

## CSA Multilateral Staff Notice 51-359

### *Corporate Governance Related Disclosure Expectations for Reporting Issuers in the Cannabis Industry*

November 12, 2019

#### **Introduction**

Staff of the securities regulatory authorities in each of Ontario, British Columbia, Québec, New Brunswick, Saskatchewan, Manitoba and Nova Scotia (collectively, **Staff** or **we**) have observed instances of inadequate transparency relating to the cross-ownership of financial interests<sup>1</sup> by reporting issuers in the cannabis industry (**cannabis issuers**) or directors/executive officers of such issuers, involved in mergers, acquisitions or other significant corporate transactions (**M&A Transactions**). We have also observed recent examples where corporate governance related disclosures were deficient.

#### **Purpose**

This notice provides supplementary guidance related to the disclosure of financial interests in the context of M&A Transactions. Strengthening governance related disclosures that address concerns about potential conflicts of interest will provide investors with the information they require to make informed decisions.

While this notice has been directed towards cannabis reporting issuers, its content is equally relevant to other issuers, including those operating in emerging growth industries.

#### **Specific issues and related guidance**

##### *1. Disclosure of financial interests in M&A Transaction documents*

The cannabis industry has experienced significant growth and M&A Transaction activity over the past few years. Early rounds of financing were often funded by high net worth individuals or friends and family of the founders. As the market expanded, many cannabis issuers and their directors and executive officers have participated in the financing of other cannabis issuers. This participation has resulted in a higher than usual cross-ownership of financial interests amongst cannabis issuers and their directors and executive officers. These financial interests may include overlapping debt and equity interests, or other business relationships.

Staff have observed M&A Transactions where either the acquirer or the acquiree (or a director/executive officer of either entity) had an undisclosed financial interest in the other

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<sup>1</sup> References to a 'financial interest' in this notice include situations in which one party to an M&A Transaction (or any of its directors or executive officers) may have a conflict of interest as a result of ownership, control or direction of equity, debt or other investments, or business relationships, related to the transaction counterparty.

entity. Staff are of the view that, in the context of M&A Transactions, detailed disclosure of the cross-ownership of financial interests (held either by the acquirer, the acquiree, or either of their directors or executive officers) is material<sup>2</sup> information for investors and their investment/voting decisions, and should be disclosed<sup>3</sup> in the applicable disclosure document<sup>4</sup>.

The cross-ownership of financial interests results in conflicts of interest that may lead investors to re-examine other variables such as purchase price, transaction timing or contingent payments. These variables may not otherwise be considered in the same manner if the conflict of interest is not disclosed. Non-disclosure of the cross-ownership of financial interests may also cause investors to question whether the M&A Transaction occurred on its own merits.

Staff are of the view that it is critical for parties to a proposed M&A Transaction to provide each of their securityholders with sufficient disclosure to address concerns about potential conflicts of interest. This disclosure will allow security holders to make a better informed determination about the merits of the M&A Transaction.

The document in which disclosure is required by cannabis issuers undertaking M&A Transactions will vary depending on the structure of the proposed transaction, whether the issuer is the acquirer or acquiree, and the applicable requirements of the stock exchange on which the reporting issuer's securities are listed. For example, an M&A Transaction may give rise to an obligation to file a material change report<sup>5</sup>, a take-over bid circular<sup>6</sup>, a listing statement / filing statement<sup>7</sup>, or an information circular<sup>8</sup>. A prospectus<sup>9</sup> may also be filed in connection with the M&A Transaction. Regardless of the form of document required to be

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<sup>2</sup> Item 13.1 of Form 51-102F2 *Annual Information Form* indicates that the materiality of the interest is to be determined on the basis of the significance of the information to investors in light of all the circumstances.

<sup>3</sup> This information should be disclosed, even if the quantum of the financial interest may not trigger the specified quantitative disclosure thresholds under securities law, such as where the financial interest represents securities carrying less than 10% of the entity's voting rights. For example, see the definition of a 'reporting insider' and 'significant shareholder' under National Instrument 55-104 *Insider Reporting Requirements and Exemptions*.

