

# Water cannot be turned into wine: Cormark and the legality of triangular hedging transactions

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The Ontario Capital Markets Tribunal's (the Tribunal's) much-anticipated decision in [Cormark Securities Inc. \(Re\)](#) [PDF] provides important guidance to market participants that enter hedging transactions in connection with private placements. The Tribunal definitively confirmed that certain "swap" transactions — such as where the private placement investor borrows freely tradeable shares to sell short while pledging to the lender as collateral the restricted shares subscribed for by the investor — are legal under Ontario securities law. The decision also addresses and provides some clarification regarding what constitutes a "distribution" of securities and who is an "underwriter". In addition, it highlights some important differences between Canadian and U.S. law on these issues.

## Background

At the heart of the matter, the Ontario Securities Commission (OSC or the Commission) alleged that certain related transactions that had been proposed and facilitated by Cormark Securities Inc. (Cormark) amounted to an unlawful distribution of securities, violating the prospectus requirements of the *Ontario Securities Act* (the Ontario Act).

A reporting issuer in Ontario, Canopy Growth Corporation (Canopy), sold 2.5 million newly issued common shares to Saline Investment Ltd. (Saline) under a prospectus exemption, which were subject to a four-month private placement hold period (the restricted shares). Concurrently, Saline borrowed 2.5 million freely tradeable common shares of Canopy (the free-trading shares) from Goldman Holdings (GH) — a company controlled by a director of Canopy — under a securities loan agreement. Saline pledged the restricted shares to GH as collateral for the loan of the free-trading shares. Saline then sold the borrowed free-trading shares in the market. Ultimately, the restricted shares were released to GH after the four-month hold period on the restricted shares had elapsed in satisfaction of Saline's obligation to return the borrowed shares to GH under the securities loan. Notably, Canopy was not itself a respondent in the proceeding or accused of any wrongdoing by the OSC.

## The OSC's position

The OSC argued that these two related concurrent transactions (the transactions) amounted to an unlawful, indirect distribution of Canopy common shares to the public by Cormark and Saline, because they had the effect of allowing Canopy and the other parties involved in the transactions to sell 2.5 million newly issued common shares into the market indirectly

without being qualified by prospectus.

The OSC cited the definition of the term “distribution” under the Ontario Act, which includes any transaction or series of transactions involving a purchase and sale of securities in the course of or incidental to a distribution. The OSC asserted that although Canopy’s distribution of the restricted shares to Saline complied with an available exemption from the prospectus requirements, the sale of the borrowed, free-trading shares into the market by Saline was itself a distribution, because it was in the course of or incidental to the private placement of the restricted shares.

The purchasers of the free-trading shares, they argued, should have been provided with the same investor protections (a prospectus and the availability of rights and remedies for any misrepresentations in the prospectus) as they would have been entitled to receive if Canopy had itself sold shares directly into the market.

The Tribunal’s decision

The Tribunal concluded that there was no violation of the prospectus requirements of the Ontario Act. They held that the extended definition of “distribution”, which includes transactions in the course of or incidental to a distribution, did not apply. The Tribunal expressly stated that it did not “accept the premise, at the heart of the Commission’s submissions, that the Transactions effectively converted the restricted shares issued under the private placement into the free-trading shares borrowed under the securities loan agreement.”<sup>(1)</sup>

The Commission argued that the transactions were in the course of a distribution because the respondents had the subjective intent to engage in two separate but related transactions involving different securities of the same class (a triangular transaction). The result was that public market purchasers acquired freely tradeable shares borrowed from a lender, rather than newly issued private placement shares from Canopy. The Tribunal rejected outright the proposition that subjective intent is relevant to whether there is a distribution (even under the extended definition) when securities are issued under a prospectus exemption, so long as those securities remain within the “closed system” and are not resold without a prospectus or prospectus exemption, during the required hold period under Ontario securities law. The Tribunal accepted that the restricted shares remained within the closed system until the end of the four-month hold period.

The Tribunal expressly held that the restricted shares and the free-trading shares were two “distinct sets of securities” and that a triangular transaction designed to have two components that worked together did not change the fact that the triangular transaction involved two separate sets of securities. In other words, the pledging of the restricted shares and their eventual use to repay the securities loan, after the expiry of the four-month hold period, did not cause the extended definition of “distribution” to apply to the market sales of the borrowed free-trading shares.

