Court File No.
CV-18-00597284-00CP

ONTARIO
SUPERIOR COURT OF JUSTICE

BETWEEN:

GRAHAM WRIGHT

Plaintiff

and

HORIZONS ETFS MANAGEMENT (CANADA) INC.

Defendant

SUPERIOR COURT OF JUSTICE COUR SUPÉRIEURE DE JUSTICE JUSTICIA

Proceeding under the *Class Proceedings Act, 1992*

STATEMENT OF CLAIM

TO THE DEFENDANT(S):

A LEGAL PROCEEDING HAS BEEN COMMENCED AGAINST YOU by the Plaintiff. The Claim made against you is set out in the following pages.

IF YOU WISH TO DEFEND THIS PROCEEDING, you or an Ontario lawyer acting for you must prepare a Statement of Defence in Form 18A prescribed by the *Rules of Civil Procedure*, serve it on the Plaintiff's lawyer or, where the Plaintiff does not have a lawyer, serve it on the Plaintiff, and file it, with proof of service, in this court office, WITHIN TWENTY DAYS after this Statement of Claim is served on you, if you are served in Ontario.

If you are served in another province or territory of Canada or in the United States of America, the period for serving and filing your Statement of Defence is forty days. If you are served outside Canada and the United States of America, the period is sixty days.

Instead of serving and filing a Statement of Defence, you may serve and file a Notice of Intent to Defend in Form 18B prescribed by the *Rules of Civil Procedure*. This will entitle you to ten more days within which to serve and file your Statement of Defence.

IF YOU FAIL TO DEFEND THIS PROCEEDING, JUDGMENT MAY BE GIVEN AGAINST YOU IN YOUR ABSENCE AND WITHOUT FURTHER NOTICE TO YOU. IF YOU WISH TO DEFEND THIS PROCEEDING BUT ARE UNABLE TO PAY LEGAL FEES, LEGAL AID MAY BE AVAILABLE TO YOU BY CONTACTING A LOCAL LEGAL AID OFFICE.

IF YOU PAY THE PLAINTIFF'S CLAIM, and $0 for costs, within the time for serving and filing your Statement of Defence, you may move to have this proceeding dismissed by the

Court. If you believe the amount claimed for costs is excessive, you may pay the Plaintiff's claim and $0 for costs and have the costs assessed by the Court.

TAKE NOTICE: THIS ACTION WILL AUTOMATICALLY BE DISMISSED if it has not been set down for trial or terminated by any means within five years after the action was commenced unless otherwise ordered by the court.

Date MAY 4/2018 Issued by ______________________
Local Registrar

Address of court office: 393 University Avenue, 10th Floor
Toronto, Ontario
M5G 1E6

TO: Horizons ETFs Management (Canada) Inc.
55 University Avenue, Suite 800
Toronto, ON M5J 2H7

DEFINITIONS/GLOSSARY

1. In this Statement of Claim, the following terms have the following meanings:

a) "**CBOE**" means the Chicago Board Options Exchange;

b) "***CJA***" means the *Courts of Justice Act*, R.S.O. 1990, c. C.43, as amended;

c) "***CPA***" means the *Class Proceedings Act, 1992*, S.O. 1992, c. 6, as amended;

d) "**Class**" and "**Class Members**" mean any person who owned Units of HVI at the close of the TSX on February 5, 2018;

e) "**contango**" and "**backwardation**": contango means a situation where the price of the second month's underlying VIX Futures Contracts purchased by HVI were trading higher than the price of the nearer term VIX Futures Contracts. Backwardation is the opposite, where the nearer term VIX Futures Contracts were trading at a higher price than the second month's VIX Futures Contracts;

f) "**Defendant**" means Horizons ETFs Management (Canada) Inc.;

g) "**derivative**" means a security that is a contract between two or more parties that is reliant upon or derived from the value of an underlying asset or group of assets;

h) "**ETF**" means an exchange traded fund, which is an investment fund traded on a stock exchange that tracks an index, commodity, or basket of assets;

i) "**ETF Facts**" means the December 22, 2017 Final ETF facts for Units of HUV, HVI and HVU;

j) "**Horizons**" means the Defendant Horizons ETFs Management (Canada) Inc;

k) "**HUV**" means BetaPro S&P 500 VIX Short-Term Futures ETF;

l) "**HVI**" means BetaPro S&P 500 VIX Short-Term Futures Daily Inverse ETF;

m) "**HVU**" means BetaPro S&P 500 VIX Short-Term Futures 2x Daily Bull ETF;

n) "**investment fund**" or "**fund**" means HVI;

o) "***OSA***" means the *Securities Act,* R.S.O. 1990, c. S.5, as amended;

p) "**Plaintiff**" means the Plaintiff, Graham Wright;

q) "**Prospectus**" refers to the December 22, 2017 Final long form prospectus that offered Units of HUV, HVI and HVU, as well as any predecessor prospectus' in relation to HVI;

r) "**net asset value**" means the value of the assets of HVI, minus its liabilities. The net asset value per Unit of HVI is the net asset value divided by the number of then-outstanding Units;

s) "**Reference Index**" means the Horizons Short VIX Short-Term Futures Index, an index manufactured by Horizons which is intended to be an inverse index to the Underlying Index. The Reference Index was published by Bloomberg L.P. and Reuters at the close of each trading day;

t) "**roll yield**" is income (or loss) derived from the difference in price at which the second month's VIX Futures Contract is sold and the price at which the first month's VIX Futures Contract is purchased. The "roll" is the accumulation of income (or loss) over time. HVI generally collected roll yield when markets were in a state of contango;

u) "**S&P 500**" means the Standard & Poor's 500, which is an American stock market index based on the market capitalization of 500 large companies listed on the New York Stock Exchange or NASDAQ. The S&P 500 measures the stock market performance of these large companies, and is widely considered as a proxy for the broader U.S. stock market;

