the use and sale of recreational cannabis, companies connected to US cannabis-related activity remain vulnerable to prosecution. This includes not only those companies with direct and indirect involvement in the cultivation and distribution of cannabis, but also issuers that provide goods and services to third parties involved in the US cannabis industry;
- As issuers in the cannabis industry may also operate in several different jurisdictions, they should provide disclosure regarding the regulatory uncertainty and differences in legal and regulatory frameworks across those jurisdictions, as well as other considerations unique to specific jurisdictions;
- Unique disclosure related issues arise in financial disclosure — interim and annual financial statements and management’s discussion analysis — including in respect of accounting policies relating to the fair

value of biological assets, which can involve significant judgment. The CSA noted that fair value and fair value related disclosure required improvement for 100% of the reviewed issuers; and

- Forward-looking information, such as anticipated production capacity or potential entrance into or expansion in the cannabis industry, should include disclosure of associated material facts, assumptions and risks.

We anticipate that securities regulators will be paying close attention to publicly listed cannabis companies in the months to come, with a particular focus on the disclosure deficiencies already identified by the CSA. As regulators, companies, investors, and other market participants continue to navigate this emerging industry without a clear roadmap, it will be essential for companies to follow robust disclosure practices that result in transparent information about financial performance, risks and uncertainties.



We anticipate that securities regulators will be paying close attention to publicly listed cannabis companies in the months to come, with a particular focus on the disclosure deficiencies identified by the CSA.

Canadian Capital Market Activity

Canadian capital market activity in the cannabis space is expected to continue on its trajectory of growth. With legalization only a few weeks behind us, and edible sales and retail store fronts still on the horizon, new and innovative players continue to flood the market. This continued growth will inevitably lead to increased merger

and acquisition trend activity as larger industry leaders continue to expand their network nationwide through the acquisition of smaller businesses.

This past year saw a number of the largest acquisitions to date, including Canopy Growth Corporation’s \$540 million acquisition of Hiku Brands Company Ltd. in

September 2018,⁶ and its \$375 million acquisition of the remaining 33% stake of BC Tweed Joint Ventures Inc. in July 2018.⁷ Aurora Cannabis Inc.'s acquisition of MedReleaf Corp. in July 2018 marked the largest cannabis merger in Canada to date, valued at more than \$2.5 billion. We believe that such consolidation M&A activity will continue to be significant.

We also anticipate that cannabis companies will increasingly turn to debt financing as a means of raising capital. In the early stages, most Canadian cannabis companies have raised financing through a combination of issuing equity and convertible securities. While this allowed companies to raise early-stage capital, it also led to shareholder dilution.

Until recently, debt financing activity to date has been virtually non-existent. Canada's major banks have been cautious about participating in the industry given the illegality of cannabis (until recently) and concerns in assessing and securing meaningful collateral.

Canopy Growth Corporation's completion of a \$600 million convertible note offering in June 2018 was the first example of a more traditional debt deal in the cannabis industry.⁸ The offering was also the largest financing in Canadian cannabis history to date and the largest convertible note offering in Canadian history. With the onset of legalization, we anticipate that debt deals will become more common in the near future, as evidenced by Tilray, Inc.'s recent convertible note offering along similar commercial terms.

Increased Litigation as a Result of Regulatory Scrutiny and Market Activity

With the rapid growth of the cannabis industry and continued capital market activity, we can expect to see an increase in litigation, both of a commercial nature and in the regulatory regime. We also expect to see increased litigation in the employment context relating to cannabis in the workplace.

As market and regulatory players navigate new and untested terrain, we anticipate a reciprocal relationship between regulators and industry participants, with regulators shaping their approach to reflect market concerns and conditions, and industry participants adapting to new regulations and the ever-changing legal landscape. Regulatory enforcement activity including in respect of disclosure violations and insider trading can be expected, but the scope and focus of such activity remains to be determined. Financial restatements and corrective disclosures of any nature will inevitably trigger class action activity.

The increasing consolidation M&A activity described above will also give rise to further transactional litigation and related regulatory proceedings, as demonstrated by the Aurora Cannabis Inc./CanniMed Therapeutics Inc. hostile bid proceedings decided in late 2017. Maturing cannabis issuers will continue to focus their efforts on improving corporate governance policies to enable their boards of directors to carefully consider and respond to such opportunities, both as targets and acquirers, in the best interests of shareholders.

Being only a few weeks into legalization, we are sure to see the onset of novel and dynamic industry-specific litigation unfold in the months, and years, to come.



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2 BLOCKCHAIN BLITZ: Tackling the Regulation of Cryptocurrency

Financial technology (FinTech) is fundamentally altering how money changes hands and is evolving faster than the law. At the centre of this evolution is cryptocurrency. The rapid and recent advent of cryptocurrency has left regulators around the world playing catch up, with the current rules being ineffectively imported from regulatory models fit for traditional securities, banking and financial services.

Given the evolving and uncertain cryptocurrency landscape, Canadian regulators initially took a cautious and collaborative approach and declined to engage in heavy-handed enforcement efforts throughout 2017 and early 2018, instead prioritizing information gathering and stakeholder engagement. In particular:

- In August 2017, the Canadian Securities Administrators (“CSA”) published its first formal position on the status of cryptocurrency offerings (“ICOs”), investment funds and exchanges: *Staff Notice 46-307 — Cryptocurrency Offerings*. This notice is emblematic of the cautious approach initially taken in respect of this dynamic industry, and confirms that the CSA would “look to substance rather than form” in determining whether a cryptocurrency satisfies the established criteria governing the classifications of securities and is, thus, subject to Canadian securities laws. Missing from the notice, however, were the specific considerations that determine what makes

cryptocurrencies qualifiable as a security, save for that each coin is “unique” and is to be assessed on a case-by-case basis. In June 2018, the CSA published a follow-up notice; ([Staff Notice 46-308 *Securities Law Implications for Offering of Tokens*](#)), specifically responding to questions surrounding “utility tokens.” The regulator noted that most of the offerings of tokens that are purported to be utility tokens that it reviewed did, in fact, involve an investment contract, and the fact that a token has a utility is not, on its own, determinative as to whether an offering will be deemed to involve a distribution of a security;

