WAKE FOREST JOURNAL OF BUSINESS AND INTELLECTUAL PROPERTY LAW

VOLUME 17 SUMMER 2017 NUMBER 4

IN RE PROSHARES: SECOND CIRCUIT DEPRIVES INVESTORS OF MEANINGFUL DISCLOSURE

John I. Sanders[†]

[†] © 2017 J.D. 2016 Wake Forest University School of Law; M.B.A. 2012 Liberty University; B.A. 2005 Wake Forest University. Currently an associate in Kilpatrick Townsend & Stockton, LLP's corporate and securities law practice group and a member of the EuroLegalNet network of international attorneys. Between 2007 and 2013, employed by The Vanguard Group as a mutual fund and ETF specialist, stock broker, and member of the management team. I would like to thank my wife Jessica. I have been blessed with a loving wife whose understanding of business, finance, and writing is exceptional. Her thoughtful critiques challenge me to produce more sound and accessible corporate and securities law arguments. I would also like to thank our son, Finn, who reads and discusses the Wall Street Journal with me each morning. Finally, thank you to the *Wake Forest Journal of Intellectual Property and Business Law* staff and editors for their professionalism and thoroughness in editing.

I. INTRODUCTION

Courts and legal scholars often state that "disclosure is at the very heart of federal securities law."[1] This concise statement belies the nature of securities law, suggesting that enumerated disclosures in the proscribed forms will provide a safe harbor to issuers and their agents. Securities law, however, is not so narrow and rigid. It is necessarily broad and malleable; sufficient to regulate, without constant legislating and rulemaking, the most innovative financial industry in the world.

Section 11 of the Securities Act of 1933 (the "Act") is a prime example of the broad and malleable nature of securities law.[2] Section 11, which applies to all securities registered under the Act, is meant "to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering."[3] The standard is especially stringent where the defendant is the issuer, as plaintiffs alleging a Section 11 violation "need not allege scienter, reliance, or loss causation" against an issuer."[4] Instead, "a plaintiff needs only plead a material misstatement or omission in the registration statement."[5] Thus, "liability against the issuer of a security is virtually absolute, even for innocent misstatements."[6]

It seems, based on its simple elements and strict standard of liability, that Section 11 is one of the most powerful weapons in the arsenal of securities law plaintiffs. Yet, many Section 11 claims that appear to pass the pleading standards of Twombly/Iqbal are dismissed.[7] Historically, Section 11 claims have been dismissed under Rule 12(b)(6) of the Federal Rules of Civil Procedure (the "FRCP"), and the current trend is that a greater percentage of Section 11 claims are meeting that fate.[8] In fact, 100% of Section 11 claims that were not settled were dismissed under Rule 12(b)(6) in 2009.[9] One reason for this is that a court may struggle to apply the straight-forward

---

[1] JAMES HAMILTON, ELEMENTS OF FEDERAL SECURITIES LAW 18 (2007).

[2] *See* 15 U.S.C. § 77k (2012).

[3] Herman & McLean v. Huddleston, 459 U.S. 375, 381–82 (1983).

[4] *In re* Morgan Stanley, 592 F.3d 347, 359 (2d Cir. 2010).

[5] *In re* Flag Telecom Holdings, Ltd. Sec. Litig., 411 F. Supp. 2d 377, 382 (S.D.N.Y. 2006).

[6] *Herman & McLean*, 459 U.S. at 382.

[7] *See* Ashcroft v. Iqbal, 556 U.S. 662, 678 (2009); Bell Atl. Corp. v. Twombly, 550 U.S. 544, 570 (2007).

[8] Amy Craiger, *From Conceivable to Impossible: The Hurdles Plaintiffs Must Overcome When Pleading Section 11 and Section 12(a) Securities Claims,* 5 BROOKLYN. J. CORP. FIN. & COM. L. 549, 567–68 (2011).

[9] *Id.* at 567.

elements of the Section 11 cause of action to novel financial products.[10] An especially troubling failure of the courts, related to claims regarding incomplete disclosures, arises in registration statements for leveraged and inverse funds. This case note discusses the possible implications of the Second Circuit's misapplication of Section 11 to those novel financial products – a timely exploration as a registration for even riskier versions of the funds at issue in those claims have been accepted by the Securities and Exchange Commission ("SEC").[11] Perhaps emboldened by the decisions analyzed in this article, the risk disclosures in the registration statements for those funds have been deemed "the equivalent of a shrug emoji."[12]

This article consists of four distinct parts. In Part II, the article will examine Section 11 of the Act, its attendant regulation, and the applicable case law. Part III introduces the case of *In re ProShares Trust Securities Litigation (In re ProShares II),* decided by the Second Circuit in 2013, which affirmed the dismissal of the plaintiffs' Section 11 claim by the Southern District of New York *(In re ProShares I)* under Rule 12(b)(6). *In re ProShares II* illustrates how courts may misapply Section 11 when examining the registration statements of novel securities. Part IV analyzes *In re ProShares II* in light of statutory and case law, arguing that the Second Circuit has set a potentially dangerous precedent in the "Mother Court" for securities law.[13] Part V serves as the conclusion of the article, arguing that the erroneous conclusion of the Second Circuit should be limited for the sake of meaningful disclosure.

II. SECTION 11 OF THE SECURITIES ACT OF 1933

An examination of Section 11 of the Act must start with the text of the statute itself. Section 11 states, in part, when "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact

[10] *See generally In re* ProShares Tr. Sec. Litig. (*In re* ProShares II), 728 F.3d 96, 102 (2d Cir. 2013) (discussed in this Note).

