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THE CASE CONTINUES: *WRIGHT V HORIZONS* AND THE DRAFT *CAPITAL MARKETS ACT*

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In an earlier publication, "Beware of a Potential New Duty of Care for Investment Fund Managers – Six Takeaways from *Wright v Horizons*", we discussed the Ontario Court of Appeal's (the "**ONCA**") decision in *Wright v Horizons ETFS Management (Canada) Inc.* ("***Horizons***") in which the court opened the door to a potentially new common law duty of care for investment fund managers and flagged the practical challenge in identifying the character of units of exchange-traded funds ("**ETFs**"). There have been new developments since the ONCA decision, certain of which are summarized in this bulletin:

1. In subsequent proceedings, the Ontario Superior Court of Justice (the "**ONSC**") confirmed that neither of the statutory civil liability routes under the *Securities Act* (Ontario) ("**OSA**") is available, in any practical sense, to investors in ETF units in the context of class action proceedings, leaving the ability for ETF purchasers to bring statutory civil liability claims under the OSA "in a problematic and uncertain state".
2. As part of its goal to modernize securities regulation in the Province of Ontario, and building on the recommendations of the Capital Markets Modernization Taskforce released in January of 2021, the Ministry of Finance requested stakeholder feedback, in connection with its draft *Capital Markets Act* ("**CMA**"), on what causes of action under the OSA, if any, should apply to the acquisition of ETF securities. The CMA was introduced to replace existing securities legislation in the Province of Ontario, though it is unlikely to become law anytime soon.
3. In subsequent proceedings, the ONSC certified the class proceeding for the claim in common law negligence, continuing the possibility that a new common law duty of care may be established for investment fund managers.

Background - *Wright v Horizons* in a Nutshell

The *Horizons* case presented a variety of novel issues that sparked much debate. A summary of the facts is below with a more fulsome description at the end of this bulletin:

- A highly complex ETF (the "**Horizons Fund**") lost over 81% of its value overnight and never fully recovered. Subsequently, the Horizons Fund was terminated and investors lost substantially all their investments

- The prospectus of the Horizons Fund contained disclosure regarding certain risks of investing
- A class action was commenced by a representative investor, Mr. Wright, who held units in the Horizons Fund
- The primary causes of action were:
  - a common law negligence claim, alleging the fund manager breached its duty of care in its creation, marketing, and management of the Horizons Fund; and
  - a claim of misrepresentation under the Primary Market Liability Regime (described below), alleging misrepresentations in the prospectus of the Horizons Fund
- In the first instance, the ONSC[1] dismissed the motion for certification of the class action holding there was no cause of action in negligence and that the action could not proceed using the Primary Market Liability Regime because units of the Horizons Fund were offered over a stock exchange (i.e., the secondary market)
- On appeal, the ONCA[2] held that the lower court erred in finding no cause of action in negligence and remanded the case back to the lower court for a decision with respect to the remaining certification factors. With respect to the civil liability claim, the ONCA disagreed that all members of the class should be considered secondary market purchasers. The ONCA granted leave to the plaintiff to amend the statement of claim as the ONCA found that the statement of claim did not contain all the necessary pleadings to properly bring an action under the Primary Market Liability Regime
- The case was further appealed to the Supreme Court of Canada, which denied leave to appeal without reasons[3]
- The case was remitted back to the ONSC, where a second class action certification could proceed following the holding of the ONCA
- The ONSC's decision with respect to Mr. Wright's second attempt at a class action certification (the "**Second Decision**")[4] certified the class proceeding for the common law negligence claim and refused to certify the claim under the Primary Market Liability Regime on the basis that ETF securities are not individually identifiable, making it impossible for the court to identify a class capable of being certified for a claim under such regime

It is worthy to note that, to date, the courts have only considered certification of the class action, and matters raised on appeal of these decisions – *not* the merits of the allegations. A recent update disclosed that the class action is in the discovery process and that no court date has been set. Investors have until July 4, 2022 to opt out of the class action.

1. The Challenges of the Statutory Civil Liability Regime with Respect to Units of ETFs

Currently, the OSA has two statutory civil liability routes:

1. **Primary Market Liability Regime**: Section 130 of the OSA contains the civil liability regime for misrepresentations under a prospectus, available to investors who acquired securities distributed under the prospectus by the issuer. A prospectus is an informational document that qualifies securities for distribution in the relevant provinces and territories of Canada.
2. **Secondary Market Liability Regime**: Section 138.3 of the OSA contains the civil liability regime for secondary market disclosure in which a responsible issuer – defined in the OSA as a "reporting issuer", or any other issuer with a real and substantial connection to Ontario whose securities are publicly traded – releases a document containing a misrepresentation and a person who acquires or disposes of an issuer's securities while the misrepresentation remains uncorrected can claim damages against the responsible issuer (among other enumerated persons).