- The CSA championed the “regulatory sandbox” initiative, which was launched in February 2017 and is designed to support FinTech businesses seeking to provide innovative products, services and applications by offering a faster and more flexible process to register and/or obtain exemptive relief from securities laws requirements;

- In August 2017, the Autorité des Marchés Financiers granted relief to an initial token offering, its first decision of this kind. The Ontario Securities Commission (“OSC”) followed suit in October of that same year. A small number of firms to date have been granted exemptive relief by Canadian securities regulators, but such decisions have limited utility for issuers given their case-specific nature and lack of transparency regarding such decisions; and
- In January 2018, the British Columbia Securities Commission (“BCSC”) issued a formal request for comment on potential regulatory action following focused consultations with stakeholders, wherein it emphasized its intention to embrace a flexible approach to cryptocurrencies, so long as investor protection concerns are adequately addressed.

Enforcement Efforts Are Stepping Up

More recently, however, as the cryptocurrency landscape has matured, Canadian regulators have begun stepping up enforcement efforts in a manner reminiscent of the United States Securities and Exchange Commission (“SEC”). Notably, the OSC and BCSC are both participating in “Operation Cryptosweep,” a coordinated series of enforcement actions by state and provincial regulators in Canada and the United States to crack down on fraudulent cryptocurrency investment products. As of September 2018, “Operation Cryptosweep” has resulted in more than 200 active investigations currently underway as well as 46 enforcement actions, including numerous warnings issued by the OSC and BCSC against cryptocurrency firms failing to comply with the relevant marketing, registration or disclosure requirements. Moving forward, it is likely that regulators such as the OSC and BCSC will exhibit a marked increase in the frequency with which they issue notices of hearing regarding allegations such as illegal distribution and fraudulent or misleading disclosure.

In addition to signalling a more aggressive and interventionist approach to regulating the industry, “Operation Cryptosweep” represents an example of the increase in cross-border collaboration amongst regulatory bodies. Given the inter-jurisdictional nature of many blockchain transactions as well as the ability to market and distribute cryptocurrencies internationally,

developing a framework for the unified regulation of cryptocurrency is of paramount importance to the long-term viability of the industry.

The Financial Stability Board (“FSB”), an agency which promotes international financial stability by coordinating national financial authorities and standard-setting bodies to develop regulatory financial sector policies, has presented a report to the G20 Finance Ministers and Central Bank Governors on its work monitoring cryptoasset markets and its efforts to develop a framework the agency will use to oversee cryptoasset markets. The FSB has concluded that cryptoassets do not present a material risk to global financial stability at their current stage, though it sees the necessity for in-depth monitoring due to the rapid development of the market. Additionally, the International Organization of Securities Commissions has established an ICO Consultation Network to aggregate and analyze data on issues experienced in connection with the International ICO market with the ultimate aim of developing a manageable and coherent uniform policy to regulation.



The rapid and recent advent of cryptocurrency has left regulators around the world playing catch up

Regulators Around the World React

While such efforts represent a step in the right direction, it is unlikely that an effective regulatory regime for such a complex and diverse technology will be agreed upon or implemented any time soon. In the meantime, international regulatory responses have ranged across a broad spectrum. In particular:

- The SEC has begun to elaborate on the classification of various types of cryptocurrencies as securities, including that cryptocurrencies that are investment contracts are likely to be classified as securities, while cryptocurrencies that attempt to serve as “replacements for sovereign currencies” or are more decentralized in nature are less likely to be considered securities;
- Regulators in the UK and Australia, similarly to Canada, have both provided that whether an ICO is subject to regulation will be decided on a case-by-case basis and is dependent on the structure and operation of the ICO, as well as the rights attached to the coin or token;
- Mexico recently passed new legislation allowing the Bank of Mexico to decide which FinTech institutions can utilize cryptocurrencies and which tokens can be listed on exchanges; and
- China and South Korea have banned ICOs altogether (though indications are that this may be merely a temporary measure).

Given the uncertain landscape, those looking to participate in ICOs, investment funds or cryptocurrency exchanges would be well-advised to keenly monitor the developing regulatory response and, in certain instances, proactively engage with the governing regulatory body in order to mitigate the risk of running afoul of securities laws.

On November 1, 2018, the OSC launched two cryptoasset educational initiatives as part of its activities for Financial Literacy Month. The first, GetSmarterAboutCrypto.ca, is geared towards investors and provides an overview of cryptoassets, the OSC’s regulation of these assets, and guidance for considerations for these types of investments. The second, TBACoin.ca, was created as an example of what a typical fraudulent ICO website might look like, in order to empower investors and enable them to more easily identify “red flags” for these types of offerings.

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Cryptocurrency in the Courts

Similar to the global securities regulators, Canadian courts are also finding cryptocurrency problematic. For example, in *Andersson v Kamran*,¹ Ontario Superior Court Justice Jonathon George ordered the plaintiff to post security for costs in the amount of \$50,000 (cash) because there was “too much uncertainty”² around the value of his company’s assets. Specifically, Justice George was concerned about the valuation of the company’s assets denominated in Bitcoin. Andersson argued that he did have sufficient assets in Ontario, and that these assets included LEO Canada Inc.’s bitcoin assets. Andersson argued that the bitcoin wallet had a current value of

several million dollars³ while Kamran argued that the bitcoin wallet showed a negligible amount.⁴ Ultimately, due to the fact that Justice George could not accurately value LEO Canada Inc.’s bitcoin wallet,⁵ he ordered Andersson to post security for costs in an amount that he thought reasonably reflected the amount of legal work that would be required.⁶

It is probable that cryptocurrency will continue to present challenges to the courts and securities regulation, and we can anticipate increased jurisdiction issues, considering the cross-border nature of FinTech.



3 NEW RULES, NEW INITIATIVES, NEW PERSPECTIVES: Shareholder Activism in an Ever-Changing Environment

Along with an overall uptick in proxy contests, this year has seen a number of shifts in the shareholder activism and corporate governance landscape. From the pending abolition of the plurality shareholder voting system for federally incorporated companies, to amplified scrutiny of “vote-buying,” to an increased focus on diversity, this has been a notable year.