The Commission also argued that the Tribunal should consider the discussion in Companion Policy 41-101CP, setting out considerations relevant to whether sales of securities under a prospectus to identified purchasers may in fact be an “indirect distribution” to a broader group of unidentified purchasers, who should then also be entitled to the broader rights and remedies of a prospectus offering. The respondents argued, and the Tribunal agreed, that this guidance had no application in the circumstances because the restricted securities were not themselves being resold, and in fact were held within the “closed system” for the required hold period. The Tribunal expressly confirmed that there is no impediment to pledging restricted securities subject to a hold period as collateral for a loan, so long as those shares are not sold into the public market without a prospectus or prospectus exemption

until after the hold period has expired. It follows that, under the Ontario Act, there is no impediment to using securities subject to a hold period — whether or not the hold period has expired — to satisfy repayment of a loan of freely tradeable securities, so long as the lender held the hold-period securities for the remainder of the hold period.

The Tribunal also rejected arguments that the transactions were anti-avoidance transactions contrary to the guidance expressed in Companion Policy 45-106CP *Prospectus Exemptions* and Companion Policy 45-501CP *Ontario Prospectus and Registration Exemptions*. The Tribunal found that Saline was not acting akin to an underwriter (as defined under the Ontario Act), that the free-trading shares and the restricted shares were not identical securities (by virtue of the hold period attaching to the restricted shares, among other things) and that the transactions were not structured to avoid delivering a prospectus for the distribution of newly issued shares to the public.

The Tribunal also rejected the Commission's argument that the 1999 [Crystallex decision](#) supported the conclusion that the sale by Saline of the borrowed free-trading shares was a distribution. In the Crystallex case, there was a continuing distribution of a single set of securities from the issuer into the hands of a third-party lender who then sold them into the market. That situation was unlike the present case, where the shares were issued to Saline in a private placement and remained within the closed system for the required hold period.

Finally, the Commission did not see any basis for making any order under its public interest jurisdiction.

#### Differences between Canada and the United States

The Commission cited to the Tribunal a U.S. Court of Appeals [decision](#) [PDF] (the Zacharias decision) relating to a “swap scheme” as a potentially relevant precedent supporting the Commission's position. The Tribunal declined to consider or rely on the Zacharias decision, given the differences between the Ontario Act and the U.S. regime, which the Commission did not analyze for the Tribunal.

In the United States, under the U.S. *Securities Act of 1933*, as amended (the 1933 Act), all sales of securities are prohibited unless a registration statement (containing a prospectus) is in effect covering the securities, or an exemption from the registration requirements is available. Secondary market trading normally takes place in reliance on a registration exemption that is available for “transactions by any person other than an issuer, *underwriter* or dealer” (the ordinary trading exemption), with dealers having the benefit of other exemptions. This construct puts considerable weight on the question of who or what is an *underwriter*. By statute, the term “underwriter” is defined to include any person “who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking”. Under this definition, the term “issuer” also includes affiliates of the issuer within the meaning of the 1933 Act. A person who is an *underwriter* within this definition is unable to rely on the ordinary trading exemption. When selling securities, an underwriter violates the registration requirements of the 1933 Act unless a registration statement is in effect, or some registration exemption other than the ordinary trading exemption is available.

Under the Ontario Act, only a trade in securities that is a “distribution” is required to be qualified by prospectus, or to be made in reliance on an available prospectus exemption. The Ontario Act defines an “underwriter” to include a person who agrees to purchase securities “with a view to distribution”. However, unlike the 1933 Act where underwriter status expressly disqualifies relying on the ordinary trading exemption, under the Ontario Act, whether a person is, or is not, an underwriter does not itself determine whether a prospectus

or prospectus exemption is required. Rather, the corresponding issue under the Ontario Act arises under the part of the definition of “distribution” that includes “any transaction or series of transactions involving a purchase and sale or repurchase and resale in the course of or incidental to a distribution...”. As such, under the Ontario Act, a sale of securities by someone who acquired them as an “underwriter” (that is, with a view to distribution) would likely itself be a transaction in the course of the original distribution, requiring a prospectus or prospectus exemption.