[11] Jason Zweig, *Are You Really Crazy Enough to Buy a Quadruple-Leveraged ETF?,* WALL ST. J. (May 19, 2017), https://blogs.wsj.com/moneybeat/2017/05/19/are-you-really-crazy-enough-to-buy-a-quadruple-leveraged-etf/.

[12] *Id.*

[13] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 762 (1975). (Blackmun, J., dissenting) (describing the Second Circuit as the Mother Court for securities law because a large portion of securities law cases arise from events on Wall Street and come through the Southern District of New York and the Second Circuit).

required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security" has a private right of action against the issuer and other statutory defendants.[14] As previously stated, the liability for issuers under Section 11 is "virtually absolute, even for innocent misstatements."[15] All a plaintiff must allege is that the registration statement contains a misstatement or omission of a material fact.[16] No scienter, reliance, or loss causation need be alleged or proven by the plaintiff.[17]

The SEC has sought to provide considerable guidance to issuers so that they might avoid making a misstatement or omission of material fact in violation of Section 11.[18] For many types of securities, the SEC has created a form to guide disclosures.[19] The SEC has provided Form N-1A for open-ended investment company products such as mutual funds and Exchange Traded Funds ("ETFs").[20] Form N-1A has nine items which must be addressed in sequence by the issuer within the registration statement.[21] The SEC has also written rules, such as Rule 421 requiring "plain English," to guide the style of registration statement disclosures.[22] The SEC also publishes non-binding guidance documents to highlight ways in which disclosures could be improved.[23] All of these actions by the SEC are meant to ensure full and correct disclosures of material fact by issuers. Still, issuers regularly face claims of violating Section 11.[24]

A particularly thorny issue which gives rise to Section 11 claims is the disclosure of principal risks.[25] In what is perhaps the most challenging Section 11 case, a court must decide whether a risk was sufficiently disclosed, from the perspective of a reasonable investor, when a novel financial product was registered.[26] The Second Circuit held that the obligations under Form N-1A are especially strong where

[14] 15 U.S.C. § 77k (2012).

[15] Herman & McLean v. Huddleston, 459 U.S. 375, 382 (1983).

[16] *In re* Flag Telecom Holdings, Ltd. Sec. Litig., 411 F. Supp. 2d 377, 382 (S.D.N.Y. 2006).

[17] *In re* Morgan Stanley, 592 F.3d 347, 359 (2d Cir. 2010).

[18] *See, e.g.*, SEC, No. 2014-08, Investment Management Guidance Update (June 2014) [hereinafter Guidance Update].

[19] *See, e.g.*, SEC, Form N-1A, http://www.sec.gov/about/forms/formn-1a.pdf [hereinafter Form N-1A].

[20] 17 C.F.R. § 274.11A (2016).

[21] Form N-1A, *supra* note 19.

[22] 17 C.F.R. § 230.421(d) (2016).

[23] *See* Guidance Update, *supra* note 18.

[24] *See generally id.*

[25] *See e.g.*, *In re* Morgan Stanley, 592 F.3d. 347, 365–66 (2d Cir. 2010) (discussing disclosures of principal risks).

[26] *Id.*

the complaint alleges the omission of risks that "were unique to investing in the fund."[27] Further, disclosures cannot be general to the fund classification (*i.e.*, money market).[28] Instead, "securities laws require issuers to disclose firm-specific information" such as the risks that arise from the issuer's unique investment-selection methodology.[29]

There may be a point, however, at which the volume of disclosures actually makes the registration statement less clear to the reasonable investor.[30] At that point, "the entire legislative scheme can be frustrated by technical compliance with the requirements of the Securities and Exchange Commission's Form."[31] With the purpose of obscuring relevant risks, issuers sometimes draft registration statements "so as to be comprehensible to only a minute part of the investing public."[32] The Seventh Circuit has recognized that "reasonable investors do not want to know everything that could go wrong, without regard to probabilities; that would clutter registration documents and obscure important information."[33] Instead, issuers must take care to "decide what information will be useful without burying investors under a blizzard of paper".[34] In short, "[i]ssuers must winnow things to produce manageable, informative filings."[35]

While courts agree that disclosures must be specific and concise enough to inform a reasonable investor, there is a circuit split on which level of sophistication the issuer may assume on the part of investors.[36] The Seventh Circuit judged the standard to be that of a financial analyst because of the great degree of intermediation within the financial industry.[37] The Second Circuit has defined the reasonable investor as the "ordinary investor"[38] and has asserted that the registration statement "must not slight the less experienced."[39]

[27] *Id.* at 365.
[28] *Id.* at 361, 366.
[29] Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 515 (7th Cir. 1989).
[30] Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp 544, 574 (E.D.N.Y. 1971).
[31] *Id.* at 564.
[32] *Id.* at 565.
[33] *Wielgos*, 892 F.2d at 517.
[34] *Id.* at 518.
[35] *Id.* at 517.
[36] *Compare Wielgos*, 892 F.2d at 517 (judging the standard to be that of a financial analyst), *with* Schlesinger Inv. P'ship v. Fluor Corp., 671 F.2d 739, 743 (2d Cir. 1982) (using the standard of a "reasonable investor").
[37] *See Wielgos*, 892 F.2d at 514.
[38] *Schlesinger Inv. P'ship.*, 671 F.2d. at 743.
[39] Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp 544, 566 (E.D.N.Y. 1971).

continued . . .