Activism on the Rise Again

Although the total number of proxy contests remains down from 2015, which saw a peak in activity, we expect that the total number of battles this year — currently 29 — will exceed the 2017 total of 32. This increase in activity has been accompanied by an increased rate of success for issuers as compared to 2017. Whereas activists were

successful in almost two-thirds of proxy contests in 2017, they have only been successful in about half so far this year.¹

Shareholder activism has also been influenced by the increased focus of securities regulators, courts, and other market participants on corporate governance and shareholder rights issues. Litigation before the courts

and securities commissions is increasingly viewed as a powerful strategic tool by activists. Following last year's high profile decision in *Eco Oro*,² activists have continued to advance their objectives by seeking regulatory or judicial scrutiny of corporate conduct, including significant financing transactions.³

As in the past, this year the majority of proxy contests have been in the materials and energy sectors. Next year, however, may mark the beginning of a shift in focus for activists. With the rise of the cannabis industry, activists may seek to seize opportunities presented by share price volatility and consolidation in that sector.

Majority Voting and “Vote No” Campaigns

One important shift in the corporate governance landscape which will influence both issuers and activists is the implementation of majority voting under the *Canada Business Corporations Act* (“CBCA”).⁴ Amendments to the CBCA this year, which have not yet come into force, mark the end of the plurality voting system for federally incorporated companies. Historically, shareholders of CBCA companies have had two options when electing directors: “for” and “withhold.” This system, which is a global outlier, essentially ignores “withhold” votes because a director may be elected with a single vote “for,” regardless of the number of votes withheld — even if that single vote is cast by the director his or herself. The recent amendments will require CBCA companies to present the voting options for each director instead as either “for” or “against” in uncontested elections.⁵ Under this system, a director may only be elected when the majority of votes cast are “for” his or her election to the board. This system will give actual weight to all shareholder votes and is a positive step toward better shareholder democracy.

Will the provinces follow suit? Earlier this year in Ontario, a private member's bill proposed similar amendments for uncontested elections in respect of Ontario incorporated companies. However, this bill died on the order paper when the Legislature was prorogued in March 2018 and has not since been reintroduced.

Although the TSX Company Manual generally requires majority voting, there are thousands of companies listed for trading on the TSX Venture Exchange and the Canadian Securities Exchange to which those rules do not apply. Shareholders of federally incorporated companies on these exchanges have been excluded from the benefits of majority voting.

Ultimately, whether we see more proxy contests and the litigation surrounding them in 2019 will depend on how effective activists and management are able to communicate and collaborate. Shareholder activism certainly isn't going away — the question is whether it will manifest as fierce and public proxy fights or backroom discussions and compromise.

One thing, however, is clear: as new rules, new initiatives, and new perspectives continue to change the activism environment in Canada, issuers and activists alike will be required to consider new and creative approaches to accomplish their objectives.



Earlier this year in Ontario, a private member's bill proposed similar amendments for uncontested elections in respect of Ontario incorporated companies.

Moreover, while the TSX Company Manual requires a director receiving less than a majority of the vote to resign, it allows the board to consider that resignation for up to 90 days and, in exceptional circumstances, decline to accept that resignation. The amendments to the CBCA, on the other hand, while allowing an incumbent director to remain on the board for 90 days while a replacement is found, only allow the board to re-appoint the resigning director to satisfy certain limited statutory requirements.

Unlike a “withhold” campaign, a “vote no” campaign can lead to tangible change — the removal of directors — without the need for a proxy contest. Such campaigns (and the threat of such campaigns) may therefore become a tool used by activists to effect change without the risk to reputation and the dedication of resources that are part and parcel of a full-blown proxy fight.

Withhold campaigns remain an effective option in circumstances in which they are available. An investor may prefer to signal discontent or apply pressure rather than replace certain directors or the entire board, or incur the cost required to do so. This is particularly so when it is an investor's intention to emphasize concern with a specific issue. For example, a withhold campaign may be used to target the chair or members of the compensation committee to signal dissatisfaction with executive compensation.

“Vote-Buying” Under Scrutiny

Another shift in the landscape which appears to be on the horizon relates to restrictions on, and likely the elimination of, vote buying in the proxy battle context. With the Canadian Securities Administrators (“CSA”) putting soliciting dealer arrangements under the microscope this year,⁷ the scope and availability of such arrangements in the future is far from certain.

A soliciting dealer arrangement is an arrangement whereby a company pays investment dealers for securing favourable votes from retail shareholders in the context of a proxy contest (or a corporate transaction which requires shareholder approval). Typically, fees are paid to the investment dealer for each favourable security successfully solicited, but only if the company is ultimately successful in the proxy contest.

The CSA’s request for comment follows the high-profile fight between PointNorth Capital Inc. (“PointNorth”) and Liquor Stores N.A. Ltd. (“Liquor Stores”). In that case, Liquor Stores offered to pay brokers \$0.05 for each share validly voted for a member of its slate if each member of the slate were elected. According to Liquor Stores, the purpose of this arrangement was to make contact with shareholders, since nearly half of its shares were held by retail objecting beneficial owners who could only be contacted by their brokers. PointNorth sought to have the Alberta Securities Commission (“ASC”) set aside the

arrangement on public interest grounds, but the ASC refused to do so on the basis that Liquor Stores’s conduct was not “clearly abusive.”⁸

Although the use of a soliciting dealer arrangement was not successful in quelling the activist shareholder in this case — PointNorth ultimately took control of the board — they have been used successfully by incumbents in the past,⁹

and have been criticized as vote buying by institutional investors and proxy advisory firms alike for a number of years.

We believe that the CSA’s request for comment with respect to soliciting dealer arrangements represents a prelude to regulatory restrictions (or an outright ban) in the context of proxy contests, although not necessarily in the context of corporate transactions due to intrinsic differences in the circumstances that give rise to soliciting dealer arrangements in each case.

In the case of a corporate transaction, the recommendation to vote in favour originates from independent directors who are free of conflict.

