

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

August Term, 2012

(Argued: May 2, 2013 Decided: July 22, 2013)

Docket No. 12-3981

IN RE PROSHARES TRUST SECURITIES LITIGATION

MARK KARASICK, STEVEN S. NOVICK, SUSAN ASAI, STEPHEN C. HERMAN,
CHARLES SANKOWICH, MICHAEL A. HYMAN, HOWARD SCHWACK, FRANCISCO JAVIER
DE LION DIAZ, RENE LACROIX, ANTHONY KOURI, ANTHONY ALEXANDER, JAY
BILYEU, JUDY BILYEU, MICHAEL ERIC CODLIN, WENDY ROCKWELL-GOFF, ROBERT
SCHUMACHER, JAMES HERSHMAN, DOROTHY HERSHMAN, SCOTT TESSLER, RICHARD
RHOADS, MARTIN GARY NORRIS, DOROTHY LOWELL, NANCY HITCHINS, THOMAS
TRUONG, EDWARD CISNEROS, CHRIS HONCIK, STEPHEN SHOAP, DMITRI ROUTSKI,
ELENA LAVENDER-BOWEN, DAVID BOWMAN, DAVID CHOW, MARK EVERETT BROWN,
JONATHAN DEAN, LAWRENCE LEWIS SINSEL, JR., KENNETH L. KRAMER, LAWRENCE
I. WEINER, JOHN E. KILLOUGH, ALAN PARKER, SCOTT A. SMELTZ, HOWARD
SCHWACK, DOUGLAS JONES, STEPHEN HERMAN, ON BEHALF OF THEMSELVES AND ALL
OTHERS SIMILARLY SITUATED, STEVEN SCHNALL, SHERRI SCHNALL, ON BEHALF OF
THEMSELVES,

Plaintiffs-Appellants,

-v.-

PROSHARES TRUST, PROSHARE ADVISORS LLC, SEI INVESTMENTS DISTRIBUTION
CO., MICHAEL L. SAPIR, LOUIS M. MAYBERG, RUSSELL S. REYNOLDS, III,
MICHAEL WACHS, SIMON D. COLLIER, PROSHARES TRUST II, EDWARD KARPOWICZ,
WILLIAM E. SEALE, CHARLES TODD, BARRY PERSHKOW,

Defendants-Appellees.

1 Before:

2 WESLEY, CARNEY, WALLACE,* *Circuit Judges.*
3

4 Appeal from an order of the United States District
5 Court for the Southern District of New York (John G. Koeltl,
6 *Judge*), entered on September 12, 2012, dismissing
7 Plaintiffs-Appellants' third amended complaint, with
8 prejudice, pursuant to Federal Rule of Civil Procedure
9 12(b)(6). Plaintiffs complain that Defendants offered
10 investments in forty-four leveraged exchange-traded funds
11 ("ETFs") through prospectuses that failed to warn them about
12 the magnitude and probability of loss in beyond-a-day
13 investments even when investors correctly predicted the
14 overall direction of the ETFs' underlying index.
15 Furthermore, Plaintiffs allege that Defendants included
16 various contra-indicators of successful long-term
17 investments in the prospectuses which the alleged omissions
18 made misleading. Accordingly, Plaintiffs seek to hold
19 Defendants liable for the alleged omissions and misleading
20 statements pursuant to sections 11 and 15 of the Securities
21 Act of 1933, 15 U.S.C. §§ 77k & 77o. After a comprehensive
22 review of the relevant prospectuses, the district court
23 concluded that the alleged omissions were immaterial as a
24 matter of law because the prospectuses warned of the risks
25 that materialized and no reasonable investor who read them
26 would have been misled about the risks of leveraged-ETF
27 investments. After our own review of the complaint and of
28 the prospectuses, we agree with that conclusion.
29

30 **AFFIRMED.**
31

32
33 CHRISTOPHER LOVELL, Lovell Stewart Halebian
34 Jacobson LLP, New York, NY (Jacob H. Zamansky,
35 Zamansky & Associates LLC, New York, NY, *on*
36 *the brief*), *for Plaintiffs-Appellants.*
37

38 ROBERT A. SKINNER, Ropes & Gray LLP, Boston, MA
39 (Nick W. Rose, Ropes & Gray LLP, Boston, MA;

*The Honorable J. Clifford Wallace, of the United States
Court of Appeals for the Ninth Circuit, sitting by designation.

1 Douglas H. Hallward-Driemeier, Ropes & Gray
2 LLP, Washington, D.C., *on the brief*), for
3 Defendants-Appellees ProShares Trust,
4 ProShares Trust II, ProShare Advisors LLC, SEI
5 Investments Distribution Co., Michael Sapir,
6 Louis Mayberg, Edward Karpowicz, William
7 Seale, Simon Collier, Charles Todd, and Barry
8 Pershkov.

9
10 Arthur H. Aufses III, Steven S. Sparling,
11 Kramer Levin Naftalis & Frankel LLP, New York,
12 NY, for Defendants-Appellees Russell Reynolds
13 and Michael Wachs.

