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Context is Crucial — *Miller v FSD Pharma Inc.*

In the recent case of *Miller v FSD Pharma, Inc.*, [1] the Ontario Superior Court of Justice clarified the standard for materiality in a motion for leave to commence an action under s. 138.3 of the *Ontario Securities Act* ("***OSA***") for misrepresentations by a responsible issuer in secondary market disclosure.

Miller stands for the proposition that, in securities law, the context of financial disclosure is crucial and will be considered by the courts in determining the market impact of misleading statements. Securities law practitioners are likely aware that investors need to be able to see and digest relevant information. If negative information is buried in a footnote to financial disclosure, as happened here, that will not be sufficient to provide notice to the market. If that negative information is later put into context and the price of an issuer's securities drop, there will be recourse for investors.

The defendant, FSD Pharma, Inc. ("**FSD**") was a new entrant in the cannabis production space. FSD needed to build a facility to grow its cannabis, and to generate income by selling it. The production facility was supposed to be "the world's largest cannabis indoor hydroponic grow operation."

In March 2018, FSD entered into a joint venture with Auxly Cannabis Group Inc. ("**Auxly**"). Auxly was to be responsible for financing, designing, and building the production facility. In September 2018, FSD announced Auxly's $7.5 million equity investment at a 32% premium, which was intended to fund the construction. A press release indicated the project was "currently underway" and that Auxly's president was "happy with the construction progress." Things looked rosy for FSD and for investors.

With these facts as the backdrop, FSD issued its third quarter Management Discussion and Analysis ("**MD&A**") dated November 29, 2018, stating that:

> **[FSD] expects the first phase construction [of the production facility] to be completed and ready for Health Canada approval by the end of December 2018.** Pending regulatory approval the Company expects to plant the first harvest in the first phase by the end of January 2019.
>
> [*Emphasis added*]

Though FSD represented to investors that construction was on schedule, it would later be revealed that the project was falling apart on financing and construction, and the joint venture with Auxly was deteriorating. Accordingly, the plaintiff's Statement of Claim alleged that FSD misrepresented material facts in a core document.

The plaintiff pleaded the misrepresentation was corrected some six weeks later in a press release dated January 8, 2019. Within a footnote to what the court described as a "distractingly positive" press release entitled "FSD Pharma Completes Harvest and Passes Analytical Testing of Second Lot", the defendant advised the construction project would "be completed in 2019", a year

late. This was objectively bad news given that FSD's profitability, and its ultimate success as a business, was contingent on building a facility to grow cannabis. Yet, remarkably, the price of shares rose by 27.6% the following day.

While the initial correction did not negatively affect the price of FSD's shares, the plaintiff argued that follow-up news releases of February 6 and 7, 2019, revealed the broader context of the statement regarding the delayed construction project. These later news releases announced, among other things, the replacement of FSD's CEO and termination of the joint venture with Auxly. After their issuance, the price of the FSD's shares swiftly plummeted by roughly 20%.

On the motion for leave, FSD argued that the lack of immediate market impact suggested the construction timeline was not material to investors. FSD's shareholders were in it for the long haul, as evidenced by the market's reaction the next day — the price of shares went up. Quite oppositely, the plaintiff argued that, regardless of the lack of immediate effect, the construction delay was a "material fact that would be considered important to the reasonable investor" and this alone satisfied the test for leave. The court's analysis therefore focussed on the issue of whether the misrepresentation was "material" or not, and the applicable legal test to determine that issue.

The court observed that a material fact, for the purposes of a s. 138.3 claim, is defined in two places: s. 1(1) of the *OSA*, and Form-51-102F1 (which circumscribes the manner in which a company's MD&A is to be prepared). The statute's approach to materiality sets out a market impact standard, while the Form sets out a less onerous "reasonable investor" standard. The court had to decide which of these applied.

Justice Morgan held that, in Ontario, our legislature made a policy choice set out in the governing statute. In defining a material fact, s. 1(1) of the *OSA* states that a:

> "material fact", when used in relation to securities issued or proposed to be issued, means a fact that would reasonably be expected to have a significant effect on the market price or value of the securities.

Accordingly, the market impact standard applies in Ontario. This presented a problem for the plaintiff because, as set out above, the evidence suggested there was no immediate market impact following the release of the pleaded corrective disclosure.

The issue ultimately turned on context. Citing *Cornish v Ontario (Securities Commission)*,[2] Justice Morgan indicated that "materiality is a highly contextual issue that . . . appl[ies] statutory obligations to a particular company in the context of its industry and market."[3] Looking at the corrective disclosure, His Honour observed it was "all but hidden" in the January 8, 2019 press release. The statement was "as physically unobtrusive as could be — one had to literally read the 'fine print' to even see it let alone to register its significance." Moreover, on its own, the corrective could have been a reference to myriad *de minimus* things like a scheduling adjustment or a supply delay.

Any market impact analysis therefore had to take account of the context of the misrepresentation, interpreted in "accord with the investor protection purposes of [the *OSA* and other analogous legislation]."[4] In considering the corrective disclosure combined with the later news releases, His Honour found "the market impact of delay in the project [could now be] understood as part of the deterioration of the . . . [joint venture] relationship", a very serious matter for investors which was reflected in the drop in the price of FSD's securities.

To make matters worse, the court observed that FSD knew the project was not proceeding as scheduled when it issued its Q32018 MD&A, eliminating its ability to advance a reasonable investigation defence. The day before the MD&A was released, FSD's president emailed Auxly to confirm certain details with respect to timeline for completion of the construction project. To put it mildly, Auxly's response suggested things were in crisis: " . . . we're drinking from a firehose right now. As soon as we have something good I'll give you the heads-up."[5] Despite this being FSD's only information, and rather than conducting any further due diligence, it proceeded to issue disclosure stating that the project was proceeding according to schedule.

The takeaway here is that companies cannot and should not try to be tricky when it comes to their financial disclosure. To quote another relevant decision from the Ontario Court of Appeal, "disclosure obligations are not a shell game where investors

are left to guess where the truth lies."[6] Disclosure ought to be full, frank, and fairly presented. Though on a strict reading of the case law, there was no immediate market impact upon the release of the pleaded corrective — once that disclosure was contextualized there was a significant market impact. Words don't have meaning until they are embedded in context, and bad news will not be taken as bad news until it is understood.

Footnotes

* Steven London has practiced securities and corporate law for over 20 years, currently as the principal of LONDON Business and Securities Law. Steven provides regulatory and legal advice to public and private investment funds and securities industry registrants, in addition to carrying on an M&A practise focused on small and mid-sized businesses. Steven has also served as a Chief Compliance Officer for 10 years. In addition to his law degree, Steven holds an MBA from Ivey Business School at Western University.

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1 *Miller v. FSD Pharma, Inc.*, 2020 ONSC 4054, 2020 CarswellOnt 10252 (Ont. S.C.J.) ["*Miller*"].

2 *Cornish v. Ontario (Securities Commission)*, 2013 CarswellOnt 3012, 2013 ONSC 1310 (Ont. Div. Ct.) ["*Cornish*"].

3 *Ibid* at para 51.

4 *Sharbern Holding Inc. v. Vancouver Airport Centre Ltd.*, [2011] 2 S.C.R. 175, 2011 CarswellBC 1102 (S.C.C.) at para 116.

5 *Miller v. FSD Pharma, Inc.*, 2020 ONSC 4054, 2020 CarswellOnt 10252 (Ont. S.C.J.) at para 30.

6 *Rahimi v. SouthGobi Resources Ltd.*, 2017 ONCA 719, 2017 CarswellOnt 14438 (Ont. C.A.).