As such, the recommendation can be presumed to be objective and in the interests of the company. This can be contrasted with the case of a proxy contest, where the recommendation to vote in favour originates from conflicted directors who are motivated to preserve their positions. As such, the recommendation can be presumed to be subjective and in the interests of the directors making it.

The conflict that exists when soliciting dealer arrangements are used in proxy battles, along with the need to avoid any erosion of the trust-based dealer-client relationship, will likely be enough to motivate the CSA to take action. It is too soon to say what that action may specifically entail, but anything short of an outright ban will leave room for creativity on the part of both issuers and activists anticipating a fight.

Canada has become the third largest market in the world for activist “short campaigns.”⁶ Public attacks designed to generate negative public sentiment towards the company and its directors and officers are often direct and occur through multiple media, including online blogs, news outlets, social media, or open letters directed to the company or regulators which allege malfeasance or governance deficiencies. Given the damage that can result from a short campaign, issuers would be well advised to develop a plan to respond to such attacks before they occur.

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Soliciting dealer arrangements have been criticized as vote buying by institutional investors and proxy advisory firms alike.

Focus on Diversity

This year, diversity in Canadian boardrooms has been the focus of a number of initiatives aimed at improving corporate governance. As this trend continues, issuers and activists alike will need to remain mindful of, and in some cases bring themselves into compliance with, these initiatives, or risk a backlash at the corporate ballot box.

Draft regulations proposed earlier this year under the newly-amended CBCA aim to establish a “comply or explain” system for reporting on diversity for federally incorporated companies. These draft regulations go further than securities laws by requiring diversity disclosure in respect of groups other than women, such as visible minorities and individuals with disabilities. Once promulgated, these regulations will require both issuers and activists to consider very carefully who they nominate to sit on the boards of federally incorporated companies.

This focus on diversity disclosure is also shared by securities regulators.

The OSC’s 2018–2019 Statement of Priorities, published in July, included prioritizing a review of the effectiveness of disclosure requirements regarding women on boards and in executive positions.¹⁰

Similarly, the CSA’s Review of Disclosure Regarding Women on Boards and in Executive Officer Positions, published in September, indicated that whether to impose more onerous disclosure requirements and/or adopt best practice guidelines on gender diversity was being considered.¹¹

The leading providers of corporate governance and responsible investment solutions have also taken steps in 2018 to promote diversity in Canadian boardrooms, focusing largely on gender.

Proxy access, which provides an alternative to proxy contests, remains decidedly unpopular in Canada. Proxy access allows shareholders who fulfill the requirements adopted by the company’s policy to save the expense of launching a proxy contest and, instead, have their nominees share the company’s ballot card. Since proxy access policies were adopted last year by Royal Bank of Canada and Toronto Dominion Bank, the first Canadian public companies to do so, they have been adopted by the other major banks and two large insurance companies, but have otherwise been ignored, despite their support from the Canadian Coalition for Good Governance.

Beginning this year, ISS is recommending that shareholders of S&P/TSX Composite Index companies withhold votes from the chair of the nominating committee if (i) the company has not disclosed a written gender diversity policy **and** (ii) there are no women on the board. ISS intends to extend this approach to the remainder of TSX listed companies in 2019.

Glass Lewis will adopt a similar approach in 2019, which will see it recommend that shareholders vote against the chair of the nominating committee if (i) the company has not disclosed a written gender diversity policy **or** (ii) there are no women on the board.

Change cannot come quickly enough. While progress is being made, women continue to represent a small minority of public company board seats. Accordingly to the CSA, only 11% of board seats were held by women in 2015, and that has only increased to 15% in 2018. Moreover, only 8% of companies had three or more women on their boards in 2015, and that has only increased to 13% in 2018.¹²

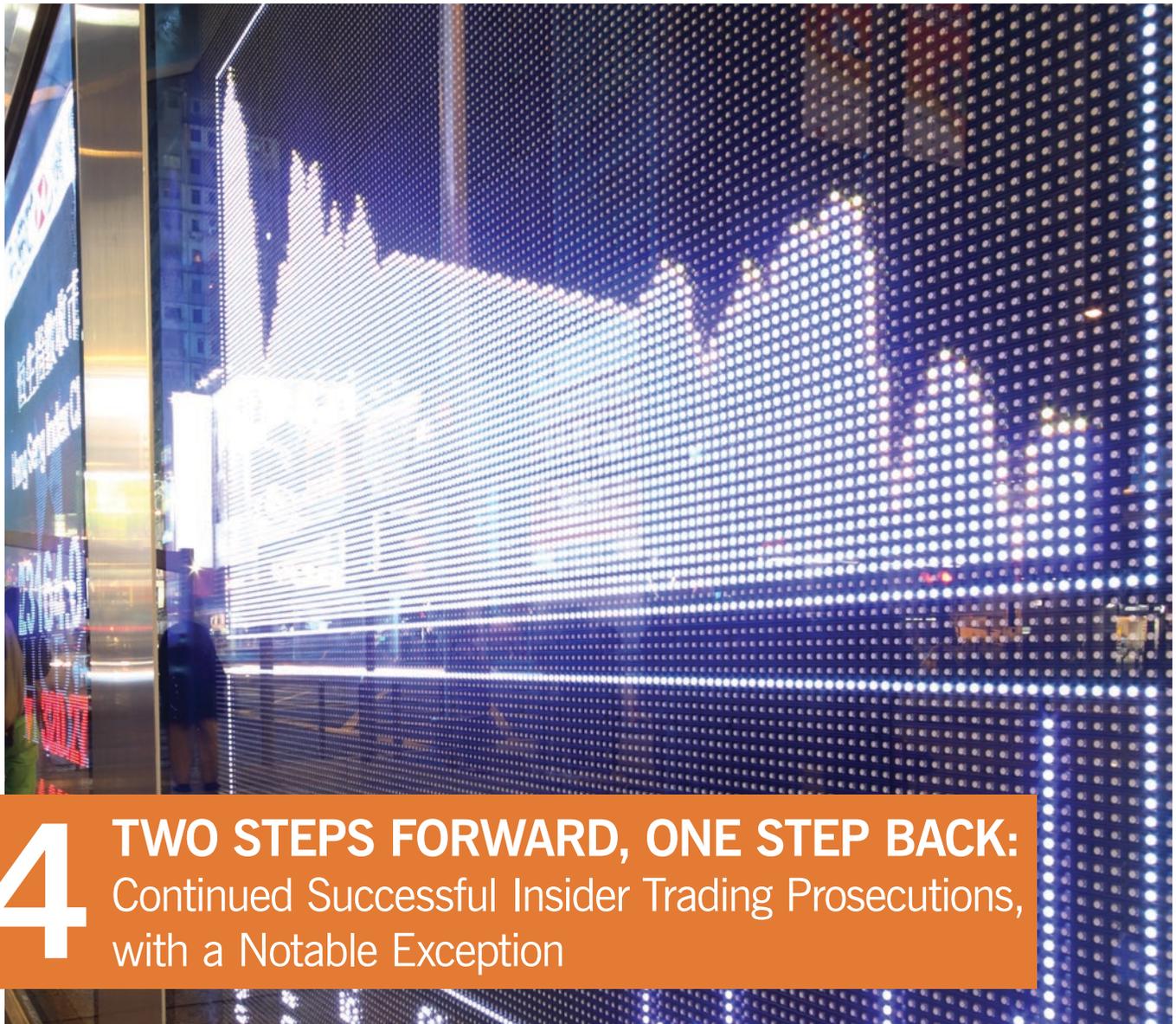
Given the significant influence that ISS and Glass Lewis have with respect to the shareholder vote in Canada, especially in the context of a contested meeting, we expect that these initiatives will be a paramount driver of change with respect to boardroom diversity, and cause others (such as institutional shareholders) to shift their attention, over the next few years.

