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Kraft (Re): Tips from Ontario's Capital Markets Tribunal—When Is Selective Disclosure in the "Necessary Course of Business"

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In a first for Canadian securities laws, on October 20, 2023 Ontario's Capital Markets Tribunal (Tribunal) released substantive guidance on the meaning of the "necessary course of business" (NCOB) exception to the prohibition against selective disclosure of material non-public information (MNPI) (more commonly referred to as "tipping"). *Kraft (Re)* is the first decision to directly consider and apply the NCOB exception to the tipping prohibition. In so doing, it provides guidance regarding a number of open questions on the purpose and limits of the exception.

Key Takeaways from *Kraft*

- **Necessary means necessary.** The word "necessary" in the NCOB exception elevates the criteria for selective disclosure beyond a mere business purpose or business rationale. "Necessary course of business" does not mean "ordinary course of business" but rather imports a level of importance, including something that is "essential," "indispensable" or "requisite" to the business. The purpose of the disclosure must be sufficiently important or necessary to the business to warrant an exception to the blanket prohibition against selective disclosure.
- **Whose business?** The Tribunal noted that the word "necessary" in the NCOB phrase is not qualified by "the issuer's". In so doing, the Tribunal left the door open to a finding that selective disclosure may be defensible where made in the necessary course of the tipper's business. Of course, without further guidance, caution is recommended until the limits of this opening have been tested in further decisions.
- **Process matters.** When relying on the NCOB exception, it is helpful to be in a position to demonstrate that you considered the tipping prohibition and the necessity of the disclosure in advance. While not exhaustive, helpful evidence might include discussions at the board or management level considering the advisability or need for the disclosure, identifying the purpose for the disclosure and, where appropriate, engaging the tippee through a formal agreement and imposing confidentiality obligations to prevent the tippee from trading on or disclosing MNPI.
- **The availability of the NCOB exception is determined objectively.** Whether disclosure is made in the NCOB must be determined on a purely objective basis; the tipper's subjective belief, even if held honestly and in good faith, is insufficient.
- **Burden of Proof.** Persons seeking to rely on the NCOB exception bear the onus of demonstrating that their disclosure was made in the NCOB.

Background

Staff of the Ontario Securities Commission (OSC) alleged that in the fall of 2017 Michael Paul Kraft, then chair of WeedMD Inc. (WeedMD), tipped his long-time friend and business associate, Michael Brian Stein, concerning material operational developments at WeedMD. At the time, WeedMD was listed on the TSX-Venture Exchange, focusing on the production and distribution of medical cannabis. In anticipation of the federal government legalizing recreational cannabis use, the company was looking to expand its production capacity. In early 2017, it commenced negotiations with Perfect Pick Farms Ltd. (Perfect) to lease substantially more greenhouse space.

During the course of the negotiations, Kraft and Stein were in regular contact, talking, as they usually did, about a variety of personal and business matters. On October 23, Kraft sent Stein an email attaching draft documents relating to the Perfect transaction, including near-final drafts of the lease and an option to purchase agreement that had been negotiated with Perfect by WeedMD management and company counsel. While Stein had a consulting agreement with WeedMD in 2015 (which had since expired), the Tribunal found that he did not have any business, contractual or employment relationship with WeedMD in 2017 nor had he otherwise been formally retained by the issuer to review any of the Perfect transaction documents. Kraft sent the email to Stein without prior clearance from management. He titled Stein his "go-to-advisor" and claimed he was seeking his friend's particular expertise in commercial real estate. The Tribunal, however, found that Kraft sent the email to Stein out of a more general "self-described habit and preference of regularly personally consulting with Stein on business matters." On October 25, Stein provided comments by email to Kraft and the CEO and CFO of WeedMD. Ultimately, the Tribunal concluded that by providing Stein with the draft Perfect documents in the October email, Kraft violated the prohibition on tipping.

The Perfect transaction was approved by the WeedMD board on November 2 and announced on November 22. On November 21, the day before the announcement, Stein acquired 45,000 WeedMD shares and then sold them over the two trading days following the announcement for a total profit of $29,345, representing an approximately 43% return. The Tribunal concluded that this was insider trading.

Necessary Course of Business Exception

The *Securities Act* (Ontario) (OSA) "prohibits a person in a special relationship with an issuer from informing, *other than in the necessary course of business*, another person of an undisclosed material fact or material change with respect to the issuer.

What Does "Necessary Course of Business" Mean?

There has been a paucity of case law or securities regulatory decisions regarding the meaning of the "necessary course of business." Earlier securities commission decisions in matters such as *George, Re* and *Air Canada, Re* highlighted the principles of equality animating the insider trading and tipping rules. These decisions also laid the groundwork for the guidance on the meaning of NCOB that we have in National Policy 51-201 – *Disclosure Standards* (NP 51-201), where the exception to the tipping rule is said to "exist so as not to unduly interfere with a company's *ordinary* business activities" (emphasis added). As an example, the policy states that the NCOB exception would generally cover communications by an issuer with the following persons: vendors, suppliers or strategic partners on issues such as research and development, sales and marketing and supply contracts; employees, officers and board members; lenders, legal counsel, auditors, underwriters and financial and other professional advisers to the company; parties to negotiations; and credit rating agencies.

In *Kraft* the Tribunal confirmed that NP 51-201, while helpful, is non-binding guidance only. The Tribunal cautioned that NP 51-201 provides only presumptive categories of persons to whom MNPI might be disclosed and that any reliance on the NCOB exception must in each case be established on the relevant facts.