<sup>4</sup> The applicable documents would include a prospectus, material change report, a take-over bid circular, a listing statement / filing statement, or an information circular, as applicable.

<sup>5</sup> Item 5.1 of Form 51-102F3 *Material Change Report* requires sufficient disclosure to enable a reader to appreciate the significance and impact of the material change without having to refer to other material.

<sup>6</sup> Item 23 of Form 62-104F1 *Take-Over Bid Circular* requires disclosure about material facts concerning the securities of the offeree issuer and any other matter not disclosed in the take-over bid circular that has not previously been generally disclosed, is known to the offeror, and that would reasonably be expected to affect the decision of the security holders of the offeree issuer to accept or reject the offer.

<sup>7</sup> The forms of disclosure set out by each respective stock exchange requires disclosure similar to Item 29 of Form 41-101F1 *Information Required in a Prospectus*, as described below.

<sup>8</sup> Item 14.1 of Form 51-102F5 *Information Circular* requires securityholders to be provided with sufficient information to enable them to form a reasoned judgment concerning matters being acted upon. Such matters may include alterations of share capital, property acquisitions or dispositions, reverse takeovers, amalgamations, mergers, arrangements or reorganizations and other similar transactions.

<sup>9</sup> Item 29 of Form 41-101F1 *Information Required in a Prospectus* requires particulars of any material facts about the securities being distributed that are not disclosed under any other Items and are necessary in order for the prospectus to contain full, true and plain disclosure of all material facts relating to the securities to be distributed.

filed, we remind issuers to disclose the cross-ownership of financial interests based on the broader materiality requirements of the applicable disclosure document.

## 2. *Independence of board members*

National Instrument 58-101 *Disclosure of Corporate Governance Practices (NI 58-101)* sets out mandatory disclosure regarding corporate governance practices. National Policy 58-201 *Corporate Governance Guidelines (NP 58-201)* provides guidance on corporate governance practices that reporting issuers are encouraged to consider in developing their own practices. These include practices related to an issuer's board and guidelines related to ethical business conduct and the ability of directors to exercise independent judgement.

We have observed instances where cannabis issuers have identified board members as being independent, without giving adequate consideration to potential conflicts of interest or other factors that may compromise their independence. This may include, for example, personal or business relationships with other directors and executive officers of the issuer that have not been properly considered in the determination of a director's independence. Independent directors must not have a direct or indirect 'material relationship' with the issuer. A material relationship is defined as a relationship which could, in the view of the board, be reasonably expected to interfere with the exercise of a director's independent judgement<sup>10</sup>.

Reporting issuers should consider the impact of relationships or any other factors that may compromise independence, including whether disclosure of these factors is warranted in the circumstances.

We have also observed instances where the chair of the board and the chief executive officer of the cannabis issuer are the same individual. NP 58-201 notes that the chair of the board should be an independent director. Where this is not appropriate, an independent director should be appointed to act as a lead director<sup>11</sup>. Investors want to know that structures are in place to permit the board to operate independently.

Reporting issuers are encouraged to adopt a written code of business conduct and ethics, which includes standards for ethical decision making and compliance, and which addresses potentially challenging situations that may arise during the normal course of business. This code may include provisions for when and how conflicts of interest should be disclosed to other board members as well as to the public. It may also include provisions to address the disclosure of cross directorships and executive officer positions in the context of M&A Transactions.

### **Conclusion and next steps**

Reporting issuers, including cannabis issuers and issuers in other emerging growth industries, should ensure that governance related disclosures address concerns about conflicts of interest. This will allow security holders to make a better determination of whether cannabis issuers have adequately addressed governance issues and potential

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<sup>10</sup> Refer to Part 1.4 of National Instrument 52-110 *Audit Committees (NI 52-110)* for the definition of a material relationship. Parts 1.4 and 1.5 of NI 52-110 also provides examples of what types of relationships may be considered material relationships.

<sup>11</sup> Refer to Part 3.2 of NP 58-201.

conflicts of interest in the context of M&A Transactions. Staff will continue to monitor these areas and will take appropriate regulatory action when warranted.

## **Questions**

Please refer your questions to any of the following:

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