

BEWARE OF A POTENTIAL NEW DUTY OF CARE FOR INVESTMENT FUND MANAGERS - SIX TAKEAWAYS FROM *WRIGHT V. HORIZONS*

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A recent decision of the Ontario Court of Appeal (COA), [Wright v. Horizons ETFs Management \(Canada\) Inc.](#) (*Horizons*), has been the subject of much discussion in the investment funds and asset management industry. The COA decision opens the door to potentially establishing a novel common law duty of care for investment fund managers. It also held that investors in exchange-traded funds (ETFs) can launch claims of misrepresentations in a prospectus using the “primary market” civil liability regime under Section 130 of the *Securities Act* (Ontario) (*Securities Act*). This is noteworthy because investors typically do not know whether or not they purchase units of ETFs in the primary or secondary market when they make purchases over a stock exchange.

The matters considered in *Horizons* raise many complicated issues for debate. This bulletin highlights key facts of the proceedings thus far and outlines six takeaways for the industry to consider as we wait for further developments.

A BRIEF OVERVIEW OF THE CASE

The Horizons Fund

Horizons involved a highly complex ETF (the Horizons Fund), designed to provide inverse exposure to stock market volatility (as represented by the daily performance of the S&P 500® VIX Short-Term Futures Index). Its investment strategy involved daily rebalancing and, like many ETFs, was passively managed. Depending on market volatility, the cost of rebalancing could erase gains accrued over months or years in one trading day. The prospectus of the Horizons Fund explicitly cautioned that investors should monitor their investment on a daily basis and that a substantial portion of all money invested in the fund could be lost. On February 5, 2018, the Horizons Fund lost over 81% of its value overnight and investors who bought units on that day purchased those units at inflated prices. The Horizons Fund never recovered and was subsequently terminated. In the press release announcing the termination, Horizons ETFs Management (Canada) Inc. (the Manager) stated that it did not want to offer a product that had the “potential to lose the majority of an investor’s capital in such a

short period of time” and that the fund “no longer offer[ed] an acceptable risk/reward trade-off for investors”.

The Claims – Negligence and Misrepresentations

A class action was commenced by a representative investor, Wright, in the Horizons Fund. Wright had sold his units of the Horizons Fund on February 6, 2018 and lost approximately \$210,000 in doing so. Wright claimed common law negligence and misrepresentations in a prospectus under the “primary market” civil liability regime under Section 130 of the *Securities Act*. It is important to note that neither the lower court nor the COA decision evaluated the merits of the allegations, but, rather, both considered certification of the class action.

Wright’s statement of claim outlined:

- A Negligence Claim – alleging the Manager breached its duty of care in its creation, marketing, and management of the Horizons Fund.
- A Misrepresentations Claim – alleging the Manager failed to fully and adequately disclose the risks of the Horizons Fund’s investment strategy, along with its valuation methods, including that the intra-day trading value could be inaccurate and that its value could drop precipitously after the close of the trading day.

Specifically, the negligence claim alleged that the Manager breached its duty of care by:

- designing and developing a fund it knew or ought to have known was excessively complex, risky, and “doomed to fail”;
- offering and promoting the Horizons Fund to retail investors knowing it contained structural design flaws, including exposure to risk of catastrophic losses, and lacked a coherent investment thesis, offering unreasonable risk/reward trade-offs to investors;
- failing to adequately explain the nature and extent of the risks involved in investing in the Horizons Fund; and
- failing to exercise its powers as manager to mitigate risks and losses to investors.

Purchases of ETF Securities – The Primary Market versus the Secondary Market

Units of ETFs can only be purchased by an investor over a stock exchange through brokers and dealers, and not directly from the issuer. An investor’s purchase of ETF securities on a stock exchange are purchases of either:

- treasury securities subscribed for the first time through a broker or dealer through a continuous distribution agreement, constituting “primary market” purchases (termed “creation units” in Horizons); or
- ETF securities that have already been in circulation (either from a broker’s or dealer’s inventory of units or

from other holders through a broker or dealer), constituting “secondary market” purchases.

Both types of ETF securities exist on the relevant stock exchange and, as the Ontario Superior Court of Justice pointed out, are comingled. The COA noted that it was not clear, on the evidence before the court, whether the manager, dealers, or any other person was able to distinguish between sales of “creation units” and previously issued units of the Horizons Fund.

The Ontario Superior Court of Justice Decision

In hearing the case, the Honourable Justice Perell of the Ontario Superior Court of Justice dismissed the motion for certification of the class action and Wright's claim.

Specifically:

- On the negligence claim, the lower court held that no cause of action in negligence could be made as the Manager had met its undertaking to investors in offering a financial product that performed in accordance with its disclosure documents, and, in any event, policy reasons discouraged further extending the Manager's duty of care as argued by the plaintiff.
- On the misrepresentations claim, the lower court held that the action could not proceed using the “primary market” civil liability regime under Section 130 of the *Securities Act* because the Horizons Fund was offered over a stock exchange (the secondary market), and not directly to investors (the primary market). Instead, the claim should have been made using the “secondary market” civil liability regime under Section 138.3 of the *Securities Act*.