14
15
16 WESLEY, Circuit Judge:

17 In this putative class action, Plaintiffs collectively
18 purchased shares in forty-four leveraged ProShares exchange-
19 traded funds ("ETFs") during the August 6, 2006 through June
20 23, 2009 class period. Third Amended Complaint ("TAC")
21 ¶¶ 1-2. They seek to hold Defendants-Appellees ProShares
22 Trust and ProShares Trust II (collectively, "ProShares")
23 liable for material omissions and misrepresentations in the
24 prospectuses for those ETFs pursuant to sections 11 and 15
25 of the Securities Act of 1933 ("'33 Act"), 15 U.S.C. §§ 77k
26 & 77o.¹

¹Defendant-Appellee ProShares Trust ("ProShares I") registered with the Securities and Exchange Commission ("SEC") as an open-end management investment company under the Investment Company Act of 1940. TAC ¶ 62(a). Defendant-Appellee ProShares Trust II ("ProShares II," collectively with ProShares I "ProShares") registered with the Commodity Futures Trading

1 **A. Exchange-Traded Funds**

2 In a series of press releases, ProShares indicated
3 that their ETFs were for “investors interested in pursuing
4 more sophisticated” trading strategies. See TAC ¶¶ 104-08
5 (internal quotation marks omitted). With ProShares ETFs,
6 investors could hedge and manage risk without having “to go
7 through the process of setting up margin accounts or
8 covering margin calls - they [could] simply trade
9 ProShares.” TAC ¶ 104 (quoting June 21, 2006 Press
10 Release). “And unlike a margin account, [an investor] can’t
11 lose more than [she] invest[s].” TAC ¶ 106 (quoting Feb.
12 1, 2007 Press Release). This is because ETFs operate like
13 indexed mutual funds but trade like stocks. TAC ¶ 82.

14 “ETFs frequently track an index, a sector of stocks, or
15 a commodity or currency.” TAC ¶ 81. They are considered to
16 be “indexed mutual funds that trade like stocks,” TAC ¶ 82,
17 but they differ from mutual funds because they are generally
18 sold to institutional investors in large blocks of shares,

Commission as a commodity pool. TAC ¶ 62(b). ProShares I
offered thirty-eight of the ETFs underlying this action;
ProShares II offered six. TAC ¶ 62(a), (b). Plaintiffs have not
identified any meaningful distinction between ProShares I’s and
ProShares II’s securities or registration statements such that
one of the fund defendants would be subject to liability while
the other would not.

1 called Creation Units. These investors generally purchase
2 Creation Units in exchange for "baskets" of securities that
3 mirror the securities in the ETF portfolio. Investors who
4 purchase Creation Units often split up the Units into
5 individual shares and sell them on a secondary market to
6 retail investors who otherwise might not be able to access
7 ETFs because of the cost of Creation Units. These retail
8 investors are then able to sell shares of ETFs on the
9 secondary market, but they generally cannot redeem shares
10 with the ETFs because the ETFs often redeem shares only when
11 they are packaged in Creation Units. TAC ¶ 82.

12 ProShares offered three types of ETFs: (1) an Inverse
13 ETF, (2) an Ultra Long ETF, and (3) an Ultra Short ETF. TAC
14 ¶ 93(a)-(c). An Inverse ETF aimed to "replicate the inverse
15 movement of the specified index over one day." TAC ¶ 93(a).
16 An Ultra Long ETF tried to "double the performance of the
17 underlying index or benchmark on a daily basis." TAC ¶
18 93(b). And an Ultra Short ETF was designed to "double the
19 inverse of the performance of the underlying index or
20 benchmark on a daily basis." TAC ¶ 93(c). Accordingly, if
21 the "specific index, benchmark, sector or commodity on which
22 an ETF [was] based[] increase[d] by 1% on a given day, then

1 [the Inverse ETF] would decrease by 1%; the [Ultra Long ETF]
2 would increase by 2%; and [the Ultra-Short ETF] would
3 decrease by 2%.” TAC ¶ 94. Each one of the ETFs in this
4 case is leveraged.

5 **B. Registration Statements**

6 ProShares I filed its registration statement on SEC
7 Form N-1A. TAC ¶ 89. ProShares II filed its registration
8 statement on Forms S-1 and S-3. TAC ¶ 91. The registration
9 statements consisted of, *inter alia*, a prospectus and a
10 statement of additional information (“SAI”). Though
11 ProShares I and ProShares II provided investors with several
12 different offering documents relevant to this appeal,
13 ProShares’ key disclosures relating to the ETFs at issue
14 here were materially consistent across all of the documents.

15 All relevant ProShares registration statements
16 disclosed that the ETFs pursued daily investment objectives
17 and daily investment results. See Skinner Decl., App’x A,
18 Item 1; App’x B, Item 1. ProShares I’s offering documents
19 make clear that these daily objectives were bets that it
20 could return a stated multiple of an ETF’s underlying index
21 each day by investing in different components of the
22 underlying index through various financial instruments. For

1 example, "principal investment strategies include[d]
2 i]nvesting in equity securities and/or financial instruments
3 (including derivatives) that ProShare Advisors believe[d],
4 in combination, [w]ould have similar daily price return
5 characteristics" of a stated multiple of the ETF's
6 underlying index. June 19, 2006 ProShares I Reg. Stmt at 7.

7 To achieve the predicted daily investment results,
8 ProShare Advisors or a Sponsor would determine the type,
9 quantity, and mix of investment positions that an ETF should
10 hold. In addition, ProShares reserved the right to
11 substitute a different index or security for an ETF's
12 underlying index and disclosed that it might over-weight or
13 under-weight certain components contained in the underlying
14 index. See, e.g., *id.* at 59-60; see also, e.g., Nov. 17,
15 2008 ProShares II Reg. Stmt. at 33-34. Furthermore, the
16 ETFs never took a defensive position and would remain "fully
17 invested at all times in securities and/or financial
18 instruments that provide exposure to its [u]nderlying
19 [i]ndex without regard to market conditions, trends, or
20 direction." June 19, 2006 ProShares I Reg. Stmt at 60; see
21 also Nov. 17, 2008 ProShares II Reg. Stmt. at 33. The ETFs'
22 views were expressly myopic: long-term objectives were

1 blurred because they were focused only on meeting a
2 benchmark tied to an underlying index one day at a time with
3 a portfolio of different securities.

4 Moreover, ProShares warned that its decision to invest
5 in a particular stock or financial instrument was not based
6 on the “investment merit of a particular security,
7 instrument, or company” and that it did not use
8 “conventional stock research or analysis, or forecast stock
9 movement or trends” in managing the assets of the funds.