v) "**Trust Declaration**" refers to the Amended and Restated Master Declaration of Trust for Horizons BetaPro ETFs, including HVI, dated March 27, 2017;

w) "**TSX**" means the Toronto Stock Exchange;

x) "**Underlying Index**" means the S&P 500 VIX Short-Term Futures Index, an index developed by S&P Dow Jones Indices LLC and licensed to Horizons to provide exposure to the VIX Index. It is comprised of two near term VIX Futures Contracts – a first month and a second month contract – that are rebalanced daily in order to maintain a continuous one-month maturity. The value of the Underlying Index is determined based on a weighted average of the VIX Futures Contracts;

y) "**Units**" means a Class "A" unit of HVI, and "**Unit**" means any one of them;

z) "**Unitholders**" means persons who held a Unit or Units and "**Unitholder**" means any one of them;

aa) "**VIX Index**" or the "**VIX**", means the CBOE Volatility Index, which is a measure of implied and expected volatility of the S&P 500 over a 30 day period. The implied level of volatility of the S&P 500 typically increases in periods of market instability, increasing the level of the VIX Index. The Underlying Index provides exposure to the VIX Index by measuring the excess return from a daily rolling long position in the first and second month VIX Futures Contracts;

bb) "**VIX Futures Contracts**" are agreements for the payment and receipt of an amount of cash based on the level of the VIX Index on a specified future date, and a "**VIX Futures Contract**" means any one of them;

cc) "**volatility**" is a statistical measure of the dispersion of returns for a given security or market index. Volatility refers to the amount of uncertainty or risk about the size of changes in the security or index's value. High volatility means that a price will fluctuate significantly, whereas low volatility means that a price will change more gradually; and

dd) "**Wright**" means the Plaintiff, Graham Wright.

CLAIM

2. The Plaintiff claims on behalf of himself and on behalf of each of the Class Members:

a) an order certifying this action as a class proceeding and appointing the Plaintiff as the representative Plaintiff;

b) a declaration that the Defendant was negligent:

   i. by developing, promoting and selling to the public an improvident investment fund (HVI) that was unsuitable for any investor;

   ii. by failing to make disclosure of the material facts concerning HVI, including its risks and rewards; and

   iii. in failing to diligently perform its duties as manager of HVI;

c) a declaration that the Defendant made one or more misrepresentations within the meaning of the *OSA* (and, if necessary, the equivalent provisions contained in the securities laws of the other provinces of Canada), and that the Defendant is liable to the Plaintiff and the other Class Members pursuant to section 130 of the *OSA* (and, if necessary, the equivalent provisions contained in the securities laws of the other provinces of Canada);

d) general damages in the amount of $38,000,000 or such other sum as this Honourable Court may find appropriate;

e) damages for loss of investment opportunity in an amount to be determined;

f) punitive, aggravated and exemplary damages in the amount of $5,000,000;

g) an accounting of all fees or commissions paid to or received by the Defendant in relation to HVI;

h) disgorgement of all fees or commissions paid to or received by the Defendant in relation to HVI;

i) an interim and permanent Order prohibiting the Defendant from seeking or obtaining indemnity or reimbursement from the assets of HVI in respect of monetary relief paid or payable to the Plaintiff and the other Class Members in this action or its costs and expenses of this action;

j) prejudgment interest in accordance with section 128 of the *CJA*;

k) postjudgment interest in accordance with section 129 of the *CJA*;

l) an Order directing a reference or such other directions as may be necessary to determine issues not determined at the trial of the common issues;

m) costs of this proceeding on a substantial indemnity basis plus, pursuant to section 26(9) of the *CPA*, the costs of notice and of administering the plan of distribution of the recovery in this action plus all applicable taxes; and

n) such further and other Relief as to this Honourable Court may seem just.

Nature of the Action

3. This claim is brought by the proposed representative Plaintiff, Graham Wright, a retail investor. Wright and the other Class Members suffered substantial losses by investing in an improvident investment product offered by Horizons, a registered investment fund manager and a

leading participant in the exchange traded funds business. The investment fund in question was BetaPro S&P 500 VIX Short-Term Futures Daily Inverse ETF (HVI), which traded on the TSX.

4. The investment objective of HVI was to provide inverse exposure to stock market volatility. It did this through a derivative structure based off the VIX Index, a volatility index published by the CBOE Options Exchange. The VIX Index is a theoretical calculation of implied volatility in the equities market, as represented by the S&P 500. It is not possible to trade the VIX Index, which is essentially a measure of human emotions (specifically fear and complacency). However, it is possible to trade VIX Futures Contracts. The S&P 500 VIX Short-Term Futures Index (the Underlying Index) tracks the performance of those futures. HVI created another index to track a one times inverse exposure to this index: the Horizons Short VIX Short-Term Futures Index (the Reference Index).

5. HVI employed a static short-volatility strategy. This is a buy-and-hold strategy that collects risk premium by selling (shorting) longer term VIX Futures Contracts, which typically trade at a premium in relation to nearer term VIX Futures Contracts. The difference is referred to as "contango", as people are typically willing to pay more for a commodity in the more remote future than the actual expected price in the near future. In the case of volatility, the contango results from the greater uncertainty as to what market sentiment will be in the future. This uncertainty dissipates as the expiry date for the contract gets closer. The profits of shorting volatility are tempting but the risks are extreme.

6. Horizons unitized the strategy into an ETF, listed the Units on the TSX and marketed it to retail investors.

7. HVI represented an esoteric volatility strategy – a form of dispersion trading where the index is human emotion rather than assets – that until recently was the exclusive domain of sophisticated hedge fund managers and the trading desks of large financial institutions. Horizons followed the example of a handful of international and U.S. product manufacturers and decided it was a good idea to package a short-volatility strategy into a security that could be sold to retail investors.