Meaning of "Necessary"

Referencing the OSC's earlier commentary in George, the Tribunal affirmed that the phrase "necessary course of business" is to be understood as distinct from "ordinary course of business." The Tribunal further clarified that "necessary" requires that the purpose of the selective disclosure must go beyond "a mere business purpose or business rationale," and that it imports "a level of importance, including that something is 'essential', 'indispensable', or 'requisite.'" Put differently, the Tribunal stated: "We find that the purpose of the selective disclosure must be sufficiently important or necessary to the business to warrant an exception to the blanket prohibition against selective disclosure."

Whose "Business"?

Staff argued that the word "business" in the NCOB exception requires that the selective disclosure be in the necessary course of the *issuer's business* and that anything short of that would introduce an "ever-shifting standard." Significantly, the Tribunal noted that "business" is not qualified by the phrase "the issuer's." That said, in the circumstances of this case, where the MNPI in question was received from WeedMD by Kraft in his capacity as a director of the company, the Tribunal and the parties accepted without debate that

the NCOB exception in this instance was to be applied with reference to the "issuer's business." The Tribunal was quick, however, to limit any generalizations from its holding on the facts: "In so finding we should not be taken to conclude that in all factual situations the NCOB exception is limited to a consideration of what may be in the necessary course of the issuer's business." In so doing, the Tribunal left the door open to a finding that selective disclosure may be defensible where made in the necessary course of the tipper's business, although caution is recommended until the limits of this opening have been tested in further decisions.

Factors to Consider

While the Tribunal noted that it would not be appropriate to identify a comprehensive set of factors relevant to establishing the NCOB exception in all cases, it did agree that in appropriate circumstances all or some of the following factors may be important considerations: the business of the issuer; the relationship between the tipper and the issuer; the relationship between the tipper and the tippee; the nature of the MNPI that was disclosed; the relevance of the MNPI to the relationship between the tippee and the issuer (that is, whether the nature of the relationship between the tippee and the issuer necessitates the disclosure of the MNPI in question); the tipper's reason for making selective disclosure to the tippee; and the credibility of the tipper seeking to establish the NCOB exception.

Process Matters

The Tribunal noted that, while it is not a precondition to availing oneself of the NCOB exception that one establish that one turned one's mind in advance of the disclosure to the question of whether it is being made in the NCOB, evidence that the tipper has considered the issue up front may "certainly be helpful" to establish after the fact the purpose for which the disclosure was made and whether that purpose was in the NCOB. In that respect, the Tribunal noted that such evidence might include: evidence of discussions at the board or management level considering the advisability or need for the selective disclosure; documents (e.g., retainer agreements, minutes, memos or other communications) specifying the purpose for making selective disclosure; and confidentiality agreements with or confidentiality instructions to the intended recipient of the selective disclosure or instructions to the intended recipient of the selective disclosure.

NCOB Exception Is To Be Established Objectively

Kraft argued that the determination of whether the NCOB exception was properly invoked by an alleged tipper should be made using a subjective/objective standard. Specifically, he argued that the Tribunal should assess whether the tipper had a subjective belief in the necessity of the disclosure and whether that subjective belief was objectively reasonable. The Tribunal rejected this approach, concluding that whether disclosure is made in the NCOB must be determined on an objective basis; the tipper's subjective belief regarding necessity, even if held honestly and in good faith, is insufficient.

Whose Burden Is It To Prove The NCOB Exception?

The Tribunal found that, while OSC Staff bear the burden of establishing the elements of the tipping prohibition (i.e., special relationship person and the selective disclosure by that person to another of MNPI), the tipper bears the burden of establishing that the NCOB exception has been made out on the facts.

Kraft Did Not Tip Stein in The Necessary Course of WeedMD's Business

Applying the foregoing principles, the Tribunal concluded that Kraft had not demonstrated that his communications to Stein were in the necessary course of WeedMD's business. While Kraft had a good faith business reason for disclosing the information to Stein – "namely, his personal desire to have the benefit of his long-time friend and business colleague providing thoughts and input as a second set of eyes – that personal business reason was not equivalent to selective disclosure made in the necessary course of WeedMD's business."

The Tribunal concluded that "Kraft was not seeking any necessary or otherwise unavailable commercial real estate experience for WeedMD" in providing the draft documents to Stein. This was supported by its findings that Kraft did not suggest that WeedMD management retain an external consultant to provide commercial real estate advice or take steps to enquire whether the advice being provided by external counsel was sufficient. The documents on which Kraft wanted Stein to comment had already been heavily

negotiated by management and WeedMD's counsel – Kraft's late-in-the game decision to solicit Stein's views was Kraft's alone and for reasons specific to Kraft:

> The thrust of Kraft's submission — namely that anything Kraft might characterize after the fact as important to him to allow him to get personally comfortable with the transaction equates to something in the necessary course of WeedMD's business — is also a construct that we do not accept.

Because the analysis of the application of the NCOB exception is objective, the Tribunal held that Kraft was unable to rely on the argument that he himself believed his correspondence with Stein was in the NCOB. Further, the Tribunal doubted that Kraft had even turned his mind to whether he could rely on the exception. This absence of consideration, taken together with the fact that Kraft's disclosure to Stein was not cleared in advance by management and that Stein had not been formally retained by WeedMD, were significant factors to the Tribunal in reaching its conclusion.

Utility of Formal Arrangements and Confidentiality Protections

Might the outcome in *Kraft* have been different had Kraft involved others at WeedMD in the decision to share the draft documents with Stein and had WeedMD retained Stein at the relevant time under a consulting or similar agreement with appropriate provisions to guard against insider trading and tipping? The Tribunal confirmed that entering into a confidentiality agreement in connection with making selective disclosure is neither necessary nor a precondition to being able to establish the NCOB exception; however, it notes that "entering into such an agreement ... is certainly potentially relevant to the question of whether the selective disclosure is being made in the necessary course of business."

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