Ontario Court Dismisses Proposed Class Action Against ETF Fund Developer and Manager Over Failed High Risk Investment

October 17, 2019

In his recent decision in *Wright v. Horizons ETFS Management (Canada) Inc.* Justice Perell of the Superior Court of Justice explores whether a duty of care ought to be extended to the creators of exchange traded funds (ETFs) for alleged pure economic loss, and whether statutory claims under s. 130 of Ontario's *Securities Act* are available for misrepresentations in a prospectus associated with the selling of ETFs in the secondary market. An ETF is an investment vehicle where the underlying assets (stocks, bonds, or commodities) are pooled in an investment portfolio. The market price of an ETF is determined by the bid and ask of buyers and sellers on the stock exchange.

The plaintiff, who had lost significant investments after a complex derivatives-based ETF collapsed, had commenced a class action against the defendant ETF provider . The plaintiff alleged that the defendant breached a duty of care owed to investors and alleged a secondary cause of action under s. 130 of the *Securities Act* for misrepresentation in the primary market for securities.

The decision echoes the Supreme Court of Canada's statement (in *Deloitte & Touche v. Livent Inc. (Receiver of)*) that what a defendant reasonably foresees as flowing from his or her negligence depends upon the purpose of the defendant's undertaking. Perell J. also confirms that strong policy reasons exist for not extending a duty of care to the ETF investor/ ETF fund developer and manager relationship. Further, the decision underscores the importance of pleading all causes of action in support of a proposed class action, particularly where the issues are novel.

Background

The defendant created and managed a complex derivatives-based ETF that retail investors were entitled to purchase through stock exchanges (HIV-ETF). This was a high risk, speculative investment. The prospectus cautioned investors that ETFs are "not conventional" and are "speculative investment tools". The risk of loss was repeated throughout the prospectus and investors were advised to monitor their investments in an ETF daily.

Overnight on February 5, 2018, investors in the HVI-ETF lost almost their entire investment, totaling tens of millions of dollars. The plaintiff lost approximately $210,000 when he sold his units on February 6, 2018. He commenced a proposed class action seeking damages based on the capital loss experienced by the ETF, on behalf of himself and the proposed class. His primary cause of action was a common law negligence claim grounded in an argument that the defendant breached a duty of care owed to investors by, among other things, selling an ETF that had an investment strategy that was too risky to be passively managed. His ancillary cause of action was the statutory cause of action under s. 130 of the *Ontario Securities Act* for alleged misrepresentations in the primary market for securities. The plaintiff did *not* advance a statutory cause of action under the *Ontario Securities Act* in secondary market securities, nor did he allege a common law negligent misrepresentation claim.

Plain and Obvious That Wright ’s Causes of Action Could Not Succeed

The first criterion for certification that a plaintiff must satisfy under s. 5 of the *Class Proceedings Act, 1992* is that the plaintiff's pleading discloses a cause of action, in that it is not plain and obvious that it cannot succeed. Perell J. declined to certify the plaintiff’s action on the basis that it failed to disclose a reasonable cause of action.

1. Pure Economic Loss

The parties agreed that the plaintiff’s negligence claim was for pure economic loss (*i.e.* a financial loss arising in respect of the value of the units themselves and not a loss resulting from physical injury to the Class Members’ person or property).

The duties pleaded by Wright were unprecedented, however, and did not fit within the established categories in which plaintiffs can recover damages for pure economic loss. Perell J. therefore undertook a duty of care analysis to determine whether investment fund developers and managers owe investors a novel duty of care in the plaintiff’s circumstances.

Perell J. was reticent to extend the scope of duty of care this far. Perell J. found that there was no doubt that there was a legally proximate relationship between an ETF investor and an ETF fund developer and manager, but held that the relationship was limited by the undertaking assumed by the fund developer and manager. Here, the defendant did not warrant or guarantee returns, and it did not suggest that there was anything other than high risks associated with the ETF. It warned of the risks. Further, the defendant did not undertake to actively manage the ETF, nor did it undertake to step in, to stop investor losses.

Perell J. also found that there are policy reasons for not extending the scope of the duty of care to ETF fund developers and managers. This kind of relationship, which is essentially one between a vendor of a product and a disappointed purchaser, is typically dealt with as a matter of contractual obligation and not through a tort claim for pure economic loss. Moreover,

[e]xtending a duty of care for pure economic loss to the creator of an index tracking ETF would: (a) deter useful economic activity where the parties are best left to allocate risks

through the autonomy of contract, insurance, and due diligence; (b) encourage a multiplicity of inappropriate lawsuits; (c) arguably disturb the balance between statutory and common law actions envisioned by the legislator; and (e) introduce the courts to a significant regulatory function when existing causes of action, the regulators, and the marketplace already provide remedies (para. 107).

2. Section 130 of the *Ontario Securities Act*

Wright's claim was framed under Part XXIII, s. 130 (which provides for civil liability in respect of the primary market) and not under Part XXIII.1, s. 138.3 of the *Ontario Securities Act* (which provides for civil liability in respect of secondary market disclosure). ETFs are connected to the secondary market, which is regulated by Part XXIII.1 of the *Ontario Securities Act*. The only connection between ETFs and the primary market is that before an ETF can begin trading on a stock exchange, its manager must file a prospectus and the regulator must issue a receipt for the prospectus. However, for purchasers of ETFs units, for all practical purposes, they are trading in the secondary market. Consequently, Perell J. found that it was obvious that the statutory claim under s. 130 of the *Ontario Securities Act* was not available for misrepresentations in a prospectus associated with the selling of ETFs in a secondary market. Wright's claim ought to have been framed under s. 138.3 of the *Ontario Securities Act*, and he ought to have pleaded both causes of action in support of his proposed action given that this was a case of first instance about whether ETFs should be subject to Part XXIII or Part XXIII.1 of the *Ontario Securities Act*.

By

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