8. As Horizons itself ultimately concluded, the risks of HVI to investors were excessive and unreasonable in relation to the rewards. The "risk-premium harvesting" by HVI was profitable over the long-term, when the VIX Index was in a state of contango. However, the fund and its Unitholders were exposed to surges in the VIX Index and periods of "backwardation" (the opposite of contango) which occur sporadically but inevitably in the volatility futures market. A surge in volatility could happen at any time for any number of reasons – anything that causes anxiety and fear in the market – and could be extremely destructive to the value of the fund due to its inverse exposure.

9. HVI was an excessively complex product for Horizons to sell to the investing public. Horizons could not reasonably expect investors to understand volatility-contingent trading strategies. Nor could it reasonably expect investors to understand how HVI worked to provide exposure to a short–volatility strategy. Both were left carefully unexplained in the Prospectus.

10. Investors in HVI lost nearly their entire investment on February 5, 2018 when volatility surged after a 4.1% decline in the S&P 500 following a positive jobs report in the U.S., which fuelled fears of inflation and higher interest rates. To a normal investor this would not appear to be

a catastrophic event, but the fickleness of volatility combined with the fact that the VIX Index had been languishing at historic lows was such that short-volatility funds like HVI were effectively eliminated.

11. HVI investors were shocked. Adding to the chaos and confusion was the fact that the majority of the fund's losses were crystallized in the market for VIX Futures Contracts after the TSX closed on February 5, 2018. When the TSX closed on February 5, 2018, the market price of HVI had declined by approximately 29% that day. However, when HVI opened on the TSX on February 6, 2018, it was down 88% since its close on February 2, 2018. Investors did not understand how they had lost the majority of their investment overnight while the TSX was closed.

12. HVI never recovered and, on April 10, 2018, Horizons announced that it was terminating the fund. Horizons admitted that after "reassessing" the performance of HVI during the first week of February, it had come to the conclusion that HVI did not offer an "*acceptable risk/reward trade-off*" for investors. While Horizons should be credited for its candour, the fact is that there was no change in the "*risk/reward trade-off*" post February 5, 2018.

13. HVI was never a suitable product for the retail market. It was not understandable for investors and the risks were simply too great. By continuously offering HVI to the public, Horizons failed to meet its duties to HVI and its unitholders.

The Parties

14. The Plaintiff is an individual residing in Toronto, Ontario. He is a retail investor who, until he lost the majority of his investing capital on February 5, 2018, actively bought and sold investments through a self-directed brokerage account.

15. The Plaintiff is a representative of the proposed Class of persons who, as a Class, owned Units of HVI at the close of the markets on February 5, 2018. The Plaintiff owned 17,500 Units at the close of the markets on February 5, 2018. He bought those Units at an average price of $15.72 for a total price of $275,125. Wright purchased the majority of his Units between 2:30 pm and 3:00 pm on February 5, 2018.

16. Horizons is a company incorporated under the laws of Canada. Horizons is the manager, investment manager, promoter and trustee of HVI. Horizons describes itself and its subsidiaries as an innovative financial services organization distributing the Horizons family of leveraged, inverse leveraged, inverse, index and actively managed ETFs. Horizons is a subsidiary of Mirae Asset Global Investments Co., Ltd., which is part of the Mirae Asset Financial Group, which the Prospectus describes as one of the world's largest investment managers in emerging market equities.

17. As the registered investment fund manager of HVI, Horizons has the responsibility and authority to manage and direct the business and affairs of HVI, including making all decisions regarding the business and affairs of HVI.

18. As the registered investment manager of HVI, Horizons operates as a portfolio manager under the *OSA* and provides investment advisory and portfolio management services to HVI.

19. As promoter of HVI, Horizons founded and organized HVI on or about April 3, 2012.

20. Horizons is also the trustee of HVI pursuant to the Trust Declaration.

HVI – How it Worked

21. HVI is an open-ended mutual fund trust established under the laws of Ontario. It is subject to *National Instrument 81-102 – Investment Funds*. It is also a commodity pool subject to *National Instrument 81-104 – Commodity Pools*. Units of HVI are issued on a continuous basis pursuant to a prospectus at a price equal to the net asset value of the Units.

22. HVI is an ETF and its Units trade on the TSX under the ticker symbol HVI. Although an investor can subscribe for Units of HVI through a designated broker, the most common way for an investor to purchase Units is through the facilities of the TSX. Similarly, while Units can be redeemed directly with Horizons at 95% of the closing price of a Unit on the TSX at closing on that date (with the 5% balance being retained by Horizons), the typical means by which Units are bought and sold is over the TSX.

23. According to the Prospectus, HVI is designed to provide daily investment results, before fees, expenses, distributions, brokerage commissions and other transaction costs, that endeavour to correspond to the single inverse (opposite) of the daily performance of the Underlying Index. According to the Prospectus, if HVI is successful in meeting its investment objective its net asset value should gain approximately as much on a percentage basis as any decrease in the Underlying Index on a given day. Conversely, its net asset value should lose approximately as much on a percentage basis as the Underlying Index increases on a given day. Simplistically, as described below, the expectation was that HVI would generate positive returns when there was minimal volatility in the markets.

24. The Underlying Index was developed by S&P Dow Jones Indices LLC and licensed to Horizons in order to provide exposure to the CBOE Volatility Index, known as the VIX Index. The Underlying Index consists of two near term VIX Futures Contracts that are rebalanced daily in order to maintain a continuous one-month maturity. The value of the Underlying Index is determined based on a weighted average of the VIX Futures Contracts.