10 June 19, 2006 ProShares I Reg. Stmt at 60; *see also* Nov. 17,
11 2008 ProShares II Reg. Stmt. at 34. Instead, ProShares ETFs
12 pursued daily results through aggressive investment
13 techniques. For ProShares I, each registration statement
14 warned that the ETFs used financial instruments and
15 “investment techniques . . . that may be considered
16 aggressive, including the use of futures contracts, options
17 on futures contracts, securities and indices, forward
18 contracts, swap agreements, and similar instruments.” *See*
19 Skinner Decl., App’x A, Item 6. ProShares I also disclosed
20 that use of these techniques and financial instruments
21 exposed the ETFs to “potentially dramatic” losses. *Id.*
22 Similarly, each relevant ProShares II prospectus warned that

1 the aggressive financial instruments had “volatile [trading
2 prices, and that] even a small movement in market prices
3 could cause large losses” because an ETF investment was
4 “speculative” and involved a high degree of risk. See *id.*,
5 App’x B, Item 6.

6 ProShares also warned that ETFs could not pursue their
7 stated objectives for beyond-a-day periods because
8 mathematical compounding and leveraging prevented the ETFs
9 from reaching those results. See *id.*, App’x A, Item 2;
10 App’x B, Item 2. In that regard, ProShares disclosed that
11 “[o]ver time, the cumulative percentage increase or decrease
12 in the net asset value of the [ETFs] may diverge
13 significantly from the cumulative percentage increase or
14 decrease in the multiple of the return of the Underlying
15 Index” due to a compounding effect of daily gains and
16 losses.² For ProShares II, the warning was even more
17 direct: “[u]sing leverage . . . should be considered . . .
18 speculative and could result in the total loss of an
19 investor’s investment.” See *id.*, App’x B, Item 6. In its
20 brief, ProShares provided a hypothetical illustration of two

²Beginning with its September 2007 registration statement, this information was moved to the SAI.

1 investors who invested in an Ultra Long ETF at separate
2 times to illustrate the effect an index's volatility would
3 have on those investments' returns. We have provided that
4 example in Appendix A.

5 **C. Alleged Omissions and Misstatements**

6 Plaintiffs principally complain that ProShares failed
7 to disclose the magnitude and probability of loss for
8 beyond-a-day investments in ProShares ETFs despite
9 investors' correct predictions regarding the overall
10 movement of the indices underlying the ETFs. Furthermore,
11 Plaintiffs allege that the registration statements contained
12 various "contra-indicators" of successful long-term
13 investments which the above omissions made materially
14 misleading. The district court rejected these arguments and
15 dismissed the complaint with prejudice pursuant to Federal
16 Rule of Civil Procedure 12(b)(6). *In re ProShares Trust*
17 *Sec. Litig.*, 889 F. Supp. 2d 644 (S.D.N.Y. 2012). In sum,
18 the district court concluded that ProShares warned of the
19 risks that materialized. For the reasons that follow, we
20 agree.

1 *Panther Partners, Inc. v. Ikanos Commc'ns, Inc.*, 538
2 F.Supp.2d 662, 668 (S.D.N.Y. 2008).

3 A plaintiff who plausibly pleads an unlawful omission
4 comes close to stating a section 11 claim because
5 materiality "will rarely be dispositive in a motion to
6 dismiss." See *Morgan Stanley*, 592 F.3d at 360.

7 Nevertheless, the materiality hurdle remains a meaningful
8 pleading obstacle, and we will dismiss a section 11 claim
9 where the alleged omission was "so obviously unimportant to
10 a reasonable investor" that reasonable minds would agree on
11 that omission's unimportance. *Id.* (internal quotation marks
12 omitted). In fact, the Supreme Court has been "'careful not
13 to set too low a standard of materiality,' for fear that
14 management would 'bury the shareholders in an avalanche of
15 trivial information.'" *Matrixx Initiatives, Inc. v.*
16 *Siracusano*, 131 S.Ct. 1309, 1318 (2011) (quoting *Basic*
17 *Inc. v. Levinson*, 485 U.S. 224, 231 (1988)).

18 In judging whether an alleged omission was material in
19 light of the information already disclosed to investors, we
20 consider whether there is "'a substantial likelihood that
21 the disclosure of the [omitted material] would have been
22 viewed by the *reasonable* investor as having *significantly*

1 altered the total mix of information [already] made
2 available.'" *DeMaria v. Andersen*, 318 F.3d 170, 180 (2d
3 Cir. 2003) (emphasis added) (quoting *TSC Indus., Inc. v.*
4 *Northway, Inc.*, 426 U.S. 438, 449 (1976)). "It is not
5 sufficient to allege that the investor might have considered
6 the misrepresentation or omission important." *Ganino v.*
7 *Citizens Utils. Co.*, 228 F.3d 154, 162 (2d Cir. 2000).
8 While the "objective of a prospectus is to solicit
9 investment by the general public" and "the intended audience
10 . . . encompass[s] both sophisticated financial analysts
11 and untutored lay persons," *Greenapple v. Detroit Edison*
12 *Co.*, 618 F.2d 198, 210 (2d Cir. 1980), the prospectuses are
13 not "'required to address [reasonable investors] as if they
14 were children in kindergarten,'" *id.* (quoting *Richland v.*
15 *Crandall*, 262 F. Supp. 538, 554 (S.D.N.Y. 1967)). In the
16 words of the district court below, "[w]hen a registration
17 statement warns of the exact risk that later materialized, a
18 [s]ection 11 claim will not lie as a matter of law."
19 *ProShares*, 889 F. Supp. 2d at 653.