However, the Second Circuit has also held that issuers "are not required to address [reasonable investors] as if they were children in kindergarten."[40] This decision seems in line with the purpose of the Act and the SEC's mandate that investors "are entitled to have within the four corners of the document an intelligible description of the transaction" that a financial industry intermediary can understand and explain.[41]

The settled law, therefore, is that issuers of open-ended products such as ETFs are required to disclose material risks in registration statements without misstatement or omission.[42] Where a risk is unique, the issuer is obligated to fully explain that risk in plain English.[43] The issuer must also make the disclosure "firm-specific".[44] The exact level of sophistication the issuer should assume in regards to investors is disputed, but certainly no greater sophistication than that of a financial intermediary should be assumed of investors.[45]

It is against this background of established law that Wall Street firms, whose innovative tendencies are rivaled perhaps only by Silicon Valley start-ups, issued the first leveraged and inverse ETFs.[46] The issuers of the new ETFs did something that no other mutual fund or ETF had ever done: they sought to track a benchmark *for one day only*, then reset the portfolio to do the same the next day.[47] Whereas other ETFs sought long-term tracking of a benchmark with short-term deviations (*i.e.*, tracking error), leveraged and inverse funds would do precisely the opposite.[48] When experienced investors made long-term bets through the new ETFs, they were surprised when long-term returns were negative despite the fact that they had correctly predicted the long-term trend of the benchmark.[49] The surprised investors filed

---

[40] Greenapple v. Detroit Edison Co., 618 F.2d 198, 210 (2d Cir. 1980) (quoting Richland v. Crandall, 262 F. Supp. 538, 554 (S.D.N.Y. 1967)).

[41] *Feit*, 332 F. Supp. at 566.

[42] *Greenapple*, 618 F.2d at 204.

[43] 17 C.F.R. § 230.421(d) (2016).

[44] Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 515 (7th Cir. 1989).

[45] *See Greenapple*, 618 F.2d at 210.

[46] *ProShares Launches First Leveraged and Inverse Biotechnology ETFs*, PROSHARES (Apr. 8, 2010), http://www.proshares.com/news/proshares_launches_first_leveraged_and_inverse_biotechnology_etfs.html.

[47] *Rebalancing Geared Fund Positions*, PROSHARES, http://www.proshares.com/media/documents/rebalancing_leveraged_and_inverse_fund_positions.pdf (last visited June 4, 2017).

[48] *Id.*

[49] Nate Raymond & Lauren LaCapra, *Court Rejects Appeal Over Leveraged Funds' Volatility*, 19 No. 18 WESTLAW J. DERIVATIVES 10, 10 (2013).

Section 11 class action lawsuits against the issuers of leveraged and inverse ETFs just a few years after the products were introduced.[50]

Two such class action lawsuits, *In re ProShares I* and *In re Direxion,* were decided in the Southern District of New York in 2012.[51] The cases shared factual scenarios involving initial registration statements for leveraged and inverse ETFs.[52] The defendants in each case filed motions to dismiss under Rule 12(b)(6).[53] Each defendant pointed out inconspicuous references to a risk resulting from daily rebalancing and general warnings in the registration statements.[54] Plaintiffs, on the other hand, noted that new risk disclosures made after investors lost substantial sums undercut the defendants' claims that initial disclosures were adequate.[55] Despite their similarities, the two cases had remarkably different outcomes. The *In re Direxion* court held that the plaintiffs stated a plausible claim that the registration statement contained material omissions.[56] The court in *In re ProShares I*, and later the Second Circuit on appeal, in *In re ProShares II*, found that the risk disclosures in the registration statements were sufficient and dismissed the plaintiffs' Section 11 claim.[57] This case note seeks to explain how the Second Circuit's decision in *In re ProShares II* set a dangerous precedent by misapplying both law and fact.

---

[50] *Id.*

[51] *In re* Direxion Shares ETF Tr. (*In re* Direxion), 279 F.R.D. 221, 221 (S.D.N.Y. 2012); *In re* ProShares Tr. Sec. Litig. (*In re* ProShares I), 889 F. Supp. 2d 644, 644 (S.D.N.Y. 2012).

[52] *In re Direxion*, 279 F.R.D. at 225–26; *In re ProShares I*, 889 F. Supp. 2d at 649–50.

[53] FED. R. CIV. P. 12(b)(6).

[54] Direxion Defendants' Memorandum of Law in Support of Their Motion to Dismiss at 8–10, *In re* Direxion Shares ETF Tr., 279 F.R.D. 221 (S.D.N.Y. 2012) (No. 1:09-CV-08011-RJH), 2011 WL 7628020; Memorandum of Law in Support of Defendants' Motion to Dismiss the Amended Consolidated Class Action Complaint at 11–12, *In re* ProShares Tr. Sec. Litig., 889 F. Supp. 2d 644 (S.D.N.Y. 2012) (No. 09-cv-6935-JGK), 2010 WL 5887691.

[55] Class Action Complaint at 5–8, *In re* Direxion Shares ETF Tr., 279 F.R.D. 221 (S.D.N.Y. 2012) (No. 09-CIV-8011), 2009 WL 3122843; Corrected Reply Brief for Plaintiffs-Appellants at 1–3, *In re* ProShares Tr. Sec. Litig., 889 F. Supp. 2d 644 (S.D.N.Y. 2012) (No. 12-3981), 2013 WL 876911.

[56] *In re Direxion*, 279 F.R.D. at 233 (following the court's decision, the defendant settled).