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So far, 2018 has been an interesting and exciting year for activism and governance. The landscape is changing, and further changes affecting issuers and investors alike are visible on the horizon. Keeping up will require remaining informed of but also sensitive to shifts in attitudes and values, and success will continue to depend on creative approaches and solutions.

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4 TWO STEPS FORWARD, ONE STEP BACK: Continued Successful Insider Trading Prosecutions, with a Notable Exception

Canadian securities regulators continue to focus heavily on insider trading and tipping investigations and prosecutions in the wake of several recent successful high profile prosecutions based on circumstantial evidence. Early in the year, the Ontario Court of Appeal endorsed the use of circumstantial evidence in a decision that will likely have a wide ranging impact on future prosecutions. We also saw a rash of settlements by individuals alleged to have engaged in insider trading or tipping, which may signal a weaker resolve to fight charges in this new era of circumstantial evidence.

The past year was not all good news for securities regulators, however, as a high profile insider trading prosecution involving shares of Amaya Gaming Group Inc. (“Amaya”) was derailed when the Quebec court stayed all charges against the former CEO of Amaya and other individuals due to prosecutorial errors. While the trend in insider trading and tipping cases has been favourable to regulators, these cases are still uphill battles due to their size, complexity, and cost.

Technicalities Work to Thwart High Profile Insider Trading Prosecution

In June 2018, Quebec’s securities regulator, the Autorité des marchés financiers (“AMF”), suffered a major setback when a high profile insider trading prosecution was stayed by the Quebec Court six weeks into the hearing against senior executives and other individuals on charges of insider trading and market manipulation in advance of a \$4.5 billion acquisition by Amaya.¹ The AMF laid charges two years prior to the hearing. Due to the quasi-criminal nature of such proceedings, Canadian securities regulators are required to disclose all relevant evidence to those charged, including exculpatory evidence, at the outset of the proceeding.

The Quebec Court granted the stay, a drastic and serious remedy, based on what it characterized as “repeated errors” by the prosecution in meeting its disclosure obligations to the charged individuals. In this case, the Quebec Court found that the AMF failed to meet its disclosure obligations due to, among other things, its inadvertent disclosure of hundreds of thousands of privileged documents, some of which disclosed the legal defence strategy of certain of the respondents, and its inadvertent disclosure of 14 million documents falling outside of the period authorized by the search warrants issued in connection with the AMF’s investigation. The Quebec Court found that the AMF’s repeated errors in managing document disclosure to the respondents had reached the point of depriving them of their right to a fair hearing and that the only appropriate remedy was a stay of proceedings.

The *Baazov* case highlights the difficulties faced by Canadian provincial securities regulators in prosecuting large scale insider trading cases, often involving millions of documents and complicated disclosure issues, given resource limitations. Despite the recent trend toward successful prosecutions by Canadian securities regulators, *Baazov* stands as a warning that many challenges to the prosecution of insider trading remain, especially in cases of voluminous circumstantial evidence. Canadian securities regulators have a duty to ensure proper organization, privilege protection, and disclosure of the evidence collected in their investigation, and this duty is the same regardless of the high volume of documents in complex cases. We anticipate that securities regulators will be more rigorous in the allocation of resources among competing enforcement priorities to try to avoid such embarrassing results in the future.



The Baazov case highlights the difficulties faced by Canadian provincial securities regulators in prosecuting large scale insider trading cases, often involving millions of documents and complicated disclosure issues, given resource limitations.

Circumstantial Affirmation: Ontario Court of Appeal Affirms “Wink and Nod” Insider Trading Convictions are Here to Stay

In the long-running, high profile insider trading prosecution of an M&A lawyer and other capital market participants, the Ontario Court of Appeal upheld the convictions of insider trading and tipping based on circumstantial evidence (*Finkelstein v Ontario Securities Commission*).² This matter involved a chain of five individuals who were alleged to have traded using material, non-public information obtained by a Bay Street corporate lawyer about pending transactions and passed successively down the chain of individuals. Relying largely on circumstantial evidence, OSC staff were successful before the Commission in obtaining a conviction against all five respondents, including the downstream “tippees” in



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the chain who did not receive information directly from the original tipper. At the first level of appeal, the Divisional Court had overturned one conviction against the farthest downstream tippee. However, on a further appeal to the Ontario Court of Appeal in January 2018, the conviction against that individual was restored.³

The Court of Appeal's decision in *Finkelstein* marks the first time that the Court of Appeal has considered the meaning of "special relationship" in the insider trading and tipping regulatory regime and the test for liability for downstream trading. Insider trading violations require that the trader or tipper be a person in a "special relationship" with an issuer and the securities regime captures successive tippees and traders by stipulating that a person who knows or reasonably ought to know that they received material non-public information from such a person is also deemed to be a "person in a special relationship." The Court of Appeal recognized that this may operate to extend the chain of liability for insider trading, without limitation, beyond direct insiders and those who directly receive tips to a multitude of individuals down the chain. Since subjective knowledge is not required, circumstantial evidence may be used to convict downstream tippees who "ought reasonably to have known" that the tip originated from an insider.