20 Here, the district court concisely summarized
21 Plaintiffs' allegations: the "thrust of the [P]laintiffs'
22 [s]ection 11 claim is that the registration statements

1 omitted the risk that the ETFs, when held for a period of
2 greater than one day, could lose substantial value in a
3 relatively brief period of time, particularly in periods of
4 high volatility.” *Id.* at 654. The district court dismissed
5 that claim in equally concise language: “the disclosures in
6 the registration statements accurately conveyed the specific
7 risk that the [P]laintiffs assert materialized: when
8 investors held the ETFs for periods longer than one day the
9 funds’ performance widely diverged from the performance of
10 the underlying indices sometimes resulting in losses despite
11 the overall direction of the underlying indices.” *Id.* at
12 656. We agree that the relevant prospectuses adequately
13 warned the reasonable investor of the allegedly omitted
14 risks.

15 **1. The Magnitude of Beyond-A-Day Losses**

16 Plaintiffs allege that the registration statements
17 omitted the risk that correctly predicting the long-term
18 movement in an ETF’s underlying index could result in a
19 substantial loss in their investment over that same period
20 of time. Plaintiffs acknowledge that the prospectuses
21 warned that the value of long-term ETF investments “may
22 diverge significantly” from that ETF’s underlying index.

1 Pls. Br. at 42. The complaint even recognizes that the
2 ProShares ETFs “did not seek to achieve long[-]term
3 cumulative investment returns in their ETFs” and that they
4 “could not seek such returns.” TAC ¶ 100. Plaintiffs
5 assert, however, that the “diverge significantly” disclosure
6 does not speak to a divergence that results in actual,
7 substantial loss.

8 “In evaluating a prospectus, we read it as a whole.”
9 *DeMaria*, 318 F.3d at 180 (internal quotation omitted). As
10 we read the prospectus cover-to-cover, we consider whether
11 the disclosures and representations, “taken together and in
12 context, would have misl[ed] a reasonable investor about the
13 nature of the [securities].’” *Id.* (quoting *McMahan & Co. v.*
14 *Wherehouse Entm’t, Inc.*, 900 F.2d 576, 579 (2d Cir. 1990)).
15 “As we have explained, ‘[a] prospectus will violate federal
16 securities laws if it does not disclose material objective
17 factual matters, or buries those matters beneath
18 information, or treats them cavalierly.’” *DeMaria*, 318 F.3d
19 at 180 (quoting *Olkey v. Hyperion 1999 Term Trust, Inc.*, 98
20 F.3d 2, 5 (2d Cir. 1996) (internal quotation marks
21 omitted)).
22

1 Here, the district court concluded that it was “not
2 possible to read the registration statements . . . without
3 understanding that the ETFs were particularly risky and
4 speculative and were intended to meet their stated goal only
5 over the course of a single day.” *ProShares*, 889 F. Supp.
6 2d at 656. The district court reasoned that while “some
7 [P]laintiffs lost money while guessing correctly on the
8 direction of the underlying index, this possibility is
9 plainly consistent with the significant divergence that was
10 disclosed in the registration statements.” *Id.* On appeal,
11 Plaintiffs maintain that the district court overvalued the
12 “diverge significantly” disclosure because “[d]iverge
13 significantly’ is not a synonym for ‘loss’” and “refers only
14 to [an ETFs’] outperforming or underperforming” a perfect
15 long-term correlation with its index. At the very least,
16 they argue, “diverge significantly” does not include large,
17 rapid losses. Pls. Br. at 42-43.

18 We are unpersuaded by this argument, and Plaintiffs’
19 efforts to find a meaningful distinction between “diverge
20 significantly” and “actual loss” strains the plain meaning
21 of the former phrase. Because one might expect the long-
22 term value of an ETF to correlate with the long-term value

1 of its underlying index, ProShares warned that the actual
2 results might diverge significantly from that prediction.
3 "Significant" means large or important; in the context of
4 the offering documents, "divergence" means the opposite from
5 one's expectation. ProShares' "significant divergence"
6 disclosures, fairly read, put investors on notice that an
7 ETF's value might move in a direction quite different from
8 and even contrary to what an investor might otherwise
9 expect.

10 Plaintiffs use a linguistic preference to read out of
11 the prospectuses a scenario which the ProShares disclosures
12 clearly contemplate. Time and again, we have said that
13 "disclosure is not a rite of confession or exercise in
14 common law pleading." *Morgan Stanley*, 592 F.3d at 365
15 (internal quotation marks omitted). Because the "role of
16 the materiality requirement is not to attribute to investors
17 a child-like simplicity," we presume that a reasonable
18 investor can comprehend the basic meaning of plain-English
19 disclosures and will not credit Plaintiffs' narrow reading
20 of "diverge significantly." See *Basic*, 485 U.S. at 234
21 (citations omitted).

22 Perhaps more importantly, the "diverge significantly"
23 disclosure takes on additional meaning within the context of

1 the prospectus as a whole. The earliest relevant
2 prospectuses make absolutely clear that the ETFs operated
3 pursuant to daily investment objectives, that they utilized
4 leveraged investment techniques to achieve those objectives,
5 and that mathematical compounding combined with leveraging
6 prevented the ETFs from achieving their stated objectives
7 over a period of time greater than one day. All the
8 ProShares I prospectuses make clear that ETFs used
9 aggressive financial instruments and investment techniques
10 that exposed the ETFs to potentially "dramatic" losses "in
11 the value of its portfolio holdings and imperfect
12 correlation to the index underlying"; ProShares II warned
13 that volatility could result in a "total loss of an
14 investor's investment." See Skinner Decl., App'x A, Item 6;
15 App'x B, Item 6.

16 Accordingly, we conclude that it is implausible that
17 substituting "actual loss" for "diverge significantly" is a
18 change substantially likely to be viewed by a reasonable
19 investor as having significantly altered the import of the
20 total mix of information ProShares made available.