Claims under Section 130 of the *Securities Act* are advantageous to claims under Section 138.3 of the *Securities Act*, as the latter type of claim requires permission to proceed, is capped on recoverable damages, and the losing party in the proceeding will be responsible for the costs of the other party.

The Court of Appeal Decision

The COA granted the appeal, in part, holding that the lower court erred in concluding that the claim disclosed no reasonable cause of action, and remanded the case back to the lower court for a decision with respect to the remaining certification factors.

In rendering its decision, the COA assumed all allegations of fact pleaded to be true.

The COA's legal analysis of the negligence claim is complex. The negligence claim was for pure economic loss. This is different from negligence claims involving physical harm or damage to property. In fact, there is debate in the legal community on whether or not claims for pure economic loss should be permitted (for reasons outside the scope of this bulletin).

In brief, there are two parts to the legal analysis for claims for pure economic loss:

1. The court must determine if the claim fits within or is analogous to a previously recognized duty of care.
2. If the answer to the first inquiry is no, the court must be convinced to recognize a novel *prima facie* duty of care and, if so recognized, the court must then evaluate whether there are policy reasons that would negate the imposition of the duty of care (including evaluating other remedies available or whether unlimited liability would be created for an unlimited class).

The COA found that it was not plain and obvious that the negligence claim was doomed to fail with respect to both parts of the analysis as outlined above. The court held that the negligence claim in *Horizons* could fit within a recognized duty of care: negligent performance of a service. It went further to state that even if it was incorrect, a novel *prima facie* duty of care for the negligent performance of a service could be recognized, and it was not “plain and obvious” that such duty should be negated by policy considerations.

In finding that a novel *prima facie* duty of care could be recognized, the COA focused on the Manager’s statutory duty to act honestly, in good faith, and in the best interests of the investment fund and to exercise the degree of care and diligence that a prudent person would exercise in the circumstances. The COA pointed to the Manager’s failure to provide full disclosure of the risks and/or the fact that the Horizons Fund was doomed to fail, coupled with its failure to develop a viable strategy for the Horizons Fund, as potential breaches of this duty of care.

On the misrepresentations claim, the COA disagreed with the lower court that all members of the class should be considered secondary market purchasers and held that some members could have purchased “creation units”. However, the statement of claim did not contain all the necessary pleadings required to properly bring an action under Section 130 of the *Securities Act* and, therefore, the plaintiff was granted leave to amend the statement of claim accordingly.

SIX TAKEAWAYS

1. This Was Not a Consideration of the Merits of the Case

As mentioned above, the COA did not opine on the merits of the case, and, therefore, the application of the COA’s findings to the development of the law is currently unknown. The test required to be met on a certification proceeding for a class action has a low threshold. The COA’s decision only considered whether the claim could be proven, assuming all facts pleaded were true, and whether it was “plain and obvious” that the claim could not succeed; in other words, whether there was a radical defect with the claim.

Accordingly, a *prima facie* duty of care for investment fund managers has not been established by the COA decision; rather, the door is now open for such a duty of care to be established. Notably, an evaluation of the

merits of the case may find that overriding policy reasons should negate establishing this *prima facie* duty of care. Therefore, we must wait for further jurisprudence on this matter to see if this novel duty of care is indeed established and the practical effect of that.

2. Disclosure is Important

Irrespective of what happens with these proceedings, disclosure always has been, and will remain, important. In addition to ensuring that a fund's disclosure documents are detailed, comprehensive, and avoid boilerplate language, the following points raised in *Horizons* can be considered when reviewing disclosure documents, particularly for complex funds:

- Are the valuation methodologies for the calculation of the fund's net asset value atypical and do they require additional and specific disclosure?
- Does the fund's design and trading strategy present unique or unusual risks that may not be expected or understood by an "average" retail investor and should be explicitly disclosed?
- Is the fund only appropriate for certain investors who can understand or appreciate a complicated trading strategy, and, if so, how can this be clearly communicated in the fund's disclosure documents?
- Is there a disparity in the way gains and losses are experienced by the fund (e.g., incremental gains versus rapid losses)? Can the fund's value significantly drop in a short period of time and are the risks adequately disclosed? Do investors have a reasonable opportunity to exit the fund?

It is interesting to note that the disclosure documents of the Horizons Fund explicitly referenced unusual, specific risks applicable to the fund. These risks included a warning to investors that, historically, the index had experienced significant one day increases on days when equity markets had large negative returns which, if repeated, could cause the fund to suffer substantial losses. The prospectus further contained disclosure that the use of derivatives could quickly lead to large losses as well as large gains, which losses could "sharply" reduce the value of the fund. There was a statement that the fund was "intended for use in daily or short-term trading strategies by sophisticated investors". The statement of claim alleged the fund's disclosure was inadequate. As noted above, until there is a hearing on the merits, it is unknown whether the courts would agree, but, in the meantime, fund managers may wish to review and potentially enhance their funds' disclosure documents with these allegations in mind.

