Why a recent ETF class action may prompt reform to the Ontario Securities Act

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In recent years, exchange traded funds have become a significant feature in the Canadian securities landscape. However, Ontario securities jurisprudence concerning ETFs remains at an early stage. The recent Ontario Superior Court of Justice decision in *Wright v. Horizons ETFS Management (Canada) Inc.*, 2021 ONSC 3120 (*Wright*) is an important development in the area that, in the court's own view, has the potential to prompt legislative or regulatory reform.

What you need to know

- In *Wright*, the Court refused to certify a primary market misrepresentation claim brought under the Ontario *Securities Act* (OSA) on behalf of a putative class of ETF unitholders because there was no identifiable class.
- In his reasons, Justice Perell of the Ontario Superior Court of Justice observed that the "hybrid regulation of ETFs" under both the OSA's primary and secondary market regimes places "the distribution of ETFs in a problematic and uncertain state" and poses "problems" for ETF class actions that "may require legislative initiative to resolve".
- This recent decision follows a 2020 decision from the Court of Appeal in the same case that made room for a potential new common law duty of care for investment fund managers.

Background: The initial certification hearing and successful appeal

In mid-2018, Mr. Wright commenced a proposed class action against Horizons, a company that designed, managed, and marketed an ETF whose value plummeted by nearly 90 per cent overnight in February 2018. Mr. Wright's primary cause of action was a common law negligence claim based on a theory of negligent design. Mr. Wright also advanced a claim for primary market misrepresentation pursuant to s. 130 of the OSA.

In 2019, Justice Perell dismissed Mr. Wright's motion for certification. Justice Perell held that the novel negligence claim did not disclose a cause of action and that the primary

market s. 130 OSA claim was not tenable because, “practically speaking, apart from the initial prospectus requirement, the trading in ETFs is a secondary market phenomenon.”

The Court of Appeal for Ontario overturned Justice Perell’s denial of certification. The Court of Appeal held that the negligence claim was potentially viable and granted Mr. Wright leave to amend his claim in order to allege that he had purchased undistributed “Creation Units,” which it held could form the basis for a s. 130 OSA claim.

The second certification hearing: 2021

After the Court of Appeal remitted the matter back to Justice Perell, he certified Mr. Wright’s negligence claim but refused to certify the s. 130 OSA claim. Justice Perell’s refusal to certify the s. 130 OSA claim hinged on the “identifiable class” criterion of the *Class Proceedings Act, 1992*.

Justice Perell observed that, at first blush, the class definition was satisfactory because it used objective criteria and was neither under-inclusive nor over-inclusive. However, on closer inspection, Justice Perell concluded that the method through which investors had acquired ETFs meant that there was “no basis in fact to show that two or more persons will be able to determine if they are in fact a member of the class.”

As Justice Perell noted, the ETFs purchased by putative class members had been acquired from brokers and dealers who had, consistent with industry practice, “co-mingled” Creation Units with ETF units that were in circulation previously. As established by the Court of Appeal’s decision, Creation Units are governed by the OSA’s primary market regime while previously distributed ETF units are governed by the OSA’s secondary market regime.

Justice Perell observed that “the paradox is that for purchasers of ETFs, it cannot be determined whether or not their ETF unit is a Creation Unit.” Without the ability to determine what kind of ETF units class members had acquired, Justice Perell held that there was no basis in fact to conclude that there were two or more class members with s. 130 OSA claims. As Justice Perell explained: “no two purchasers of Horizons’ ETF can prove that they purchased Creation Units. That is a problem of indeterminacy not a problem of overinclusiveness.”

In a “postface” to his decision, Justice Perell expressed concern about the “hybrid” regulation of ETFs and the inability of ETF unitholders to demonstrate the existence of an identifiable class. Justice Perell remarked that the combination of his decision and that of the Court of Appeal “leaves the law about the Ontario *Securities Act*’s statutory causes of action about the distribution of ETFs in a problematic and uncertain state,” suggested that Mr. Wright's necessary resort to a common law negligence claim that "takes the matter outside the Ontario *Securities Act*" is "a problem worth the attention of the Ontario Securities Commission or the Legislature."

Implications

It remains to be seen whether there will be any legislative or regulatory reforms addressing the concerns raised by Justice Perell. In the meantime, due to the difficulty of pursuing statutory OSA misrepresentation claims against ETF issuers, future class

proceedings may instead resort to creative common law causes of action such as the novel negligence claim advanced in *Wright*.

By

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