21 See *Basic*, 485 U.S. at 232.

22 **2. The Probability of Long-Term Loss**

23 Plaintiffs also complain that ProShares omitted that

1 certain market circumstances would “*necessarily* [cause]
2 quick and potentially large losses” despite an investor’s
3 correct prediction of the overall, beyond-a-day direction of
4 an ETF’s underlying index. Pls. Br. at 1 (emphasis added);
5 *see also id.* at 24-25; TAC ¶¶ 12-26. The complaint further
6 asserts that ProShares possessed an “undisclosed
7 mathematical formula” which “very accurately predicted and
8 described the relationship between the movements in each
9 type of ETF’s price and the movements in the index
10 underlying the ETF in any market scenario.” See TAC ¶ 13.
11 Based on this formula, Plaintiffs allege that ProShares knew
12 and omitted that certain market conditions could materialize
13 that would put investors “who held ProShares products for
14 extended periods of more than a day” in “a ‘must lose’
15 position.” TAC ¶ 15. These market conditions existed,
16 Plaintiffs maintain, when “the volatility (*i.e.*, the day-to-
17 day changes in prices) of the underlying index significantly
18 exceeded its performance over time.” TAC ¶ 16.

19 The district court concluded that the existence of the
20 undisclosed mathematical formula was implausible on its
21 face. *ProShares*, 889 F. Supp. 2d at 656. In the
22 alternative, the district court concluded that such a
23 formula would “rely on inputs from the underlying index or

1 benchmark, that those inputs could not be known in advance,"
2 and that failure to predict future market performance was an
3 immaterial omission. *Id.*

4 Here, Plaintiffs continue to pursue the argument and
5 allege that ProShares "knew and could simulate from their
6 mathematical formula exactly what was going to happen to
7 investors **for each market scenario**, including the
8 continuation of the actual, existing current daily
9 volatility circumstances." Pls. Br. at 11 (emphasis in
10 original) (complaint citations omitted). According to
11 Plaintiffs, ProShares knew "to the day when, if current
12 actual volatility circumstances continued, their ETFs would
13 become dysfunctional and an investor necessarily would lose
14 from a correct judgment about the market." Pls. Br. at 24-
15 25 (complaint citations omitted).

16 We remain unpersuaded. Assuming, *arguendo*, that
17 ProShares possessed an undisclosed mathematical formula that
18 accurately predicted potential market conditions and the
19 effect market volatility would have on ETF shares,
20 Plaintiffs' argument amounts to nothing more than an
21 allegation that ProShares failed to disclose that the more
22 an ETF's underlying index changed value day-to-day for a
23 particular investor, the more likely it became that the

1 investor would experience long-term losses depending on when
2 she invested. That does not constitute an actionable
3 omission of an objective fact, but rather a general omission
4 regarding the risks associated with (1) hypothetical
5 investments over (2) hypothetical periods of time during (3)
6 hypothetically volatile market conditions. ProShares cannot
7 be expected to predict and disclose all possible negative
8 results across any market scenario. Appendix A illustrates
9 this point.

10 In tandem with this argument, Plaintiffs assert that
11 ProShares failed to disclose the risks of “excess daily
12 index volatility” which its mathematical formula predicted
13 and that eventually materialized.⁴ ProShares, however,
14 consistently disclosed the effect market volatility had on
15 ETFs. The first relevant ProShares I prospectus warned,
16 under Principal Risk Considerations, that the “equity
17 markets are volatile, and the value of securities, futures,
18 options, contracts and other instruments correlated with the
19 equity markets may fluctuate dramatically from day-to-day.”

⁴Plaintiffs make a distinction between “inherent facts” and “materialization facts.” For example, Plaintiffs argue that ETFs were subject to an inherent risk of excess market volatility which ProShares omitted and that once the markets became excessively volatile those inherent risks became materialized risks. For the purpose of our analysis, this distinction is without a difference.

1 June 19, 2006 ProShares I Prospectus at 8, 64. "This
2 volatility may cause the value of an investment in a[n ETF]
3 to decrease." *Id.* at 65. ProShares also warned that the
4 net asset value of an ETF and its market price would be made
5 more volatile than its underlying index on account of
6 leveraged investment techniques that magnify exposure to the
7 underlying index. Finally, ProShares highlighted and
8 bullet-pointed the risk: "**Volatility Risk** - [Leveraged ETFs]
9 seek to achieve a multiple of an index and therefore will
10 experience greater volatility than the index underlying its
11 benchmark and consequently ha[ve] the potential for greater
12 losses." *Id.* at 9. In addition, the earliest ProShares II
13 prospectus warned that price "volatility, which is
14 exacerbated by the use of leverage, may possibly cause the
15 total loss of an investor's investment." Nov. 17, 2008
16 ProShares II Reg. Stmt. at 4.

17 While "it is not sufficient that overtones might have
18 been picked up by the sensitive antennae of investment
19 analysts," *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281,
20 1297 (2d Cir. 1973) (Friendly, *Judge*), no reasonable
21 investor could read these prospectuses without realizing
22 that volatility, combined with leveraging, subjected that
23

1 investment to a great risk of long-term loss as market
2 volatility increased.

3 **B. Misleading Statements**

4 "Our conclusion that the [¹⁹33 Act] did not directly
5 require defendants to disclose the allegedly omitted
6 information does not mark the end of our inquiry." *Morgan*
7 *Stanley*, 592 F.3d at 365. "Section 11 [also] call[s] for
8 the disclosure of information that is necessary to avoid
9 rendering misleading the representations in prospectuses."
10 *Id.* (citing 15 U.S.C. § 77k(a)). Our inquiry here is the
11 same as it was above: "we review documents holistically and
12 in their entirety." *Id.* (citing *Olkey*, 98 F.3d at 5). "The
13 literal truth of an isolated statement is insufficient; the
14 proper inquiry requires an examination of defendants'
15 representations, taken together and in context." *Id.*
16 (quotation marks and citation omitted).