[57] *In re* ProShares II, 728 F.3d 96, 102 (2d Cir. 2013); *In re* ProShares I, 889 F. Supp. 2d 644, 656–57 (S.D.N.Y. 2012).

III. IN RE PROSHARES I AND II

ETFs differ from open-ended mutual funds in several important aspects.[58] For example, investors trade ETF shares on the secondary market rather than purchasing and redeeming them directly through the issuer.[59] ETFs also trade at a market price, which may be above or below Net Asset Value ("NAV"), rather than always being priced at NAV.[60] However, there are still more similarities between ETFs and mutual funds than differences. Most significantly, both mutual funds and ETFs typically track "a specific index, sector, commodity, or currency."[61] By 2006, investors had a firm grasp of the risks and benefits of ETF ownership and were embracing the product.[62]

The ETFs, which ProShares launched in 2006, differed significantly from the ETFs investors had grown accustomed to over the previous decade.[63] None of the ProShares ETFs were ordinary index funds.[64] Instead, ProShares created and operated three unique types of ETFs: Inverse, Ultra Long, and Ultra Short.[65] The inverse ETFs were designed to "replicate the inverse movement of a specific index over one day."[66] The Ultra Long ETFs were designed to "double the performance of the underlying index or benchmark on a daily basis."[67] The Ultra Short ETFs were designed "to double the performance of the underlying index or benchmark on a daily basis."[68] Each of these ProShares fund types, and their shared one-day performance goal, were new concepts to ETF investors in 2006.[69]

In October 2007, just a year after the first ProShares registration statement was filed, the United States stock market went into a steep decline as the financial crisis began to unfold.[70] Some assets, such as

---

[58] *In re ProShares II*, 728 F.3d at 99.

[59] *Id.*

[60] *Vanguard ETF or Fund: Demystifying the Choice*, IN THE VANGUARD 1, 12 (2010) https://www.vanguard.com/pdf/itvsummer2010.pdf?2210047840.

[61] *In re ProShares I*, 889 F. Supp. 2d at 649.

[62] *Barclays ETF Group Net Inflows on Pace with 2006*, REUTERS (Mar. 14, 2007), http://www.reuters.com/article/etfs-barclays-usa-idUSN1430053220070314 (describing a 40% increase in U.S.-based ETFs from the end of 2005 to the end of 2006).

[63] Todd Shriber, *Another Look at ETF Industry Growth,* ETF TRENDS (Jan. 17, 2014, 9:30 AM), http://www.etftrends.com/2014/01/another-look-at-etf-industry-growth/.

[64] *In re ProShares I*, 889 F. Supp. 2d at 650–51.

[65] *Id.* at 649.

[66] *In re* ProShares II, 728 F.3d 96, 99 (2d Cir. 2013).

[67] *Id.*

[68] *Id.*

[69] *Id.*

[70] *The Origins of the Financial Crisis: Crash Course*, THE ECONOMIST (Sept. 7,

continued . . .

the stock of financial companies, were seen as especially toxic during that period.[71] Some investors seem to have recognized opportunities to profit from the decline by investing in ProShares' new ETFs. For example, the ProShares Ultra Short Financials ETF ("SKF") promised to increase two times whatever the Dow Jones U.S. Financials Stock Index fell.[72] If the financial stocks continued to fall as institutions like Bear Stearns and Lehman Brothers failed, investors in SKF could grow rich in the middle of a historic stock market decline.[73]

The returns on the ProShares ETFs, however, were not as investors expected. Over an eighteen month period between January 2008 and June 2009, the Dow Jones U.S. Financials Stock Index experienced a decline of fifty-two percent.[74] The investors who correctly predicted the drop expected a corresponding positive return of 104% for SKF.[75] SKF investors actually experienced a *loss* of sixty-one percent.[76] Other ProShares ETFs delivered equally surprising losses to their investors.[77]

Over the summer of 2009, ProShares began to change the risk disclosures it provided to investors.[78] On June 23, 2009, ProShares filed a prospectus stating for the first time that "volatility of the benchmark may be at least as important to the Fund's return for the period as the return of the benchmark."[79] The same registration statement also expressly stated that a one year period described therein was "used for illustrative purposes only."[80] These new disclosures finally made the risk clear: long-term investors could not profit from the ETFs because they were *only* suitable for one-day trading strategies.[81] The investors who had lost money in forty-four

2013), http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article.

[71] *Id.*

[72] *In re* ProShares I, 889 F. Supp. 2d 644, 650–51 (S.D.N.Y. 2012).

[73] *See id. See generally The Origins of the Financial Crisis: Crash Course*, *supra* note 70.

[74] *In re ProShares I*, 889 F. Supp. 2d at 651.

[75] *Id.*

[76] *Id.*

[77] *Id.* at 649, 651 (stating that similar surprises were held by ProShares ETFs that promised inverse and leveraged returns of emerging market stocks and broad-based U.S. stock indices).

[78] *In re* ProShares II, 728 F.3d 96, 103–04 (2d Cir. 2013).

[79] Second Amended Consolidated Class Action Complaint at 76, In re ProShares Tr. Sec. Litig., 889 F. Supp. 2d 644 (S.D.N.Y. 2012) (No. 1:09-cv-06935-JGK), 2011 WL 1256908.

[80] *Id.* at 185.

[81] *See id.* at 262–63.