25. The VIX Index is a theoretical calculation based on the prices of put and call options on the S&P 500. It measures the implied and expected volatility of the S&P 500 over a 30 day period. The S&P 500 is an index that measures large-cap U.S. stock market performance. It is a weighted index of 500 U.S. operating companies and real estate investment trusts selected by the U.S. Index Committee. The VIX Index is known in the investment industry as the "fear gauge" of the U.S. equities market. The implied level of volatility of the S&P 500 typically increases in periods of market instability, increasing the level of the VIX Index.

26. It is not possible for investors to invest directly in the VIX Index. However, certain investors can invest in forward market volatility (the expectation as to what volatility will be in the future), measured by the VIX Index, through VIX Futures Contracts.

27. According to the Prospectus, HVI invests in financial instruments that have similar return characteristics as one times (100%) the inverse (opposite) of the performance of the Underlying Index. In order to achieve this objective, HVI obtains exposure to the Reference Index, an index manufactured by Horizons that is intended to be an inverse index to the Underlying Index. The Reference Index was published by Bloomberg L.P. and Reuters at the close of each trading day,

but is not priced intra-day. HVI typically uses the price of the Reference Index determined at approximately 4:00 pm as the reference for its investment objective.

28. HVI was a complex product – a derivative three times removed from its esoteric subject (market sentiment) – wrapped in the deceptively benign and familiar package of an ETF.

HVI's Short-Volatility Strategy – Don't Try this at Home

29. The investment strategy underlying HVI has been employed by the derivatives trading desks of sophisticated and well capitalized financial institutions in the form of "selling index volatility" or "index shorting". These are income strategies, known as "risk-premium harvesting", and are analogous to selling insurance. Income is generated by selling exposure to the Underlying Index in exchange for a rate of return. HVI was typically able to generate "roll yield" as the fund rebalanced daily and HVI sold the more distant term VIX Futures Contracts at a price higher than the nearer term VIX Futures Contracts that HVI was buying. Historically, the yield curve for the forward contracts in the Underlying Index had been in a condition of contango, with the more distant contracts trading at higher prices than the nearer term contracts.

30. While HVI collected "roll yield", its exposure from short-selling the distant term forward contracts created theoretical unlimited risk, which could manifest itself instantly in the event of an unexpected market shock. The risks of "index shorting" applied to volatility have increased significantly due to the rapid growth of algorithmic trading, which exacerbates the market's reaction to news events. Consequently, only the most sophisticated hedge funds, which constantly monitor market news and stock market behaviour, have sufficient expertise to dynamically manage the underlying risk of this strategy on a continuous intra-day basis. Retail investors are

unequipped to fully appreciate, let alone manage, the almost instantaneous catastrophic risk exposures associated with "index shorting" expressed through the HVI product.

31. HVI represented the realization of a very sophisticated and risky trading strategy, typically only undertaken by the most sophisticated institutional trading desks, packaged to be sold to retail investors. It was not reasonable or responsible for Horizons to design and offer an "index shorting" strategy in relation to volatility to the investing public at large. It should have been clear to Horizons that investors would not have the proficiency to successfully trade and manage the risk associated with HVI and it was entirely foreseeable to Horizons that investors would lose most or all of their investment.

32. In the Prospectus, Horizons notes that, "*[v]olatility is a market condition that is easier to identify than it is to manage*". However, in a memorandum posted on its website, "What Happened to HVI Between February 2-6, 2018?", Horizons acknowledged that "*[t]his product is only appropriate for investors who understand volatility and its associated risks before they make a trade in HVI.*" Horizons was well aware, or should have been, that the investing public would not understand volatility-contingent investing.

33. Although it may have been 'innovative' for Horizons to package a version of a short-volatility trading strategy into an ETF designed for retail investors, it was not prudent. As an ETF, HVI was a qualified investment for registered retirement savings plans, registered retirement income funds, registered education savings plans and tax-free savings accounts. Horizons marketed HVI on the basis that it was an eligible investment for such accounts.

What Happened when the Inevitable Occurred

34. A sustained period of low volatility in the market during 2016 and 2017 caused short-volatility funds like HVI to be very profitable as they collected volatility risk-premium without significant interruption. Predictably, a large amount of investor money flowed into HVI and its equivalents during 2017 and the first quarter of 2018. However, the inherent riskiness of HVI had become more pronounced due to the historically low level of the VIX Index. The long-term average (since 1990) for the VIX Index is 19.7 (as of December 2016), whereas the VIX Index had dropped below 10 in January 2018 and was subsequently languishing in the low teens. The low teens were viewed in the institutional market as a relatively solid "floor" for the VIX Index.

35. This left the VIX Index susceptible to a large and rapid increase in percentage terms. Market analysts were expressing concerns that a one day decline in equities of 3% or 4% could cause a significant spike in the VIX Index (in percentage terms) and trigger catastrophic losses for volatility-contingent strategies. Some analysts were of the view that the unwinding and rebalancing of volatility strategies could become self-propelling due to limited liquidity, especially during periods of market stress, which would rapidly drive up the price of VIX Futures Contracts.

36. Horizons took no action as investment manager to reduce or close out HVI's position in the face of this developing scenario of increased downside risk.

37. The risk to HVI investors manifested itself in dramatic fashion on February 5, 2018. That day, the S&P 500 declined by 4.1% due to concerns about rising inflation following a report of unexpected increased jobs in the U.S., which raised the prospect of inflation and accelerated

interest rate rises. This "event" was sufficient to create enough anxiety amongst investors to cause a spike in volatility during the course of the day. As a result, HVI lost approximately 88% of its value. The majority of that loss was crystalized after the close of the TSX when HVI rebalanced its portfolio and calculated its net asset value. Any investor holding HVI at the close of the market experienced the loss of nearly their entire investment.