3. Warning – Disclosure May Not Be Enough

Perhaps the most notable finding of the COA is the suggestion that an investment fund manager's duty of care may require "more" than just creating and managing an investment fund that operates and performs exactly as described in its disclosure documents. Creating a fund that is not suitable for "any" investors because it has

a “design flaw” rendering it “doomed to fail” is described by the COA as potentially constituting a breach of a fund manager’s duty of care. It seems unlikely that the majority of investment funds would be considered to have a “design flaw” rendering them “doomed to fail”. However, the question remains: are there other types of “design flaws” that could constitute a breach of this duty of care?

Even more importantly, the COA’s decision opens the door to the possibility that “perfect” disclosure is not enough. Depending on how the jurisprudence on this develops, fund managers may wish to make an assessment of the “designs” of their funds, including:

- How does the fund perform under a variety of market conditions and what factors impact performance?
- Will only sophisticated investors understand the fund’s performance variables?
- Does the fund present an “acceptable risk/reward trade-off for investors”?
- Does the fund have inherent risks that could render it unsuitable for “all” investors and open to allegations that it is “doomed to fail”?
- Are the investment strategies of the fund too complex or do they present risks rendering the fund unsuitable for passive management?

Unfortunately, how to practically and meaningfully address the results of any such assessment is difficult, especially until the jurisprudence further develops.

4. Reconsider what Passive Management Means

The plaintiff alleged in *Horizons* that the Manager had a positive duty to take action in response to declining and volatile markets, despite the fact that the Horizons Fund, like many ETFs, was passively managed. If this allegation is ultimately accepted, fund managers and possibly portfolio managers could face potential liability for failing to take positive action to mitigate losses in certain conditions. Practically, this may mean a manager may have to call the stock exchange to halt trading in certain circumstances or take steps to actively manage the investments of an ETF. This could fundamentally shift how passive funds are managed. Consider how such an obligation could impact management of passive funds during extreme circumstances, such as the COVID-19 pandemic. Managers of passive funds will likely want to keep careful watch on how this issue develops.

5. The Primary Market vs. the Secondary Market

The misrepresentations claim in *Horizons* focused on whether the claim could proceed using the “primary market” civil liability regime under Section 130 of the *Securities Act* relating to sales of ETF securities. As outlined above, the type of claim a potential plaintiff can pursue hinges on the type of ETF securities purchased, which is problematic because investors typically do not know what type of ETF securities they have

purchased.

Horizons is significant because the COA found that, despite this difficulty, Section 130 of the *Securities Act* can apply to purchases of ETF securities. It will likely be challenging to show whether an investor purchased “creation units” as opposed to units already existing in the secondary marketplace and to address the fact that not all investors who wish to participate in the class action may have purchased “creation units”. The COA noted that these determinations would be addressed in the course of the litigation, but not much guidance was given outside of that.

Aside from the potential of increasing the number and types of future misrepresentations class actions that may be commenced against ETFs, the *Horizons* decision raises practical considerations that industry participants may wish to consider further. For example, is there a practical way of identifying purchases as being on the primary or secondary market? If so, can or should investors have any control over how purchases are made? If given the choice, an investor would likely wish to purchase on the primary market for the reasons noted above.

6. Suitability May be Worth a Thought (Not Just for Dealers)

Another complex allegation in *Horizons* was that the Manager was liable for creating a fund that was not suitable for “any” investor. If accepted, this could be taken to mean that fund managers have some type of suitability obligation to investors. The imposition of such an obligation, if ultimately affirmed, could have significant implications for the industry, and could raise a number of difficult questions:

- How would such an obligation be limited? Would liability only be imposed if a fund manager created a fund that is not suitable for “any” investor?
- How would such an obligation of the fund manager complement or supplement other registrants’ suitability obligations?
- If a fund’s disclosure documents clearly disclose that the fund is only suitable for a certain type of investor, who would be responsible if an investor that does not meet the disclosed qualifications ends up investing in the fund? What steps could industry participants take to mitigate these potential risks?
- Would saddling registrants with new suitability assessments paralyze the creation of innovative products? Could this result in investors having less choice in selecting financial products in the future?

These takeaways aim to highlight the potential far-reaching implications this decision could have on the industry. Not only could investment fund managers be subject to new duties, obligations, and potential liabilities, these changes could impact how investment fund managers create products, interact with other industry participants, and seek to fulfil investor expectations. Unfortunately, at this point, *Horizons* raises more

questions than it answers. However, the Manager appears to be pursuing an application for leave to appeal this case to the Supreme Court of Canada, so more clarity may be provided in the future. We will keep you apprised of any further jurisprudence on the important questions raised by this case.

Please contact any member of the Investment Funds and Asset Management Group at McMillan LLP for more information.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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