The Court of Appeal also reaffirmed the substantial deference that appellate courts will give to the decisions of securities regulators. Similar to the Divisional Court's decision in *Fiorillo*, which we commented on last year, the Court of Appeal affirmed in *Finkelstein* that a reviewing court should not re-weigh the evidence that was before the Commission and should only overturn a Commission's findings if they fall outside a reasonable range of outcomes based on the evidence. With the Court of Appeal's approval, regulators will likely continue to rely heavily on circumstantial evidence to advance cases against downstream tippees going forward.

A Wave of OSC Settlements

In the wake of regulators' recent successes in insider trading and tipping cases, this year saw a number of high profile insider trading and tipping settlements, including the following:

- **Cheng:** Executives of an investment fund manager reached a settlement and admitted to illegal tipping and insider trading in a separate prosecution by the Ontario Securities Commission related to trading in advance of the \$4.5 billion acquisition by Amaya. The co-chief investment officer and portfolio manager agreed to a six year trading ban and ban on being an officer, director, fund manager or other registrant in the capital markets and a \$400,000 monetary penalty.⁴ The chairman and chief executive officer of the fund manager agreed to a two year ban and a \$135,000 monetary.⁵ The national sales manager agreed to a two year ban and disgorgement of \$5,500. The remaining individual defended the charges in a hearing on the merits in the fall of 2018 and the decision is pending.

- **Hutchison:** A former legal assistant employed at a major Bay Street law firm admitted to providing material non-public information about six transactions to a friend who worked in the securities industry. In April 2018, the former assistant entered into a settlement with the OSC whereby she received a reprimand, a two year ban on participation in capital markets and agreed to provide cooperation in the OSC's prosecution of the tippees, which remains ongoing. The *Hutchison* settlement is unique in that it did not include any monetary penalties. This was in recognition of the respondent's limited finances, the fact that she received relatively little money from her misconduct compared to the other individuals, and the benefit to Staff in receiving her cooperation and agreement to provide evidence against the other respondents.⁶

Outlook

With appellate court endorsement of convictions based on circumstantial evidence and broad interpretation of liability for successive tippees, we expect a continued focus on insider trading and tipping investigations and prosecutions. Trading activity in advance of significant corporate transactions, including mergers and acquisitions, is an area heavily scrutinized by regulators. Corporations and their directors, officers and compliance officers would be well advised to prioritize robust compliance regimes to detect and prevent illegal insider trading and tipping.



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5 CLASS IS IN SESSION: Key Updates to the Securities Class Actions Landscape in 2018

Securities class action filings have been on the decline for the past two years.¹ This downward trend is likely to continue as courts apply the meaningful leave test for statutory secondary market class claims and clarify the circumstances in which they will assume jurisdiction over

foreign issuers and foreign trades. On the other hand, for those actions that do survive the leave test, the courts have confirmed that defendants who attempt to rely on the reasonable investigation defence must marshal credible evidence to succeed.

Jurisdiction: Where in the World Should These Cases be Tried?

Over the past year, Ontario courts have wrestled with the scope of their jurisdiction over secondary market misrepresentation claims. Most recently, in *Yip v HSBC Holdings plc*,² the Ontario Court of Appeal clarified the jurisdiction of the Ontario courts with respect to

secondary market misrepresentation claims where the issuer is a foreign corporation that does not trade on any Canadian stock exchange. The Court of Appeal stayed the proposed class action on the basis that there was no real and substantial connection to Ontario.

Class actions involving jurisdictional issues require the court to consider whether it has *jurisdiction simpliciter* (as informed by the “real and substantial connection” doctrine); and if so, whether Ontario is the most appropriate forum to adjudicate the dispute. In *HSBC*, the Court of Appeal had to determine whether the phrase “real and substantial connection” in s. 138.1 meant something broader than the common law doctrine. The plaintiff argued that the court should adopt a unique interpretation of the “real and substantial connection” in the *Securities Act*³ and find that HSBC had a real and substantial connection to Canada since it knew or ought to have known that its investor information was being made available to Canadian investors.

The Court of Appeal rejected this argument, holding that the legislative intent was to mirror the common law test for jurisdiction. In doing so, it recognized the risk

that adhering to the plaintiff’s interpretation could cause Ontario to become a “universal jurisdiction” for secondary market misrepresentation claims. In applying the common law test for “real and substantial connection,” the Court of Appeal concluded that downloading disclosure material in Canada from an issuer’s website where that issuer’s securities are not sold on any Canadian exchanges is an extremely weak connection to Ontario. The Court of Appeal further found that HSBC Holdings is not a responsible issuer under the *Securities Act* because it has no real and substantial connection to Ontario.

By contrast, where an issuer’s securities trade both in Ontario’s secondary market and also on a foreign stock market, Ontario does have jurisdiction, at least over Canadian-resident purchasers, and the *Securities Act* applies to the trades in Ontario as well as extraterritorially to foreign trades.⁴

The Court as Gatekeeper

Courts continue to apply and refine the Supreme Court of Canada’s guidance from *CIBC v Green*⁵ regarding the meaningful nature of the leave test. The Ontario Superior Court of Justice recently refused to grant leave to commence a statutory secondary market misrepresentation claim in a proposed class action relating to financial disclosure. The Court in *Paniccia v MDC Partners Inc.*⁶ held that the plaintiff had failed to demonstrate any reasonable possibility that the putative class would be successful at trial and reaffirmed the important gatekeeper role of the court in securities class actions. In particular the court held that the leave test requires more than a superficial examination of the evidence. Rather, the leave test is a robust deterrent screening mechanism requiring a reasoned consideration of the evidence.