17 Plaintiffs complain that ProShares prospectuses
18 included "numerous" misleading statements about the positive
19 results of 1, 3, 5, and 10 year investments in ProShares
20 ETFs. See Pl. Br. at 38 (complaint citations omitted).
21 Indeed, Plaintiffs provide us with a string citation to the
22 complaint outlining at least eight categories of misleading
23 statements across various prospectuses. See, e.g., TAC ¶

1 102(a)-(h). Plaintiffs' appeal, however, focuses on only
2 three specific alleged misrepresentations. See *Tolbert v.*
3 *Queens College*, 242 F.3d 58, 75 (2d Cir. 2001) ("[I]ssues
4 adverted to in a perfunctory manner, unaccompanied by some
5 effort at developed argumentation, are deemed waived."
6 (internal quotation omitted)).

7 **1. 1, 3, 5, and 10 Year Cost Projections**

8 Plaintiffs contend that ProShares provided tables which
9 illustrated the hypothetical costs of investing in ProShares
10 I ETFs for 1, 3, 5, and 10 year periods, which misleadingly
11 implied that ProShares ETFs were suitable 1, 3, 5, and 10
12 year investments. See TAC ¶ 102(a). The district court
13 dismissed the argument for two reasons. First, it reasoned
14 that the "various projections . . . fall far short of
15 undercutting the emphasis on the daily nature of the ETFs."
16 *ProShares*, 889 F. Supp. 2d at 655. Second, it concluded
17 that because Form N-1A required disclosure of that exact
18 information, ProShares could not expect that the SEC would
19 require that information be specifically "identified,
20 qualified, or tempered." *Id.* We agree with the first half
21 of the district court's analysis and affirm its conclusion.

22 The contested tables are presented as an example of the
23 costs of investing in ProShares I ETFs assuming a \$10,000

1 investment for time periods spanning 1, 3, 5, and 10 years -
2 assuming a 5% return each year. Form N-1A requires those
3 assumptions. This makes sense because the example is
4 intended to help investors compare the cost of investing in
5 ProShares with the cost of investing in other funds. It
6 would be difficult to cross-compare the costs of investing
7 in different funds were prospectuses to use different time
8 periods, different assumptions about annual returns, and
9 different assumptions about the amount invested. The
10 ProShares I prospectuses also tie cautionary language to the
11 tables, which Form N-1A does not expressly require: the
12 table was for "illustration purposes only" and was not
13 "meant to suggest actual or expected fees and expenses or
14 returns, all of which may vary." See, e.g., Sept. 28, 2007
15 Reg. Stmt. at 20.

16 We conclude that the cost tables, placed in context,
17 would not lead a reasonable investor into thinking that
18 ProShares I ETFs were safe 1, 3, 5, and 10 year investments.
19 We also agree with the district court that the tables do not
20 undercut the disclosures regarding the ETFs' daily
21 objectives with all the attendant warnings already described
22 in this opinion. Accordingly, we are unpersuaded by
23 Plaintiffs' attempt to isolate and construe a single element

1 of ProShares I's prospectuses. See *DeMaria*, 318 F.3d at
2 180. It is therefore implausible that a reasonable investor
3 would have been misled by the cost tables.⁵

4 **2. Correlation Risks and Line Graphs**

5 Beginning with the September 28, 2007 ProShares I
6 prospectus, Plaintiffs assert that ProShares I included
7 correlation-risk disclosures which included line-graph
8 examples that misled them into thinking that an ETF's
9 divergence from its underlying index would be somewhere in
10 the ballpark of 0.6%-2.2%. TAC ¶¶ 29-43, 102, 203-220.

11 The correlation-risk disclosure expressly warns that
12 there is no guarantee that an ETF will achieve a high degree
13 of correlation with its benchmark and lists factors that
14 prevent perfect correlation. For Plaintiffs' leveraged
15 funds "there [was] a special form of correlation risk[:] for
16 periods greater than one day, the use of leverage tends to

⁵ The district court also commented that the tables did not create liability because the "plaintiffs point[ed] to no case that holds that information that the SEC requires must be specifically identified, qualified, or tempered." *ProShares*, 889 F. Supp. 2d at 655. While Form N-1A requires the allegedly misleading table, it also requires this information to be "in plain English under rule 421(d) under the Securities Act." See *Skinner Decl. Ex. 5* at 11 (SEC Form N-1A). Rule 421(d) requires that financial data be presented in "an understandable manner" and that any information provided "must not be misleading." 17 C.F.R. § 230.421(d)(3). Accordingly, there remains a possibility that an issuer might present required information in a misleading manner. That, however, is not this case.

1 cause the performance of an [ETF] to be either greater than
2 or less than the index performance." See Sept. 28, 2007
3 ProShares I Reg. Stmt at 8.

4 To "illustrate" how leveraging increases correlation
5 risk, the prospectus included three line graphs that
6 "simulated [a] hypothetical one year performance of an index
7 compared with the performance of a fund that perfectly
8 achieved its investment objective of twice (200%) the daily
9 index return." *Id.* "Each of the graphs [assumed] a
10 volatility rate of 15%, which [was] an approximate average
11 of the five-year historical volatility rate" of certain
12 indices. *Id.* But, "[o]ther indexes to which the [ETFs] are
13 benchmarked ha[d] different historical volatility rates;
14 certain of the [ETFs] historical volatility rates [were]
15 substantially in excess of 15%." *Id.*

16 The line graphs show that where a leveraged ETF meets
17 its daily objectives each day, with the above assumptions,
18 its value could diverge from the index's performance by 2.2%
19 in a flat market, 0.7% in an upward-trending market, and
20 0.6% in a downward-trending market. After the presentation
21 of the graphs, the prospectus referred potential investors
22 to the SAI "for a further discussion of how both index
23 volatility and index performance can impact" ETF
24 performance. The SAI includes a "wedge graph" that

1 represents the effect market volatility would have on a
2 leveraged ETFs' annual correlation with index volatility
3 ranging from 0%-40% at 5% intervals. The wedge graphs
4 clearly demonstrate that at high levels of volatility an
5 ETF's value could move in the opposite direction from its
6 underlying benchmark. We have included an example wedge
7 graph in Appendix B.