38. The price of HVI did not recover. The loss of net asset value on February 5, 2018 was sufficiently large that it would have taken years for HVI to replenish its net asset value – through a resumption of risk-premium harvesting – once volatility returned to its mean and the yield curve returned to a condition of contango.

39. On February 27, 2018, Horizons announced that it would not be accepting any new subscriptions for Units of HVI, and discouraged investors from purchasing Units on the TSX. A press release of that date stated the suspension was "*[d]ue to a change in business, operations and affairs of HVI*" and indicated that Horizons was "*assessing various courses of action with respect to HVI*". The press release also indicated that after the close of trading on February 28, 2018, Horizons expected that the performance of HVI would only correspond to approximately one half times the inverse of the daily performance of the Underlying Index, and that Horizons intended to call a meeting of Unitholders "*in order to amend HVI's investment objectives*".

40. On March 13, 2018, Horizons announced that it would resume accepting new subscriptions for HVI on March 14, 2018, and indicated that it expected that the performance of HVI would correspond to approximately one half times the inverse of the daily performance of the Underlying Index.

41. On April 10, 2018, Horizons announced that it would be terminating HVI and HVU effective as of June 11, 2018, and that effective immediately no further direct subscriptions for Units of the ETFs would be accepted. An April 10, 2018 press release stated that Horizons had reassessed the viability of HVI and concluded that *"[i]n the specific case of leverage and inverse exposure to volatility futures, we now feel the potential risk of loss simply exceeds the potential reward*". It also indicated that:

> "*After reassessing the performance of HVU and HVI, particularly their respective performance following the first week of February, when volatility futures contracts spiked by more than 100% during one 24-hour trading period,* ***we have come to the conclusion that these ETFs no longer offer an acceptable risk/reward trade-off for investors***," said Steve Hawkins, President and Co-CEO of Horizons ETFs. "*...Ultimately,* ***we do not want to be offering investment products that have the potential to lose the majority of an investor's capital in such a short period of time***." [italics in original; emphasis added]

42. Horizons' admission applies with equal force to the period before February 5, 2018. The potential for loss was always greater than the potential reward, particularly over a short time frame. As the short-volatility strategy underlying HVI was an income strategy, the fund would be expected to generate an incremental positive return on a daily basis (the average daily increase was 0.27% in the six months ending February 1, 2018). However, the fund faced a real yet unpredictable risk at any time of losing all or a substantial part of its net asset value over that same period (HVI lost 88% over two trading days from February 2 to 6, 2018). The radical disparity in the risk/reward ratio of owning HVI over a short time frame was completely unreasonable for retail investors.

HVI was a Buy-and-Hold Strategy Improperly Packaged in a Short-Term Product

43. The risk/reward trade-off was always skewed for HVI. However, the situation was made worse for HVI investors by misleading and confusing disclosure about how returns are generated from a short-volatility strategy.

44. Both the HVI Prospectus and ETF Facts state that HVI was a product intended for use in daily or short-term trading strategies by sophisticated investors. Horizons repeatedly warns investors in the Prospectus and elsewhere that the product did not seek to achieve its investment objective for longer than one day[1]. In fact, with very rare exceptions, for an investor to profit to any material extent from owning HVI they would have to hold it longer term, at least for several months. For a volatility-contingent strategy, that is a significant amount of time and the buy-and-hold strategy required to experience a material increase in the value of HVI Units would not be considered "short-term".

45. During that time an investor could, within the space of a day, lose their entire investment.

46. The Prospectus does not explain that HVI represented an income strategy that enhanced its net asset value by collecting premiums in exchange for taking on the risk of a spike in volatility (i.e. selling insurance against a spike in volatility). This was material if investors were to stand any chance of understanding the risk/reward ratio of HVI. The lack of explanation in the Prospectus could leave a reasonable investor to conclude, erroneously (as outlined in paragraphs 44-45

[1] HVI was not intended to mirror the inverse performance of the Underlying Index for a period of time of longer than one day, and depending on the level of volatility in HVI's performance, a single investment in HVI had the potential to deviate significantly from its daily objective if held over time.

above), that there was an equal chance of HVI experiencing a large single day gain as there was to incur a substantial loss.

47. The potential to trade HVI on a short-term basis to capture larger daily gains, rather than invest for the incremental roll-yield, would be highly sporadic following a spike in volatility. It is well established that the VIX Index rallies quickly and declines slowly. In theory, an investor tracking a real-time feed on the VIX Index (and the Underlying Index) could identify a surge in volatility and, provided they timed their purchase of HVI perfectly, on a day *after* it had rebalanced to reflect the increase in volatility, capture an increase in the value of HVI as the VIX Index slowly declined. While this may be possible, it is contrary to the established rationale for a short-volatility strategy. Rather than a buy-and-hold strategy to capture the collection of volatility risk-premium, a short-term trading stràtegy would involve owning HVI only infrequently. This would necessarily preclude an investor from benefiting from the accumulation of volatility risk-premium income.

48. Notwithstanding the theoretical possibility of making a short-term trading gain with HVI, the underlying short-volatility strategy of HVI was inherently an income strategy to generate incremental returns over a longer term time horizon. It was therefore materially misleading for the Prospectus and ETF Facts to convey the impression that HVI was a product that could be traded for large gains on a daily or short-term basis.