The following key takeaways are worth noting:

- The absence of restatement of financial statements is a powerful fact for defendants. In the context of a motion for leave to pursue a statutory cause of action, the plaintiff can rely on the fact of a restatement as an admission that the company has made a material misrepresentation. In the absence of a restatement, however, the plaintiff must adduce some evidence to show there is a reasonable prospect of demonstrating at trial that the company misled the market by publishing an untrue statement of material fact or by failing to disclose a material change in a timely manner;

- The opinion of an accounting expert may not be useful in determining whether a fact or change is material. While an accounting expert can opine on materiality from an accounting or auditing perspective, the determination of a material fact or material change under the securities regulatory regime is a legal test and ultimately up to the court to decide; and
- The commencement of a regulatory investigation, without more, does not trigger a disclosure obligation. A reasonable investor would not expect a company to disclose a subpoena or a regulatory investigation (and in Canada, regulatory investigations are usually confidential). Instead, a reasonable investor would expect the company to respond to the subpoena, cooperate with the investigator, conduct an internal investigation and determine whether there is a material fact to correct or a material change to report.



The leave test is a robust deterrent screening mechanism requiring a reasoned consideration of the evidence.

When is a “Reasonable Investigation Defence” Reasonable?

Section 138.4(6)(a) allows an issuer⁷ to defend a misrepresentation claim (or an allegation of failure to make timely disclosure) by relying on the fact that the issuer conducted a “reasonable investigation.” The Court had an opportunity to consider the reasonable investigation defence in *Wong v Pretium Resources*.⁸ The Court accepted that the plaintiff had met the requirements of the leave test in demonstrating that the fact that two of the issuer’s experts arrived at opposite findings on sample testing was material and ought to have been disclosed. When the Court considered the reasonable investigation defence, it found that although the defendants had conducted a reasonable investigation, there still remained a reasonable possibility that at the time each of the impugned documents was disclosed, the defendants had reasonable grounds to believe that they contained misrepresentations. This was because, prior to the disclosure of each document at issue, one of the defendant’s experts had advised the defendant to disclose the results of the sample testing, which it chose not to do on the basis that the results were premature. The Court found that given the disagreement amongst the defendants respective experts, the defendants ought to have disclosed the results and provided an explanation as to why the results were premature.

The Court of Appeal also had occasion to consider the reasonable investigation defence in the context of an appeal of a successful leave motion in *Rahmi v South Gobi Resources Ltd.*⁹ The issuer had published a restatement noting that certain revenue transactions were recognized in the company’s financial statements prior to meeting relevant revenue recognition criteria. On the leave motion, the issuer argued that its restatement and press release were actually inaccurate, not the prior financial statements, and that the restatement was in fact undertaken, not because of any securities law

requirements, but due to pressure from their auditors, the Securities and Exchange Commission, and their new parent company. In other words, there was no misrepresentation during the class period but rather, only in connection with the restatement. The Court of Appeal rejected these arguments as well as the defendants’ attempt to rely on the reasonable investigation defence. The Court concluded that the defendants had not led any “truly uncontroverted” or contemporaneous evidence to support a reasonable investigation defence. Instead, there was contradictory evidence from the defendants themselves on the key issue for determination. Further, the fact that the defendants never took any steps to correct the allegedly inaccurate restatement weakened the very credibility of their position.

As the above decisions demonstrate, courts continue to exercise a meaningful gatekeeper role through enhanced scrutiny at the leave stage. This, combined with jurisdiction challenges, may well lead to a further decline in new class action filings. However, Courts are also putting defendants to the test in their treatment of the reasonable investigation defence. This defence must be grounded in contemporaneous evidence of investigation and diligence.

Courts continue to exercise a meaningful gatekeeper role through enhanced scrutiny at the leave stage.

Endnotes

Hazy Risks and Investor Highs in Emerging Cannabis Market

- ¹ OSC Staff Notice 51-729, “Corporate Finance Branch 2017-2018 Annual Report” at p 23 and p 28.
- ² Deloitte’s 2018 Report on Cannabis Industry.
- ³ CIBC’s Industry Primer on Cannabis: Almost Showtime dated May 7, 2018.
- ⁴ October 10, 2018, “CSA Staff Notice 51-357: Staff Review of Reporting Issuers in the Cannabis Industry” at p 1.
- ⁵ February 8, 2018, “CSA Staff Notice 51-352 (Revised): Issuers with US Marijuana-Related Activities.”
- ⁶ Cassels Brock: Canopy Growth Completes \$540 Million Acquisition of Hiku Brands. <http://www.casselsbrock.com/Doc/Canopy_Growth_Completes__540_Million_Acquisition_of_Hiku_Brands_47517>.
- ⁷ Cassels Brock: Canopy Growth Completes \$375 Million Acquisition of Remaining 33% of BC Tweed. <http://www.casselsbrock.com/Doc/Canopy_Growth_Completes__375_Million_Acquisition_of_Remaining_33_of_BC_Tweed_47492>.
- ⁸ <<https://business.financialpost.com/cannabis/canopys-500-million-raise-means-debt-financing-may-finally-be-on-the-horizon-for-cannabis-companies>>.

Blockchain Blitz: Tackling the Regulation of Cryptocurrency

- ¹ 2018 ONSC 5191.
- ² *Ibid* at para 20.
- ³ *Ibid* at para 18.
- ⁴ *Ibid* at para 19.
- ⁵ *Ibid* at para 20.
- ⁶ *Ibid* at para 28.