8 Plaintiffs complain that the line graphs misled them
9 into believing that annual ETF returns ran the risk of only
10 a slight disconnection (.6% - 2.2%) from an index's
11 performance. We have already concluded that the ProShares
12 prospectuses, absent the wedge graphs, clearly described the
13 daily investment objectives, the nature of ETFs, and, in
14 plain English, warned that leveraging, volatility, and
15 compounding could cause an ETF's performance to
16 significantly diverge from its underlying index. We have
17 also already concluded that the relevant prospectuses
18 disclosed that aggressive investment techniques exposed the
19 ETFs to dramatic losses and an imperfect correlation with
20 its index.

21 The addition of the line graphs does not alter those
22 conclusions, and we agree with the district court that this
23 one-year representation does not undercut the
24 representations throughout the rest of the prospectuses.

1 This is especially true because the disclosure introducing
2 the line graphs clearly explained that the line graphs
3 assumed 15% volatility and that many of the ETF indices have
4 historically experienced volatility substantially in excess
5 of 15%. It is therefore implausible that a reasonable
6 investor would expect that an ETF's divergence from its
7 underlying index would be only minimal.

8 **3. SAIs and Wedge Graphs**

9 Plaintiffs argue that the district court impermissibly
10 relied upon the wedge graphs to dilute their cost-table and
11 line-graphs arguments and to bolster ProShares' disclosures.
12 See Pls. Br. at 46-47. That argument is misplaced, however,
13 because the district court concluded, as we do here, that it
14 was "not possible to read the registration statements - even
15 those issued before the wedge graphs were added in September
16 2007 - without understanding that the ETFs were particularly
17 risky and speculative and were intended to meet their stated
18 goal only over the course of a single day." *ProShares*, 889
19 F. Supp. 2d at 655. Moreover, the district court also
20 concluded that the "diverge significantly" disclosures
21 plainly contemplated the possibility that certain investors
22 would lose money despite correctly predicting the direction
23 of an underlying index. Accordingly, the district court did
24

1 not rely on the wedge graphs to reach its conclusions; nor
2 do we.

3 Plaintiffs also contend that the wedge graphs
4 constitute a unique principal-risk disclosure that ProShares
5 impermissibly buried in the SAI. Plaintiffs' argument,
6 however, merely repackages what they argued earlier:
7 ProShares failed to disclose the effect of excess daily
8 volatility in the principal-risk portion of the
9 prospectuses. Because we concluded that ProShares'
10 volatility disclosures and prospectuses sufficiently warned
11 of the effects excess market volatility would have on an
12 ETF, spelling out the details of those disclosures in the
13 SAI does not violate the securities laws. As we have
14 recognized: "to avoid prospectus disclosures that are too
15 long and complex, Form [N-1A] calls for a streamlined,
16 simplified prospectus" and an SAI which "offer[s] issuers
17 the opportunity to provide more detailed discussions of
18 matters required to be in the prospectus." *Morgan Stanley*,
19 592 F.3d at 352 n.2 (quotation marks and citations
20 omitted).⁶

⁶ProShares asserts that the law of this Circuit permits reliance on information contained in the SAI in evaluating section 11 claims. See ProShares' Br. at 53 (citing *Hunt v. Alliance N. Am. Gov't Income Trust, Inc.*, 159 F.3d 723, 730-31 (2d Cir. 1998)). *Hunt*, however, only looked at an SAI to

1 Finally, Plaintiffs allege that the wedge graphs
2 themselves were materially misleading for not contemplating
3 the effects of volatility above 40% and the effect
4 volatility would have on short-term investments.⁷ But, as
5 the district court concluded, no reasonable investor could
6 read the prospectuses without understanding beyond-a-day
7 risk exposure or that risks increased as volatility
8 increased above 40%. In fact, the complaint itself
9 acknowledges that ProShares could not meet its objectives
10 beyond a day, TAC ¶ 100, and all of the ProShares
11 prospectuses made clear that leveraging, compounding,
12 volatility, and aggressive investment techniques subject the
13 ETFs to high degrees of risk.⁸ Accordingly, it is

contextualize a prospectus' disclosures. *Id.* Accordingly, *Hunt* does not permit relegating to the SAI material risk disclosures that Form N-1A requires to be in the prospectus; nor could it.

⁷We note a bit of an internal inconsistency in Plaintiffs' theories of liability: Plaintiffs argue that the district court impermissibly relied upon the wedge graphs "buried" in the SAI in analyzing the complaint while simultaneously maintaining that this same buried information misled them about ETF risks. Plaintiffs' complaint actually presents the point heading "Additional Misleading Statements in the SAI." TAC ¶¶ 44-47. It's curious that Plaintiffs could not find this information to get a more in-depth understanding of the funds but have no trouble using that same information to shoulder ProShares with liability.

⁸Plaintiffs argue that *In re Direxion Shares ETF Trust* counsels against reliance on the "daily objective" disclosures. 279 F.R.D. 221 (S.D.N.Y. 2012). The district court here,

1 implausible that a reasonable investor would read these
2 offering documents without understanding the potential for
3 rapid, substantial loss.