ProShares ETFs[82] responded to the new risk disclosures by filing a class action lawsuit alleging violations of Section 11 of the Act.[83]

The plaintiffs alleged that the registration statements omitted the material fact that investors could suffer large losses, despite correctly predicting long-term trends in the underlying benchmarks, because of volatility.[84] In response to the plaintiffs' allegations, ProShares filed a motion to dismiss pursuant to Rule 12(b)(6).[85] In deciding such a motion, the "court accepts the allegations in the complaint as true, and draws all reasonable inferences in the plaintiffs' favor."[86] The determinative issue in ruling on ProShares' motion was whether the plaintiffs "plausibly alleged a material misstatement or omission in any of the registration statements at issue".[87] In this case, the inquiry focused on whether there was an omission.[88]

The court correctly defined an omission as material if there is a substantial likelihood that a reasonably prudent investor would consider it important is making a decision.[89] The court further stated that the allegation of an omission would only be dismissed if it was "so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of [its] importance."[90] This seemed to set a low bar for plaintiffs. One of the few instances in which a claim might be dismissed under this standard is if the registration statement actually did disclose, in plain English, the exact risk that later materialized.[91] Stated conversely, the court must not dismiss the claim if the specific risk that the plaintiffs allege was omitted cannot be matched with a disclosure present in the registration statement.[92]

The Southern District of New York, and later the Second Circuit on appeal, held that the ProShares ETF registration statement disclosed the precise risk that the plaintiffs alleged was omitted.[93] The Second Circuit was convinced that several disclosures covered the risk.[94] First, the Second Circuit noted that ProShares stated in press

[82] *In re ProShares I*, 889 F. Supp. 2d at 647.

[83] *In re ProShares II*, 728 F.3d at 99.

[84] Reply Brief for Plaintiff-Appellants at 7, In re Pro Shares Tr. Sec. Litig., 728 F.3d 96 (2013) (No. 12-3981-CV), 2013 WL 876911.

[85] Fed. R. Civ. P. 12(b)(6).

[86] *In re ProShares I*, 889 F. Supp. 2d at 648.

[87] *Id.* at 653.

[88] *Id.*

[89] Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988).

[90] Goldman v. Belden, 754 F.2d 1059, 1067 (2d Cir. 1985).

[91] Partners Inc. v. Ikanos Commc'ns, 681 F.3d 114, 122 (2d Cir. 2012).

[92] *See id.*

[93] *In re ProShares I,* 889 F. Supp. 2d at 656.

[94] *In re* ProShares II, 728 F.3d 96, 109 (2d Cir. 2013).

releases that their ETFs were for "investors interested in pursuing more sophisticated trading strategies."[95] Second, ProShares had stated the funds were "particularly risky and speculative."[96] Third, the registration statements disclosed that "[o]ver time, the cumulative percentage increase or decrease in the net asset value of the [ETFs] may diverge significantly from the cumulative percentage increase or decrease in the multiple of the return of the Underlying Index."[97] The district court concluded that "the disclosures in the registration statements accurately reflected the specific risk that the plaintiffs assert materialized."[98] The district court dismissed the Section 11 claim against ProShares.[99] The Second Circuit affirmed on the same grounds.[100]

IV. ANALYSIS

The Southern District of New York, in *In re ProShares I*, found that ProShares had disclosed "the specific risk" that the plaintiffs alleged was omitted from the registration statements.[101] If this is true, then the court was obviously correct in granting ProShares' Rule 12(b)(6) motion to dismiss. However, the court was mistaken about this vital point. It was mistaken because it was confused about the exact risk the plaintiffs alleged was omitted *and* the meaning of disclosures present in the registration statements.[102] The Second Circuit, the supposed "mother court" of securities law failed to see the error on appeal.

A. Misunderstanding the Allegedly Omitted Risk

Nowhere is the courts' misunderstanding of the alleged omission clearer than when comparing two statements found on consecutive pages of the *In re ProShares I* opinion. In one statement, the district

[95] *Id.* at 99.
[96] *In re ProShares I*, 889 F. Supp. 2d at 655.
[97] *In re ProShares II,* 728 F.3d at 101.
[98] *In re ProShares I*, 889 F. Supp. 2d at 656.
[99] *Id.*
[100] *In re ProShares II*, 728 F.3d at 109.
[101] *See In re ProShares I*, 889 F. Supp. 2d at 656.
[102] The plaintiff's brief to the Second Circuit began with the statement that the "[d]efendants mischaracterize Plaintiffs' claims, Defendants' disclosure obligations, and the chasm between the substance of what Defendants did disclose and the omitted material facts." Corrected Reply Brief for Plaintiffs-Appellants at 1, *In re ProShares II*, 728 F.3d 96 (2013) (No. 12-3981), 2013 WL 876911, at *1. This should have put the Second Circuit on notice for sleight of hand, but it repeated the mistake made by the lower court despite the warning.

court correctly framed the risk that had allegedly been omitted by stating, "[t]he plaintiffs argue that the registration statements contained omissions because they did not disclosure the magnitude of the risk, namely that particularly during period of high volatility an ETF investor could be correct about the direction of the underlying index and nonetheless lose money."[103] This is the proper framing of the plaintiffs' allegation.[104]

On the preceding page of the same opinion, in the heart of the court's discussion, the court framed the omitted risk disclosure differently by stating, "This was the precise risk that the plaintiffs allege later materialized: the plaintiffs held the ETFs for long periods of time beyond one day, and their value diverged significantly from the expected daily result causing large losses."[105] These two framings of the allegedly omitted risk disclosure seem similar because they contain some of the same wording. However, the first statement describes the risk that volatility is a primary risk which might cause a large loss despite the investors' correct prediction of the market's direction.[106] The second statement describes the risk that volatility may cause returns to differ from those of the funds' benchmarks (*i.e.*, tracking error risk).[107] These are very different risks.