New Rules, New Initiatives, New Perspectives: Shareholder Activism in an Ever-Changing Environment

- ¹ These statistics were compiled by Kingsdale Advisors, a leading shareholder services and advisory firm, in its 2018 Proxy Season Review. Since numerous activist campaigns do not result in a proxy contest (or even a public statement), it is not possible to track the rate of activist agitation more generally.
- ² *Re Eco Oro Minerals Corp.*, 2017 ONSEC 23. The Ontario Securities Commission overturned the decision of the TSX approving the issuance of shares following a partial debt conversion largely on the basis that the issuance had a “tactical motivation” in the face of a proxy contest for board control.
- ³ See for example *Re Sandpiper Real Estate Fund Limited Partnership et al.*, 40 O.S.C.B. 9321, and *Re Land and Buildings Investment Management, LLC*, 40 O.S.C.B. 9658, both of which were ultimately withdrawn only a few days before their hearings.
- ⁴ *An Act to Amend the Canada Business Corporations Act the Canada Cooperatives Act, the Canada Not-for-profit Corporations Act and the Competition Act*, S.C. 2018, c. 28.
- ⁵ These amendments have also done away with slate voting, meaning that each director must stand on her own for election to the board.
- ⁶ According to a 2018 report published by Activist Insight, a London based firm that tracks investor activism worldwide.

- ⁷ CSA Staff Notice 61-303 and Request for Comment — *Soliciting Dealing Arrangements*.
- ⁸ *Re PointNorth Capital Inc.*, 2017 ABASC 121.
- ⁹ In 2013, Agrium Inc. (“Agrium”) successfully used a soliciting dealer arrangement to help resist an attempt by JANA Partners LLC to seize control of Agrium’s board. All of Agrium’s incumbent nominees were ultimately elected.
- ¹⁰ OSC Notice 11-781 — Notice of Statement of Priorities for Financial Year to End March 31, 2019.
- ¹¹ CSA’s Multilateral Staff Notice 58-310 — Report on Fourth Staff Review of Disclosure Regarding Women on Boards and in Executive Officer Positions.
- ¹² CSA’s Multilateral Staff Notice 58-310 — Report on Fourth Staff Review of Disclosure Regarding Women on Boards and in Executive Officer Positions.

Two Steps Forward, One Step Back: Continued Successful Insider Trading Prosecutions, with a Notable Exception

- ¹ *Baazov v. Autorité des marchés financiers*, 2018 QCCQ 4449, <<http://canlii.ca/t/hssk8>> [“Baazov”].
- ² *Finkelstein v Ontario Securities Commission*, 2018 ONCA 61, <<http://canlii.ca/t/hq2wh>> [“Finkelstein”].
- ³ We note that an application for leave to appeal to the Supreme Court of Canada by the downstream tippee whose conviction was overturned by the Divisional Court, but restored by the Court of Appeal, is currently pending.
- ⁴ *Cheng (Re)*, 2018 ONSEC 34, <http://www.osc.gov.on.ca/en/Proceedings_oth_20180615_chengb.htm>.
- ⁵ *Cheng (Re)*, 2018 ONSEC 43, <http://www.osc.gov.on.ca/en/Proceedings_oth_20180831_chengb.htm>.
- ⁶ *Hutchinson (Re)*, 2018 ONSEC 22, <http://www.osc.gov.on.ca/en/Proceedings_set_20180424_hutchinsond.htm>.

Class is in Session: Key Updates to the Securities Class Action Landscape in 2018

- ¹ *Trends in Canadian Securities Class Actions: 2017 Update*, NERA Economic Consulting, February 20, 2018.
- ² 2018 ONCA 626.
- ³ Section 138.1 defines a responsible issuer to mean “(a) a reporting issuer, or (b) any other issuer with a real and substantial connection to Ontario, any securities of which are publicly traded.”
- ⁴ *Paniccia v MDC Partners Inc.*, 2017 ONSC 7298.
- ⁵ 2015 SCC 60.
- ⁶ 2018 ONSC 3470.
- ⁷ Or any person who could be liable for secondary market misrepresentation under section 138.3.
- ⁸ 2017 ONSC 3361.
- ⁹ The court also commented on the leave test generally, noting that a leave motion should not be treated as a mini-trial, especially where credibility issues are involved. Instead, credibility issues ought to be left for determination at trial, especially where a court has already determined that the plaintiff has made a *prima facie* case of misrepresentation.



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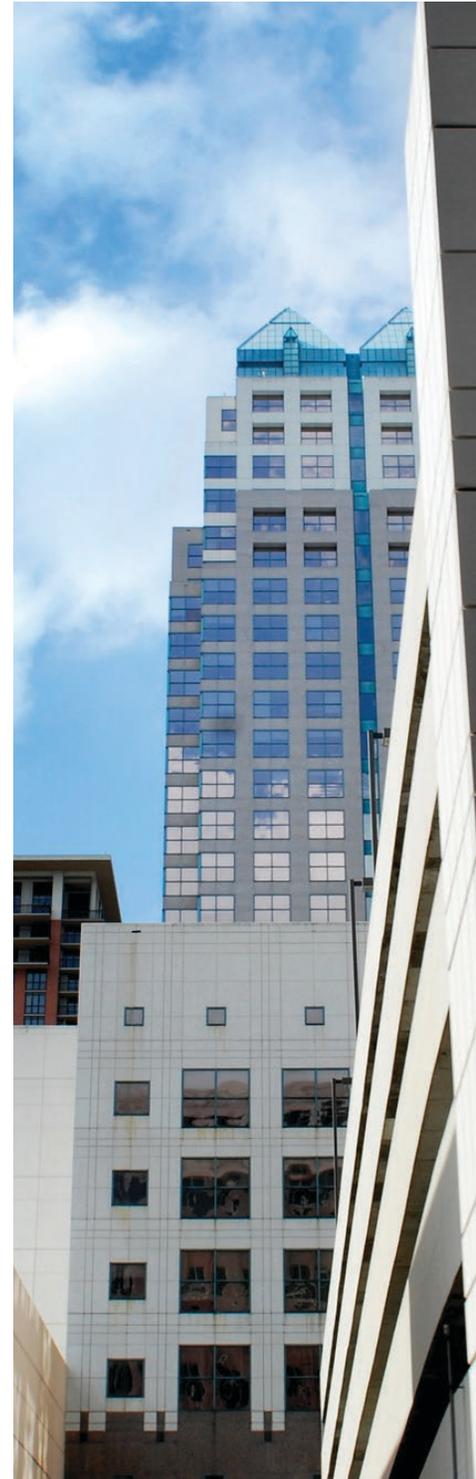
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