The availability of the Primary Market Liability Regime or the Secondary Market Liability Regime hinges on the type of securities purchased – either treasury securities (which are newly created) issued by the issuer to investors in the primary market, or previously issued securities purchased from another investor in the secondary market. In *Horizons*, the courts coined the term "Creation Units" to refer to "primary market" securities of the Horizons Fund.

The Primary Market Liability Regime is considered more advantageous to purchasers because, unlike the Secondary Market Liability Regime, there are no permissions required for claims to proceed, no cap on recoverable damages, and the losing party in the proceeding is not responsible for the costs of the other party.

Throughout the *Horizons* proceedings, the ONSC and ONCA repeatedly discussed the difficulties in determining if investors had purchased "Creation Units" or whether purchased units were in circulation in the secondary market already. In its Second Decision, the ONSC ultimately held that "ETF units are not individually identifiable… No one who purchases ETF units over an Exchange can determine if they are receiving a Creation Unit, or an ETF unit that has been in circulation previously." Ultimately, the Court felt that this designation challenge made it impossible to identify a class capable of being certified for a claim under the Primary Market Liability Regime.

The Court further remarked in *obiter* that "the law about the Ontario *Securities Act*'s statutory causes of action about the distribution of ETFs [is] in a problematic and uncertain state. The problems may require legislative initiative to resolve. … The paradox is that for purchasers of ETFs, it cannot be determined whether or not their ETF unit is a Creation Unit. … Thus, the problem in the immediate case is that no two Class Members can identify themselves as subject to either [the Primary Market Liability Regime or the Secondary Market Liability Regime]."

This is not the first time a potential gap has been identified in securities legislation, nor will it be the last,

especially as new technologies and innovations continue to disrupt the market.

2. The CMA Consultation

The challenges identified in *Horizons* present interesting circumstances so it was unsurprising that the Ministry of Finance included in the CMA consultation specific questions on how the statutory liability regime should apply to ETF units. Specifically, the consultation sought feedback on the following (in addition to other related questions):

- Consideration as to whether there are any ETF statutory causes of action options that would be more appropriate for Ontario capital markets than the Secondary Market Liability Regime or the Secondary Market Liability Regime supplemented by certain rights found in the Primary Market Liability Regime; and
- If it is believed that secondary market rights supplemented by prospectus rights would be more appropriate for the Ontario capital markets, identification of the prospectus rights that persons or companies who purchased ETF units on an exchange should be deemed to have.

Submissions were received by the Ministry from 43 stakeholders, in addition to submissions from 10 individuals. Of the 43 submissions that are publicly available (submissions by individuals are not available for review), it appears that there is general hesitancy to treat ETF units and their purchasers any differently than other securities and investors. A breakdown of the commentary is provided below:

- 9 of the 43 publicly available submissions (21%) supported the Secondary Market Liability Regime as the appropriate remedy for ETF investors
- 3 of the 43 publicly available submissions (7%) supported the Primary Market Liability Regime as the appropriate remedy for ETF investors with varying reasons why
- 2 of the 43 publicly available submissions (5%) supported introducing secondary market rights supplemented by prospectus rights as the appropriate remedy for ETF investors

Interestingly, 29 of the 43 publicly available submissions (67%) did not specifically comment on the statutory liability regime as it relates to units of ETFs.

The issues flagged in *Horizons* highlight the tension that can arise between the judicial and legislative branches of government. In this circumstance, the courts flagged a gap in securities regulation and the Ministry of Finance swiftly responded as part of its effort to modernize securities regulation in Ontario. It is important that any changes in this area of the law is well reasoned, considered, and aimed at benefitting all the players and stakeholders in the Ontario capital markets.

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3. Certification of the Claim in Common Law Negligence

It remains worthy to note that, in addition to evaluating the statutory liability regime with respect to ETF units, the door remains open to potentially establishing a novel common law duty of care for investment fund managers.

The ONCA's previous decision loomed large over the ONSC's Second Decision. In regards to the common law negligence claim, Justice Perell wrote that "[t]he Court of Appeal held – comprehensively – that Mr. Wright had satisfied the cause of action criterion for his novel negligence cause of action." However, Justice Perell refused to say whether a new duty of care could or did in fact exist for fund managers, given that this was a class action certification motion; that is, not a decision on the merits of the case. Instead, Justice Perell left the matter to the trial judge. As he said: "[i]t may be that after a trial, a court will rule that there is no duty of care or that the duty of care is shaped in a particular way. The court will also have to address the other elements of a negligence cause of action, but all that is for another day".