The Second Circuit was just as confused in framing the allegedly omitted risk on appeal as the district court had been. The Second Circuit adopted the language of the district court, and framed the omitted risk yet a third way by stating, "The thrust of the plaintiffs' Section 11 claim is that the registration statements omitted the risk that the ETFs, when held for a period of greater than one day, could lose substantial value in a relatively brief period of time, particularly in periods of high volatility."[108] This is the risk that losses could be greater and more sudden in volatile markets.[109] This is even more general than the district court's framing and could best be described as a "boilerplate" risk disclosure. Any issuer could properly state that this risk exists for the securities it is offering.[110] Therefore, the disclosure does not alert the investor to any risk particular to the offering.

If the courts' misunderstanding of the alleged omission is because

[103] *In re ProShares I,* 889 F. Supp. 2d at 655.
[104] *Id.*
[105] *Id.* at 654.
[106] *See generally id.* at 654–55.
[107] *See generally id.*
[108] *In re* ProShares II, 728 F.3d 96, 102 (2d Cir. 2013) (quoting *In re ProShares I*, 889 F. Supp. at 654).
[109] *See id.* at 102–03.
[110] *Id.*

they misunderstood ProShares' products, that would be understandable. Many investors and even financial professionals seem to have been equally confused about the risks associated with those products.[111] In fact, the SEC issued a special alert on September 31, 2009, three months after the class period closed, highlighting risks posed by leveraged and inverse ETFs.[112] The alert warned that "a number of leveraged and inverse ETFs have been introduced to the market that are very different from the traditional variety of ETFs."[113] The SEC noted that "it is possible that you could suffer significant losses even if the long-term performance of the index showed a gain."[114] The SEC's warnings are clearer than any of the risk disclosures made by ProShares, even in the firm's corrective disclosures.

On the same day that the SEC published its alert, FINRA issued a Regulatory Notice to broker-dealers about leveraged and inverse ETFs.[115] The FINRA notice boldly stated that while those products "may be useful in some sophisticated trading strategies," they "are unsuitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets."[116] This clear statement by FINRA to its broker-dealers is especially remarkable given that it was directed at firms and individuals who FINRA had licensed to give investment advice to and place securities transactions for the public.[117] The FINRA statement, in concert with the SEC alert, indicates that ProShares' risk disclosures fell well short of what was necessary even if the reasonable investor is deemed to be a financial professional.

While the Second Circuit might be excused for misunderstanding

---

[111] *Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors,* SEC (Aug. 1, 2009), http://www.sec.gov/investor/pubs/leveragedetfs-alert.htm.

[112] *Id.*

[113] *Id.*

[114] *Id.*

[115] *Non-Traditional ETFs*, FINRA (June 2009), http://www.finra.org/industry/notices/09-31.

[116] *Id.*

[117] At least one brokerage firm, The Vanguard Group, responded to FINRA's message by changing the way it placed traded for leverages and inverse ETFs. Clients could no longer buy the products online. They were forced to call the firm, then were routed to a senior-level broker on the block desk for a full conversation about the unusual risks posed by the products. Junior-level brokers, although fully licensed, were not able to trade the products. Their trading software blocked the trades and directed them to contact a senior-level broker. *See ETF Investing Can Add Flexibility to Your Portfolio*, VANGUARD, https://investor.vanguard.com/etf/?lang=en (last accessed June 24, 2017).

the risks posed by ProShares' products, the court is not excused from the error of law that flowed from that misunderstanding. It is not incumbent on a court, hearing a Rule 12(b)(6) motion in response to an allegation under Section 11, to understand the full complexities of the financial product at issue.[118] Instead, the law requires the court to take the allegations as true, compare them to the disclosures made, and determine if a reasonable jury might conclude that the disclosures insufficiently address those disclosures which were allegedly omitted.[119] That is all. By failing to follow this process, the Second Circuit made a serious error of law.

B. Misunderstanding the Issuer's Disclosures

Not only did the Second Circuit fail to comprehend the allegedly omitted risk disclosures, but it also failed to comprehend the actual disclosures made by ProShares. The disclosures that the Second Circuit cited as sufficiently covering the alleged omissions can be broken into two categories: irrelevant and general. The example of an irrelevant disclosure comes from the Second Circuit's reading of "diverge significantly".[120] The Second Circuit observed that the "[p]laintiffs acknowledge that the prospectuses warned that the value of long-term investments 'may diverge significantly' from that ETF's underlying index."[121] The risk disclosure that the Second Circuit found relevant might seem to match the risk as articulated by the plaintiffs.[122] If there is a match, it forecloses a Section 11 claim.[123] However, the disclosure cited by the Second Circuit has absolutely nothing to do with the risk the plaintiffs alleged was omitted.

The Second Circuit found the warning that the ETFs might "diverge significantly" from the performance of the underlying benchmark "put investors on notice that an ETF's value might move in a direction quite different from and even contrary to what an investor might otherwise expect."[124] This is not what the disclosure means. In fact, this risk disclosure is boilerplate language that can be found in any index ETF registration statement.[125] For example, one registration

[118] *See generally In re* ProShares I, 889 F. Supp. 2d 644, 648 (S.D.N.Y. 2012) (The Court's function on a motion to dismiss is not to weigh the evidence, but to determine if the complaint itself is legally sufficient).