#### The U.S. Zacharias decision

The scheme at issue in the Zacharias decision was a triangular transaction. Zacharias and another individual were officers and directors of Starnet Communications International, Inc. (Starnet), a U.S. public company. They were affiliates of the issuer under the 1933 Act, and sales of the Starnet shares they held (the affiliate held shares) would have required a registration statement under the 1933 Act to be in effect covering those sales, unless made under an available registration exemption other than the ordinary trading exemption, such as in a private placement resulting in resale restrictions for the purchaser. Instead of selling the affiliate held shares into the market, they entered into an arrangement with Alfred Peeper and entities controlled by him. Under that arrangement, the Peeper entities sold a number of different, previously owned and freely tradeable Starnet shares into the market (the previously held shares), and then purchased the affiliate held shares to replenish their original holdings of previously held shares.

The U.S. Securities and Exchange Commission (SEC) concluded, and the U.S. Court of Appeals affirmed, that these two transactions should be linked together and treated as a single transaction, which violated the registration requirements of the 1933 Act. They determined that the parties involved were “underwriters” under the 1933 Act, affirming a previous SEC interpretive position regarding triangular transactions. As a result, the sale of the previously held shares into the market by the Peeper entities could not rely on the ordinary trading exemption, as it is unavailable to an underwriter. It did not matter to the Court that the previously held shares and the affiliate held shares were identifiably different securities, that the Peeper entities sold the previously held shares into the market before they purchased the affiliate held shares or that the Peeper entities did not make any subsequent resale of the affiliate held shares during the period that they continued to be subject to 1933 Act resale restrictions.

As noted above, the Tribunal declined to consider or rely on the Zacharias decision, given the differences between the Ontario Act and the U.S. regime.

#### The U.S. PIPEs cases

Prior to the Zacharias decision, the SEC unsuccessfully pursued a number of enforcement proceedings involving hedging in PIPE (private investment in public equity) transactions (the PIPEs cases). In the PIPEs cases, the purchasers borrowed freely tradeable shares to sell into the market to hedge the resale-restricted shares they had acquired in the private placement, while awaiting the effectiveness of a registration statement covering resales of the restricted shares. The SEC’s complaint was not that the purchasers engaged in hedging, but rather that they used the actual shares purchased in the private placement to repay the lenders.

What they should have done, the SEC said, was to do what “everyone knows” is the correct way to repay a securities loan in those circumstances: a so-called “double print”. The private placement purchasers should have sold the shares that they purchased in the private placement into the market after the resale registration statement became effective and then purchased different shares in the market to deliver back to the securities lenders to satisfy the loan (that is, executing or “printing” two separate trades). This would have avoided the

alleged violation of the 1933 Act arising from the private placement shares having been “presold” to the lenders before the registration statement became effective.

In effect, and potentially inconsistent with the outcome of the Zacharias decision, the SEC argued that the private placement purchasers should have used a “double print” (which is effectively a triangular transaction) to repay the securities loan. The SEC’s position was that the separation of the components of that type of triangular transaction would be respected so long as the purchasers were exposed to a “meaningful economic risk” through the double print, even if mitigated through further hedging at their own expense. The practice of double printing is not typical in Canada, and the Cormark decision would appear to support the position that double printing is not necessary in Canada given that freely tradeable shares sold in the market in connection with hedging activity are different securities than, and distinct from, the shares subject to a hold period that are purchased in the private placement.

What the Cormark decision tells us

The Tribunal expressed a number of significant conclusions in the Cormark decision:

- The extended definition of “distribution” under the Ontario Act, based on the Tribunal’s decision, does not transform a distribution of one set of securities into a distribution of another set of securities. “Distribution” should be interpreted as if the definition read, “...and also includes any transaction or series of transactions involving a purchase and sale or a repurchase and resale *of the very same securities that are the subject of the distribution* in the course of or incidental to a distribution, *and not any other securities of the same class, or any other related securities...*” (emphasis added).
- If securities are issued pursuant to a private placement exemption resulting in a hold period, and remain within the “closed system” for the required hold period during which no resales are made without a prospectus qualifying those resales (or an available prospectus exemption), then *any subsequent transactions in those securities after the end of the required hold period will not, based on the Tribunal’s decision, be captured by the extended definition of “distribution”*. The decision suggests that there is no need to consider factors such as the intent of the purchaser at the time of the original purchase, or whether the original purchaser was exposed to investment risk, in connection with subsequent transactions by that original purchaser.
- Triangular transactions in prospectus-exempt offerings should not be objectionable so long as two identifiably separate sets of securities are involved in each leg of the transaction. This should mean that it is permissible for an issuer to sell securities to an investor on a private placement basis, with the purchaser respecting that hold period, while at the same time the issuer or another party arranges for different, freely tradeable securities to be transferred by an existing holder of outstanding securities of the same class to a purchaser that is unwilling or unable to accept securities subject to a hold-period restriction.
- More generally, the decision provides greater clarity with respect to transactions in which two parties agree to exchange between them securities that are subject to resale restrictions for previously issued and outstanding securities that are not subject to a resale restriction, so long as there is an available prospectus exemption for the sale of the

restricted securities. The implication of the decision is that free-tradability is, in effect, an economic attribute of shares that can be bought and sold. There is no prohibition against a party monetizing the value of the freely tradeable nature of its shares by agreeing to exchange them for securities of the same class that are subject to a hold period and assuming the associated resale restrictions.

- In the words of the Tribunal, “Hedging or managing risk is a normal and accepted part of participating in the capital markets. Merely because a structure might reduce or eliminate risk does not make it contrary to the animating principles of the Act.”<sup>[2]</sup>

What the Cormark decision does not tell us

Although the Cormark decision provides important — and, hopefully, definitive — guidance on many issues regarding indirect distributions, investment intent and triangular transactions that have previously been mired in uncertainty, it also leaves a number of other, related issues open for future determination.

Among the most notable:

- What factors should determine whether a purchaser acquiring securities in a resale transaction from a first purchaser is indirectly acquiring securities in the course of the original distribution by the issuer?
  - The Cormark decision suggests that a resale transaction will not be considered part of the issuer’s initial distribution so long as the required four-month hold period has expired.
  - The Cormark decision does not tell us in what circumstances a resale by the first purchaser during the hold period could result in a violation of Ontario securities laws by the issuer as well as by the first purchaser, on the basis that the sale by the first purchaser was an indirect part of the issuer’s original distribution.
  - Finally, the Cormark decision does not tell us what factors may need to be considered in determining when a distribution ends, such that no further prospectus exemption is required for further resales, in the context of a prospectus exemption that does not result in a four-month hold period (such as OSC Rule 72-503 *Distributions Outside Canada*, which cannot be relied on for indirect distributions back into Canada because the resales by the first purchaser outside Canada would amount to an indirect distribution in Canada by the issuer).
- To what extent might U.S. case law and analysis under the 1933 Act definition of “underwriter”, and considerations of a purchaser’s investment intent and exposure to economic risk, be relevant to the corresponding issue of whether a resale is in the course of an “indirect” distribution by the issuer within the extended definition of “distribution” under the Ontario Act?
  - Unless a four-month hold period has been imposed and has expired, a purchaser’s investment intent and exposure to economic risk would still seem relevant to the analysis of the expanded definition of “distribution” under the Ontario Act, continuing the need for an analysis of when securities “come to rest” so as to be able to conclude that a distribution is complete.

- Finally, under what circumstances the Tribunal might consider the extended definition of “distribution” to apply, or the potential justification for taking action under its public interest jurisdiction, under facts suggestive of a plan or scheme to avoid the application of Ontario law, or that might bring the Ontario capital markets into disrepute?

The Cormark decision is a helpful one that addresses a number of longstanding questions in a very complicated and technical area of Ontario securities laws. It offers particularly helpful guidance in the context of triangular transactions where one leg of the transaction consists of a private placement of securities that remain held within the “closed system” for the required hold period. However, the specific facts and circumstances of all triangular transactions and other transactions potentially involving indirect distributions of securities still must each be carefully considered, to ensure that they do not result in violations of Ontario securities laws.

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[1] *Cormark Securities Inc (Re)*, 2024 ONCMT 26, para. 40.

[2] Para. 154.