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Federal Judge Tosses Geared ETF Class Action

By Jay G. Baris and Kelley A. Howes

A federal district court has dismissed a class action against 44 ProShares exchange-traded funds ("ETFs"), their investment adviser, officers and trustees.

In granting defendants' motion to dismiss, the federal district court for the Southern District of New York unambiguously stated that "the disclosures in the registration statements accurately conveyed the specific risks that the plaintiffs assert materialized."

The court said that "'it is not possible to read the registration statements . . . without understanding that the ETFs were particularly risky and speculative" and were intended to meet their stated investment goal over only a one day period.

The case was brought under Sections 11 and 15 of the Securities Act of 1933 by investors in certain ETFs that were part of ProShares Trust and ProShares Trust II. The ETFs included Inverse ETFs (which seek to replicate the inverse movement of an index over one day); Ultra Long ETFs (which seek to double the performance of an index over one day); and Ultra Short ETFs (which seek to double the inverse of the performance of an index over one day).

The plaintiffs argued that the prospectuses failed to adequately disclose the risk that, when held for more than one day, the ETF shares could lose substantial value particularly in periods of high volatility. Plaintiffs said that this lack of disclosure was a material misstatement or omission of a material fact for purposes of Section 11 of the Securities Act. The plaintiffs also claimed that the defendants knew, but did not disclose, a mathematical formula from which an investor could determine that there was a "must lose" risk at certain volatility levels, and that the "must lose" risk in fact materialized. The court characterized the plaintiff's claim that the defendants knew in advance that large losses would occur as "implausible."

Generally, Section 11 imposes strict liability on the parties who play a direct role in a registration statement. To establish a claim under Section 11, the court said, a "plaintiff need only plead a material misstatement or omission in the registration statement." The liability against the issuer for misstatements is virtually absolute, while others who participated, such as fund trustees, may have a defense to liability if they can show that they exercised due diligence.

Notwithstanding this strict liability standard and the requirement that, under the Federal Rules of Civil Procedure, a court must review a motion to dismiss in the light most favorable to plaintiffs, the court found no grounds for Section 11 liability.

The court noted that the registration statements at issue stated in "plain English that the ETFs' objectives were daily only, that it was mathematically impossible for the ETFs to achieve their goals for periods longer than one day, and that the ETFs' value could 'diverge significantly' from the underlying index when the ETFs were held for longer than one day." Noting that this was the "precise risk" that actually resulted in loss to the plaintiffs, the court said that a reasonably prudent investor would have understood from reading the registration statement not only that the ETFs could not meet their goal if held for more than one day but that the resulting losses could be significant.

The court distinguished several recent cases involving other ETFs. For example, unlike the funds in Rafton v. Rydex Series Funds, the ProShares funds did not impose any sales charges if an investor sold shares after holding them for a short period. Thus, there was no "penalty" for holding ProShares ETFs for a short time period. The court distinguished the disclosure regarding the daily nature of the ETFs in In re Direxion Shares ETF Trust on the basis of the relatively clear and specific warnings included in the ProShares disclosure.

Because the court granted the motion to dismiss the Section 11 claim, the Section 15 claim (which arises upon a finding of primary liability under Section 11 and control of the primary violator) was also dismissed. A state law claim for breach of contract similarly could not stand given the failure of the Section 11 claim.

The ProShares case underscores the importance of clear and specific risk disclosures, in plain English, as a means of mitigating potential liability of not only the registrants but also the individuals who sign the registration statements. It also signals that the courts will not look favorably on sophisticated investors who claim that they lost money by investing in risky funds when the fund prospectuses clearly described those risks.

Plaintiffs have 30 days within which to file a Notice of Appeal with the Second Circuit.

(Morrison & Foerster LLP represents the independent trustees of ProShares Trust.)

In Re ProShares Trust Securities Litigation, 09 Civ. 6935 (JGK), Opinion and Order (Sept. 10, 2012)

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