[119] *Id.*

[120] *In re* ProShares II, 728 F.3d 96, 102 (2d Cir. 2013).

[121] *Id.*

[122] *See id.* at 96.

[123] FED. R. CIV. P. 11.

[124] *In re ProShares II*, 728 F.3d 96 at 103.

[125] *Id.* at 102.

statement for a stock index ETF states, "[t]he market prices of Shares may deviate significantly from the NAV of the Shares during periods of market volatility."[126] That disclosure, which is substantively identical to the disclosure fixed upon by the *In re ProShares II* court, is within a section labelled "Unit Premiums and Discounts."[127] It described tracking error risk, which is common to all index funds.[128] It has nothing to do with the risks associated with the daily-rebalancing of a leveraged or inverse ETF portfolio in times of volatility.[129] It certainly is not understood to mean an underlying index might return 100% while the market price of the investment sinks 62%.[130] Consequently, the Second Circuit finding that an unrelated boilerplate disclosure articulated the "exact risk" that the plaintiffs alleged was omitted is clearly erroneous.[131]

In addition to giving ProShares credit for a risk disclosure irrelevant to the plaintiffs' claims, the Second Circuit cited several general disclosures as evidence that the allegedly omitted risks were actually disclosed.[132] One of the risk disclosures that the Second Circuit cited was the statement that the ETFs were for "'investors interested in pursuing more sophisticated trading strategies."[133] This general disclosure does not inform the investors in any meaningful way, does not alert them to any specific risk, and could reasonably be viewed as Wall Street sales puffery intended to induce investors.[134] Also, the Second Circuit observed that the registration statements, read as a whole, made it clear that the ETFs were "particularly risky and

[126] *ETF is Series Trust I Prospectus*, *Form N-1A*, SEC.GOV 1, http://bioshares.com/investor-materials.html (last visited July 11, 2017).

[127] *Id.*

[128] *Tracking Error*, INVESTOPEDIA, http://www.investopedia.com/terms/t/trackingerror.asp (last visited Aug. 17, 2017).

[129] *In re ProShares II*, 728 F.3d at 103. In perhaps the most exasperating passage of the Second Circuit's opinion, the court cites the plaintiffs' correct interpretation of the "diverge significantly" risk disclosure and dismisses it. The plaintiffs' counsel might be faulted for not demonstrating as I have in this paper that the same disclosure appears in registration statements for basic index funds.

[130] *See generally id.* (using these numbers as an example suggesting "diverge significantly" does not include large, rapid losses).

[131] *Id.* at 102.

[132] *See id.* at 101–02.

[133] *Id.* at 99 (citing Third Amended Complaint at 104–08, *In re ProShares II*, 728 F.3d 96).

[134] It is not unusual for Wall Street firms to introduce products to the general public that claim to possess sophisticated or even professional qualities. Consider the name ProShares. It suggests that the firm's products are for professional traders. Yet, they have deliberately been placed on the public stock exchanges. The name ProShares, as well as the claim of "sophisticated trading strategies," are typical Wall Street puffery with little substantive meaning.

speculative."[135] This disclosure that the Second Circuit divines from the registration statement also does not put the investors on notice in any substantive way. Neither general disclosure highlighted by the court could reasonably be said to address the specific risk the plaintiffs alleged was omitted without misapplying law from the Second Circuit.[136]

Existing law clearly indicates that general disclosures do not provide a defense to a claim under Section 11.[137] Regulations governing registration statements state that the issuer must disclose "the most significant factors that make the offering speculative or risky" and must not "present risks that could apply to any issuer."[138] The Seventh Circuit has held that "[s]tatements along the lines of 'all businesses are risky' . . . come to nothing more than caveat emptor" and fall short of what is required by federal securities law.[139] The Second Circuit has also held that risk disclosures must be "unique to investing in the fund."[140] The Second Circuit, in *In re ProShares II*, clearly departed from precedent by giving weight to general disclosures of risk where the complaint alleged a specific disclosure was omitted.[141]

In *In re ProShares II*, the Second Circuit was presented with the record, which included the plaintiffs' claim that the issuer had failed to disclose specific and material risks and evidence that the issuer had made several general risk disclosures in its registration statement.[142] The Second Circuit, like the lower court, generalized the allegation, misinterpreted irrelevant disclosures, and found that the lower court had not erred in determining that the general disclosures were sufficient to put investors on notice. If our disclosure-based system of securities law is to provide investors any protection, this cannot be the correct application of Section 11. If courts may generalize allegations and pair them to irrelevant or general disclosures, then an issuer would never be liable under this important anti-fraud provision of the Act.[143] Section 11, one of the most significant investor protections in securities law, would then be a nullity. This cuts not just against the

---

[135] *In re* ProShares I, 889 F. Supp. 2d 644, 655 (S.D.N.Y. 2012).

[136] *In re* Morgan Stanley, 592 F.3d 347, 360 (2d Cir. 2010).

[137] *See* Asher v. Baxter Int'l Inc., 377 F.3d 727, 733 (7th Cir. 2004).

[138] 17 C.F.R. § 229.503(c) (2016).

[139] *Asher*, 377 F.3d at 733.

[140] *In re Morgan Stanley*, 592 F.3d at 364.

[141] *See generally In re* ProShares II, 728 F.3d 96 (2d Cir. 2013) (holding "the disclosures in the registration statements . . . adequately warned the reasonable investor of the allegedly omitted risks").