49. Horizons' misleading characterisation of the underlying investment strategy was repeated in public statements following the catastrophic losses incurred on February 5, 2018: "*[t]hese products are really designed for short-term day traders who are looking to access a very specific asset class ... they are looking to make a high-risk high-reward investment and we have been*

strong believers that investors should have access to trading vehicles to make those short-term investment decisions."[2] The Horizons memorandum commenting on market activity between February 2 and February 6, 2018, referenced in paragraph 32, stated: "*HVI is intended to serve a very specific purpose for investors who have a firm conviction and expectation of a decrease in S&P 500 short-term volatility, and choose to trade HVI to seek a potential short-term trading gain.*"

50. These statements are contrary to the conventional understanding of how a short-volatility strategy works. They are also contradicted by suggestions and statements in marketing materials to the effect that HVI could be held as a profitable long-term investment. It is telling that Horizons' own disclosure and marketing of HVI is confused and internally inconsistent. Horizons itself had trouble explaining why investors should purchase HVI.

51. Further, Horizons knew or should have known that packaging a long-term trading strategy into an inverse ETF was problematic because of HVI's daily reset feature, which meant that its performance over a longer term would be difficult to predict.

52. The key characteristics of HVI as an investment were further obscured by Horizons' decision to use one Prospectus for three different volatility-contingent ETFs. The Prospectus was shared with Horizons' HUV and HVU funds, which provided exposure one times (100%) and two times (200%) respectively to the performance of the Underlying Index. Unlike HVI, those funds were long rather than short volatility. Also unlike HVI, those funds *were* designed to be traded short-term or used as a portfolio hedge for a decline in the equity markets. General statements

[2] Steven Hawkins, co-chief executive officer of Horizons, Globe and Mail March 19, 2018.

made in the Prospectus that may have been accurate in relation to HUV and HVU were wrong or otherwise misleading with respect to HVI.

53. Unlike HVI, the long volatility funds would consistently lose value when the VIX Index was low and the yield curve for VIX Futures Contracts was in contango. In that respect they would behave in an opposite manner to HVI. However, they *could* increase in value quickly in the event of an increase in volatility. In this respect, the opposite did not apply to HVI for the reasons outlined above, as the VIX Index has historically declined slowly. It was foreseeable that the inclusion of investment funds with entirely different trading strategies in the same Prospectus would cause confusion amongst investors as to the key investment features of HVI.

54. In totality, Horizons' disclosure was misleading. Horizons failed to represent the material elements of the product so that investors would understand the rationale for investing in HVI or the trade-off between the potential risks and rewards of the product. Investors were not provided the material facts necessary for them to make an informed decision about whether HVI was suitable for their investment objectives or risk tolerance.

HVI was too Complex for Retail Investors

55. As outlined in paragraph 32 above, Horizons admitted in its memorandum after the losses on February 5 and 6, 2018 that HVI was "*only appropriate for investors who understand volatility and its associated risks*". **No such warning is contained in the Prospectus or ETF Facts.**

56. However, the statement is clearly correct. An understanding of volatility-contingent strategies was necessary for an investor to know how to trade HVI; no attempt was made to

provide such guidance in the Prospectus. Further, it is necessary to have a high degree of financial and investment industry literacy in order to understand the Prospectus in the first place.

57. For example, the risk factors outlined in the Prospectus include, "*Contango and Backwardation Risk*", "*Risk Associated with the Reversion of the VIX Index to its Mean*", "*Market Price v. Futures Risk*", "*Price Volatility Risk*", and "*Leverage Risk and the Effect of Compounding on Returns*". The Prospectus assumes throughout a pre-existing knowledge of concepts with limited application outside of the world of institutional alternative investment strategies.

58. Ultimately, the Prospectus could not and did not remedy the fact that HVI was an inappropriate product to offer to the investing public because of the complexity of the strategy and the extreme risk. However, Horizons compounded this fundamental problem by providing confusing and opaque disclosure that fell well short of its statutory duty to provide full, true and plain disclosure of the material facts related to HVI.

HVI Becomes Dislocated from its Net Asset Value

59. Large volumes of HVI Units traded over the TSX on February 5, 2018 – there were 12,987 trades with a trade value of $37.25 million – at prices that did not reflect the massive increase in implied volatility in the market reflected in the VIX Index. Triggered by the decline in the equities market, the VIX Index had increased by approximately 67% by 2:45 pm and 106% by 3:00 pm. By 4:00 pm, when the TSX closed, the VIX Index had increased by 115.60%. The Underlying Index had also increased by 96% by the close. In contrast, HVI closed on the TSX at $13.40, representing a decrease of 28.7% from the opening.

60. Clearly, the market price determined by investors trading HVI on the TSX had become dislocated from HVI's net asset value. Notwithstanding the statement by Horizons that it had a final net asset value at 4:00 pm of $12.68, it would have been apparent to Horizons (and to other institutional trading desks) that the nearer term VIX Futures Contracts were going to be priced at a much higher level and that the net asset value of HVI would need to be marked significantly downwards. Horizons highlights in its subsequent press releases that all of the price movement occurred between 4:00 pm and 4:15 pm – a possibility that it claims (erroneously) was explained in the Prospectus. Presumably Horizons sought to justify the gross disparity in the TSX closing price and the net asset value struck that evening.

61. The reality is that the price movement in VIX Futures Contracts that occurred in that 15 minute window was expected by market participants who understood the volatility futures market – the VIX Futures Contracts are, after all, priced off the VIX Index. The spike in the price of VIX Futures Contracts on the evening of February 5, 2018 was inevitable. By that time, other institutional traders in the marketplace would have known that HVI was obligated to buy a significant number of VIX Futures Contracts to effect the required daily rebalance. These traders would have repositioned themselves to systematically exploit HVI's economic vulnerability – in other words, the institutional traders were simply "bayonetting the dead". This flaw – which exposed investors to catastrophic price reductions after the close of trading, when they were unable to protect themselves – was inherent in the design of HVI.