Horizons is a remarkable case that continues to have potential far-reaching implications. Whether a novel duty of care is introduced in the future and, if so, its practical application to fund managers, remains to be seen. To introduce a new duty of care applicable to fund managers could fundamentally impact the frequency in which fund mangers create products and how innovative such products may be. Such a duty of care could increase the burden of enhanced disclosure on fund managers and potentially require fund managers to do 'more' than just creating and managing an investment fund that operates and performs as described in its disclosure documents. It may also impact how fund managers interact with other industry participants by shifting how investor protection responsibilities are allocated. It will be interesting to see if a novel duty of care is indeed established and what type of expectations will come along with fulfilling such duty of care, including how this might impact industry practices of Canadian registrants and innovation generally. In the event this matter proceeds to trial, more clarity may be provided. However, this matter may be settled out of court, leaving some of these questions for another day indeed.

Wright v Horizons – Detailed Summary of the Proceedings

Mr. Graham Wright was a unit owner in the Horizons Fund, which was managed by Horizons ETFS Management (Canada) Inc. (the "**Manager**"). The Horizons Fund itself was passively managed, and "was a highly complex derivative… ETF designed to provide inverse exposure to stock market volatility." In essence, the Horizons Fund's value was inversely tied to the S&P 500 VIX Short-Term Futures Index's (the "**VIX Futures Index**") performance. If the VIX Futures Index decreased in value, the Horizons Fund's net asset value increased by the same percentage. Conversely, if the VIX Futures Index increased, the Horizons Fund's net asset value decreased by the same amount.

The prospectus of the Horizons Fund contained a warning to investors that the investment was "highly speculative and involve[d] a high degree of risk", but failed to reference that the investment was inappropriate for certain investors. Investors were not able to determine with certainty whether they had purchased "Creation Units" ("primary market" securities) or units that had been in circulation previously ("secondary market" securities). This uncertainty was a problem for Mr. Wright; whether he bought treasury units or secondary markets units would inform which statutory civil liability route was available pursuant to the OSA.

Ultimately, the Horizons Fund lost most of its value on February 5, 2018 when the VIX Futures Index suddenly increased in value. On April 10, 2018, the Manager issued a press release stating it had "come to the conclusion that these ETFs no longer offer an acceptable risk/reward trade-off for investors" and the Horizons Fund was terminated on June 11, 2018.

Mr. Wright brought a class action claim against the Manager for negligence and for liability for a prospectus misrepresentation under Section 130 of the OSA, as described above. At the ONSC, Justice Perell dismissed the motion for certification of the class action. The ONSC held that there was no cause of action in negligence as the fund manager fulfilled all undertakings to investors: specifically, that the Horizons Fund offered a security that performed as stated in its disclosure documents. Moreover, due to public policy reasons, it was held that a fund manager's duty of care should not be extended. In regards to Mr. Wright's claim that there was a misrepresentation in the prospectus, the ONSC stated that the Horizons Fund was offered over a stock exchange, therefore the claim should have been brought under Section 138.3 of the OSA (the secondary market civil liability regime), not Section 130 of the OSA.

On appeal, the ONCA overturned the ONSC's decision, in part. The appeal court held that Mr. Wright's negligence claim could fit within a recognized duty of care (the negligent performance of a service), or may even be an instance where a new *prima facie* duty of care for the negligent performance of a service could be recognized. As to Mr. Wright's misrepresentation claim, the ONCA held that there may have been some unit holders who held Creation Units and, as such, Mr. Wright was allowed to amend his pleadings to properly bring an action under Section 130 of the OSA – his current pleadings did not state the material facts necessary to establish such a cause of action.

Facing a potential new class action stemming from the ONCA's ruling, the Manager appealed to the Supreme Court of Canada. In a very short decision without reasons, the Supreme Court denied leave to appeal. As such, Mr. Wright's matter was remitted back to the ONSC, where a second class action certification could proceed following the authority of the ONCA.

On May 3, 2021, the ONSC released its decision regarding Mr. Wright's second attempt at a class action certification. In the end, Justice Perell certified the class proceeding for Mr. Wright's claim in common law

negligence. However, he refused to certify the claim under the Primary Market Liability Regime because of the inability to identify the genesis of the units of the Horizons Fund for each investor.

[1] 2019 ONSC 3827
[2] 2020 ONCA 337
[3] 2020 CanLII 102982
[4] 2021 ONSC 3120

by Leila Rafi, Jennie Baek, and Madeline Klimek (Articling Student)

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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