[142] *See id.*

[143] 15 U.S.C. § 77k (2012).

purpose of Section 11, but against the bedrock principle of disclosure in securities law.[144] In *In re ProShares II,* the Second Circuit engaged in a manipulation of fact and a misapplication of law with potentially wide-ranging implications.

C. After In re ProShares II

A few years have passed since the Second Circuit's error in *In re ProShares II*. Fortunately, district courts that have addressed similar factual scenarios after *In re ProShares II* have not followed the Second Circuit's lead. There are several cases demonstrating this point. In 2013, the Federal District for the Middle District of North Carolina held that a discussion of risk factors should be specific to the particular issuer.[145] Similarly, the Massachusetts District Court held in 2014 that the issuer must go beyond boilerplate disclosures to articulate what factors make the offering speculative or risky.[146] In 2016, the Northern District of California denied a motion to dismiss a claim where the issuer disclosed past product failures and the potential for future failures, but did not disclose the existence of failures known at the time of registration statement's filing.[147] Finally, and perhaps most significantly, the South District of New York denied a motion to dismiss a claim where the issuer made "only generalized disclosures that described the risk of a delayed launch" of a key product without communicating the "known risks regarding the delayed launch."[148] These decisions, unambiguously declaring the necessity of precise risk disclosures in registration statements, stand in sharp contrast with the *In re ProShares II* decision.[149] They offer hope that *In re ProShares II* will be limited to its facts.[150] That hope may be soon tested as issuers

[144] *See generally* HAMILTON, *supra* note 1, at 18.

[145] *See generally* Plymouth City. Ret. Ass'n. v. Primo Water Corp., 966 F. Supp. 2d 525 (M.D.N.C. 2013).

[146] *See generally* Silverstand Invs. v. AMAG Pharm., Inc., 12 F. Supp. 3d 241 (D. Mass. 2014).

[147] Robb v. Fitbit Inc., 216 F. Supp. 3d 1017, 1035 (N.D. Cal. 2016), *reconsideration denied*, No. 16-CV-00151-SI, 2017 WL 219673 (N.D. Cal. 2017).

[148] In re iDreamSky Tech. Ltd. Secs. Litig,, No. 15-CV-2514 (JPO), 2017 WL 706336, at *3 (S.D.N.Y. 2017).

[149] *Compare In re ProShares II*, 728 F.3d 96 (2d Cir. 2013) *with* Plymouth City. Ret. Ass'n. v. Primo Water Corp., 966 F. Supp. 2d 525 (M.D.N.C. 2013); Silverstand Invs. v. AMAG Pharm., Inc., 12 F. Supp. 3d 241 (D. Mass. 2014); Robb v. Fitbit Inc., 216 F. Supp. 3d 1017, 1035 (N.D. Cal. 2016), *reconsideration denied*, No. 16-CV-00151-SI, 2017 WL 219673 (N.D. Cal. 2017); In re iDreamSky Tech. Ltd. Secs. Litig., No. 15-CV-2514 (JPO), 2017 WL 706336 (S.D.N.Y. 2017).

[150] *Plymouth Co. Ret. Ass'n*, 966 F. Supp. 2d at 525; *Silverstand Invs*., 707 F.3d at 95.

are now preparing to launch ETFs which are "wildly risky" supercharged versions of the ETFs at issue in the ProShares cases.[151]

V. CONCLUSION

The Second Circuit turned its back on a significant body of case law in deciding *In re ProShares II*. The standard for disclosure under Section 11 has historically been high, requiring precise descriptions of the risks "unique to investing in the fund."[152] The Second Circuit instead generalized the allegedly omitted risk disclosure, misread irrelevant risk disclosures, and accepted general risk disclosures as sufficient to cover unique risks.[153] Such a departure in the Second Circuit, if it is not limited to its facts, could have sweeping implications on federal securities law. Many more unique factual scenarios, created by novel financial products, will come before the federal courts. As has often been observed, the means of manipulation and fraud are "limited only by the ingenuity of man."[154]

If not limited to its facts, the opinion might be used by the Second Circuit, district courts bound by its precedent, and other federal courts that look to the influential "Mother Court" for guidance in securities law matters to deprive investors of their basic right: meaningful disclosure.[155] The influence of the opinion would deal yet another setback to securities law plaintiffs. Instead of being entitled to complete and specific disclosures, they would receive standard broad warnings which do not alert them to the risks actually posed by the investment.[156] Because there will certainly be a steady stream of novel products introduced by Wall Street firms in the years ahead, each more devilishly complex than its predecessor, Courts and plaintiffs' attorneys should earnestly strive to limit *In re ProShares II* to its facts.

---

[151] Zweig, *supra* note 11.

[152] *In re* Morgan Stanley, 592 F.3d 347, 365 (2d Cir. 2010).

[153] In fact, the contradiction is much deeper than it appears. The *In re Morgan Stanley* opinion cited throughout this case, noted as the proper rule requiring specific disclosures, also came from the Second Circuit and the opinion in that case was also written by Judge Wesley.

[154] Cargill, Inc. v. Hardin, 452 F.2d 1154, 1163 (8th Cir. 1971).

[155] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 762 (1975) (Blackmun, J., dissenting) (describing the Second Circuit as the Mother Court for securities law because a large portion of securities laws cases arise from events on Wall Street and come through the Southern District of New York and the Second Circuit).

[156] *See generally In re* ProShares II, 728 F.3d 96 (2d Cir. 2013).