62. The fact that so many Units of HVI were exchanged over the TSX at spurious prices is a troubling by-product of the misconceived concept of packaging a sophisticated institutional trading strategy as an exchange traded product for retail investors. That retail investors were

largely oblivious to the nuances of the product and its underlying strategy was on display on February 5, 2018; the investing public trading HVI on the TSX did not fully understand what was coming. Unfortunately, buyers of HVI that afternoon, such as Wright, significantly overpaid for Units that were going to be marked down in value after the close of the market once HVI rebalanced and calculated its net asset value.

63. Horizons could have contacted the TSX to halt trading in the Units of HVI as it became apparent that its market price was becoming dislocated from its net asset value. Apparently, it did not do so. As a result, many investors bought HVI Units at inflated prices, exacerbating their losses. No doubt there were many investors like Wright who believed that if they bought HVI at a time when the VIX Index (and the Underlying Index) had spiked, they could profit by holding HVI when the VIX Index returned to its mean. This mistaken belief was cultivated by Horizons' inadequate and misleading disclosure outlined above, which implied that HVI could be traded for large short-term gains by catching a sharp decline in volatility.

64. Fundamentally, the maintenance of HVI's asset value relied on sufficient liquidity after the close of trading so that HVI's algorithm could close its position by repurchasing the futures contracts that it had sold on opening and maintain its asset value. Horizons failed to realize that, in times of extreme volatility, liquidity would decrease and drive up the cost of closing out HVI's position, thereby reducing HVI's asset value. The inflexibility of HVI's investment mandate, which required it to close out its positions after 4:00 p.m. each day regardless of the cost to do so, further exacerbated that fundamental design flaw.

65. In the end, Horizons created a scenario in which a large number of retail investors needlessly lost tens of millions of dollars by investing in a misconceived derivative product that served no purpose other than to add an ETF to the Horizons' "innovative" suite of products, from which it received management fees.

66. Wright experienced net losses on February 5, 2018 of approximately $225,000 as a result of the loss of value of his Units of HVI.

Horizons' Breaches of The Duty of Care

67. Pursuant to section 9.7 of the Trust Declaration, section 116 of the *OSA*, OSC Rule 31-505 – *Conditions of Registration,* and the common law, at all material times Horizons owed the following duties to HVI and to the Unitholders, including the Class Members:

a) a duty to exercise the powers and discharge the duties of its office honestly, in good faith and in the best interests of HVI and its Unitholders;

b) a duty to act fairly, honestly and in good faith with its clients, which included the Unitholders;

c) a duty to exercise the degree of care, diligence and skill that a reasonably prudent trustee, investment fund manager and investment manager would exercise in comparable circumstances; and

d) duties to ensure that:

    i. HVI was appropriately designed, developed and manufactured so that it could be owned and traded by Unitholders;

ii. HVI was appropriately tested so that it could be owned and traded by Unitholders;

iii. HVI was appropriately marketed and distributed to Unitholders;

iv. the risk/reward ratio of HVI was appropriate for Unitholders; and

v. Unitholders were appropriately warned of the risks of owning HVI.

68. Contrary to its obligations, by its acts and omissions, Horizons has failed to:

a) act fairly, honestly, in good faith and in the best interests of Unitholders, including the Class Members;

b) exercise the degree of care, diligence and skill that a reasonably prudent manager, investment manager, promoter and trustee would exercise in comparable circumstances;

c) properly design, develop, manufacture, test, market, or distribute HVI; and/or

d) warn investors of the risks of owning HVI.

69. Specifically, and by virtue of the actions of Horizons particularised in paragraphs 29-65 above, Horizons breached its duties to Unitholders and the Class by:

a) developing the underlying strategy of HVI into an ETF when it knew or ought to have known that an ETF structure would put Class Members at a disproportionate risk of loss;

b) designing a product that was too complex to be marketed to retail investors;

c) failing to ensure that HVI tracked its net asset value during intra-day trading;

d) failing to structure HVI in a manner that would avoid significant changes in its net asset value after the close of markets;

e) structuring HVI with an inflexible investment mandate that required HVI to close out its positions in VIX Futures Contracts after 4:00 pm each day regardless of the cost of doing so;

f) failing to address the dislocation of HVI from its net asset value on February 5, 2018;

g) failing to conduct proper or adequate testing of HVI prior to launching it;

h) failing to ensure that HVI could withstand significant increases in market volatility without a significant drop in value or, in the alternative, failing to warn investors of that risk;

i) failing to ensure that HVI would not lose a majority of its value in a single day or, in the alternative, failing to warn investors of that risk;

j) promoting, marketing and selling HVI, which it knew or should have known was based on an excessively complex and risky strategy, organized into an unsuitable retail investment product;

k) failing to disclose in the Prospectus the material facts necessary to understand HVI, including the rationale for the investment strategy of HVI and the manner in which HVI would increase or decrease in value;

l) failing to adequately warn Unitholders of the nature and extent of the risks of investing in HVI;

m) simultaneously marketing HVI as a short-term and a long-term investment;

n) failing to foresee the ways in which Unitholders might buy, sell or hold HVI;

o) implying through the Prospectus and other disclosure that HVI could generate short-term profits commensurate with the potential for short-term losses;

p) failing to diligently perform its duties as manager of HVI;

q) failing to conclude that HVI did not have an "*acceptable risk/reward trade-off*" for investors prior to February 5, 2018;

r) failing to continuously monitor or update HVI's investment strategy to reflect the risks disclosed by academic, scholarly and industry research;

s) continuing the operation of HVI when it knew or should have known that the downside risk of the investment was becoming more extreme and potentially more imminent;

t) failing to warn investors when it knew or should have known that the downside risk of the investment was becoming more extreme and potentially more imminent; and/or

u) engaging in a continuous offering of HVI in light of the above.

70. HVI was introduced into the market for the sole or primary purpose of generating fees and income for Horizons.

Prospectus Misrepresentations

71. The Plaintiff asserts against Horizons the right of action for prospectus misrepresentation in section 130 of the *OSA* (and, if necessary, the equivalent provisions contained in the securities law of the other provinces of Canada).

72. Horizons has prepared, filed and disseminated the Prospectus to permit the continuous offering of HVI Units to the public.

73. Pursuant to section 56(1) of the *OSA* (and, if necessary, the equivalent provisions contained in the securities law of the other provinces of Canada), the Prospectus is and was required to provide full, true and plain disclosure of all material facts relating to the securities issued or proposed to be distributed under the Prospectus.

74. The Prospectus is a prospectus for the purposes of section 130 of the *OSA* (and, if necessary, the equivalent provisions contained in the securities law of the other provinces of Canada).

75. At all times, the Prospectus contained misrepresentations within the meaning of the *OSA* (and, if necessary, the equivalent provisions contained in the securities law of the other provinces of Canada) by omitting to state material facts necessary to make the Prospectus not misleading, including that it failed to disclose, or in the alternative fully or adequately disclose:

a) the fundamental strategy of HVI – the accumulation of assets through an income strategy by selling VIX Futures Contracts;
b) the risks of investing in HVI as compared to the potential rewards;
c) that the intra-day trading value of HVI might be inflated or inaccurate;
d) the potential for HVI's assets to drop rapidly in value after the close of the trading day;
e) the fact that HVI could lose all or substantially all of its value in a single day in volatile markets; and/or
f) the valuation methodologies for the calculation of the net asset value.

76. In totality, Horizons' disclosure was misleading. Horizons failed to represent the material elements of the product so that investors would understand the rationale for investing in HVI or the trade-off between the potential risks and rewards of the product. Investors were not provided the material facts necessary for them to make an informed decision about whether HVI was suitable for their investment objectives or risk tolerance.

77. Horizons certified and signed the Prospectuses as required by National Instrument 81-101 – *Mutual Funds Prospectus Disclosure* and Form 81-101F2, and is liable pursuant to section 130(1)(e) of the *OSA* (and, if necessary, the equivalent provisions contained in the securities law of the other provinces of Canada).

78. The offering of Units of HVI to which the Prospectuses related constituted distributions of the Units in Ontario and/or distributions of the Units from Ontario to persons outside Ontario. The offering was governed by the *OSA* and its subsidiary instruments and regulations, and was carried out under Ontario securities laws.

Causation and Damages

79. But for the negligence and negligent misrepresentations of Horizons, described above, the Plaintiff and the other Class Members would not have suffered loss and damage on investments in HVI.

80. As stated above, the Plaintiff and the Class Members have suffered the following damages and losses:

a) the loss of the capital invested in HVI, totalling approximately $38,000,000, between February 2, 2018 and February 6, 2018; and
b) the loss of the market returns on the capital lost from February 6, 2018 to the date of trial.

81. The Plaintiff and the Class Members are also entitled to recover costs in accordance with the *CPA*, the costs of notice and of administering the plan of distribution of the recovery in this action, plus reasonable legal fees.

82. The Plaintiff and the Class Members are entitled to an accounting of all fees or commissions and other payments made to or received by Horizons in relation to HVI as well as disgorgement of those sums.

83. The conduct of Horizons pleaded above demonstrates a calculated disregard of Horizons' duties to the Plaintiff and the Class Members such that an award of punitive, aggravated and exemplary damages is warranted.

Real and Substantial Connection with Ontario

84. The Plaintiff pleads that this action has a real and substantial connection with Ontario because, among other things:

a) the Plaintiff is resident in Ontario;

b) Horizons is domiciled in Ontario;

c) Horizons carries on business in Ontario;

d) HVI is a reporting issuer in Ontario;

e) the Prospectus was disseminated in Ontario;

f) a substantial portion of the Class Members reside in Ontario; and

g) a substantial portion of the damages sustained by the Class were sustained by persons and entities domiciled in Ontario.

Relevant Legislation

85. The Plaintiff pleads and relies on the *CJA*, the *CPA*, the *OSA,* and all relevant amendments thereto.

Place of Trial

86. The Plaintiff requests that this action be tried in the City of Toronto, in the Province of Ontario, as a proceeding under the *CPA*.

May 4, 2018

CRAWLEY MACKEWN BRUSH LLP
Barristers & Solicitors
Suite 800, 179 John Street
Toronto ON M5T 1X4

Alistair Crawley (LSUC# 38726D)
Tel: (416) 217- 0806
acrawley@cmblaw.ca
Clarke Tedesco (LSUC# 55391C)
Tel: (416) 217-0884
ctedesco@cmblaw.ca
Michael L. Byers (LSUC# 61796U)
Tel: (416) 217-0886
mbyers@cmblaw.ca

Tel: (416) 217-0110
Fax: (416) 217-0220

Lawyers for the Plaintiff

Cv-18-00597284-00CP

GRAHAM WRIGHT
Plaintiff

-and-

HORIZONS ETFS MANAGEMENT (CANADA) INC.
Defendant

Court File No.

ONTARIO
SUPERIOR COURT OF JUSTICE

PROCEEDING COMMENCED AT
TORONTO

STATEMENT OF CLAIM

CRAWLEY MACKEWN BRUSH LLP
Barristers & Solicitors
Suite 800, 179 John Street
Toronto ON M5T 1X4

Alistair Crawley (LSUC# 38726D)
Tel: (416) 217- 0806
acrawley@cmblaw.ca
Clarke Tedesco (LSUC# 55391C)
Tel: (416) 217-0884
ctedesco@cmblaw.ca
Michael L. Byers (LSUC# 61796U)
Tel: (416) 217-0886
mbyers@cmblaw.ca

Tel: (416) 217-0110
Fax: (416) 217-0220

Lawyers for the Plaintiff