4 **C. Corrective Disclosures**

5 Plaintiffs allege that ProShares made new disclosures
6 beginning on the last day of the class period, thereby
7 tacitly conceding that the class-period disclosures failed
8 to reveal critical facts. These new disclosures include,
9 *inter alia*, (1) acknowledging that volatility could cause an
10 ETF to “move in [the] opposite direction as the index,” TAC
11 ¶ 181 (quoting July 31, 2009 Am. No. 16 of Reg. Stmt. at
12 410); (2) stating that an “investor’s views on the future
13 direction and volatility of the markets can be useful tools
14 for investors,” TAC ¶ 185-186 (quoting July 31, 2009
15 Amendment No. 16 of Reg. Stmt. at 410); and (3) advising
16 that investors should be willing to “monitor and/or
17 periodically rebalance their portfolios,” *id.*

18 We have previously noted that where the “quality of [a]
19 disclosure could have been improved[,] the advisability of
20 revision does not render what was done deceptive or

however, relied on the total mix of ProShares’ disclosures and correctly identified significant differences between *Direxion’s* offering documents and ProShares’ offering documents. Without commenting on *Direxion’s* merits, Plaintiffs have not persuaded us that the district court erred in parsing these differences.

misleading.” *Greenapple*, 618 F.2d at 211. The question always remains “whether the prospectuses, as written, adequately apprise the reader of the essential nature” of the securities. See *id.* Accordingly, these revisions do not alter our conclusion that the earlier ProShares prospectuses adequately warned of volatility’s effect on the magnitude and probability of loss. It is of no matter that ProShares came to use different, arguably clearer language. To hold an issuer who alters disclosures deemed adequate in the first instance suddenly liable because it found a better way to say what has already been said would perversely incentivize issuers not to strive for better, clearer disclosure language. Accordingly, the “corrective disclosures” do not alter our conclusions.

D. Section 15

Plaintiffs also brought claims under section 15 of the ‘33 Act against the individual defendants. “To establish [section] 15 liability, a plaintiff must [first] show a ‘primary violation’ of [section] 11” *Hutchinson v. Deutsche Bank Secs. Inc.*, 647 F.3d 479, 490 (2d Cir. 2011) (internal quotation marks omitted). Having affirmed the dismissal of Plaintiffs’ section 11 claims, we also affirm the dismissal of their section 15 claims. See *id.*

1 **CONCLUSION**

2 The order of the United States District Court for the
3 Southern District of New York (John G. Koeltl, *Judge.*),
4 entered on September 12, 2012, dismissing Plaintiffs-
5 Appellants' third amended complaint, with prejudice,
6 pursuant to Federal Rule of Civil Procedure 12(b)(6), is
7 hereby AFFIRMED.

APPENDIX A

Hypothetical ETF Investments Seeking to Double the Daily Return of its Underlying Index

	<u>Index</u>	<u>Investor A</u>	<u>Investor B</u>
Initial Investment	\$1,000	\$1,000 (Purchased beginning of day 1)	\$1,000 (Purchased beginning of Day 2)
Day 1 Return	\$900 (-10%)	\$800 (-20%)	
Day 2 Return	\$1,008 (+12%)	\$992 (+24%)	\$1,240 (+24%)
Day 3 Return	\$982.80 (-2.5%)	\$942.40 (-5%)	\$1,178 (-5%)
Day 4 Return	\$1,007.40 (+2.5%)	\$989.52 (+5%)	\$1,236.90 (+5%)
Total Return (Days 1-4)	+\$7.40 (+.74%)	-\$10.48 (-1.05%)	
Total Return (Days 2-4)	+\$107.40 (+11.9%)	+189.52 (+23.7%)	+\$236.90 (+23.7%)

1

APPENDIX B

2

Example Wedge Graph

Estimated Fund Return Over One Year When the Fund Objective is to Seek Daily Investment Results, Before Fees and Expenses, that Correspond to Twice (200%) the Inverse of the Daily Performance of an Index.

One Year Index Performance	200% Inverse of One Year Index Performance	Index Volatility								
		0%	5%	10%	15%	20%	25%	30%	35%	40%
-40%	80%	177.8%	175.7%	169.6%	159.6%	146.4%	130.3%	112.0%	92.4%	71.9%
-35%	70%	136.7%	134.9%	129.7%	121.2%	109.9%	96.2%	80.7%	63.9%	46.5%
-30%	60%	104.1%	102.6%	98.1%	90.8%	81.0%	69.2%	55.8%	41.3%	26.3%
-25%	50%	77.8%	76.4%	72.5%	66.2%	57.7%	47.4%	35.7%	23.1%	10.0%
-20%	40%	56.3%	55.1%	51.6%	46.1%	38.6%	29.5%	19.3%	8.2%	-3.3%
-15%	30%	38.4%	37.4%	34.3%	29.4%	22.8%	14.7%	5.7%	-4.2%	-14.4%
-10%	20%	23.5%	22.5%	19.8%	15.4%	9.5%	2.3%	-5.8%	-14.5%	-23.6%
-5%	10%	10.8%	10.0%	7.5%	3.6%	-1.7%	-8.1%	-15.4%	-23.3%	-31.4%
0%	0%	0.0%	-0.7%	-3.0%	-6.5%	-11.3%	-17.1%	-23.7%	-30.8%	-38.1%
5%	-10%	-9.3%	-10.0%	-12.0%	-15.2%	-19.6%	-24.8%	-30.8%	-37.2%	-43.9%
10%	-20%	-17.4%	-18.0%	-19.8%	-22.7%	-26.7%	-31.5%	-36.9%	-42.8%	-48.9%
15%	-30%	-24.4%	-25.0%	-26.6%	-29.3%	-32.9%	-37.3%	-42.3%	-47.6%	-53.2%
20%	-40%	-30.6%	-31.1%	-32.6%	-35.1%	-38.4%	-42.4%	-47.0%	-51.9%	-57.0%
25%	-50%	-36.0%	-36.5%	-37.9%	-40.2%	-43.2%	-46.9%	-51.1%	-55.7%	-60.4%
30%	-60%	-40.8%	-41.3%	-42.6%	-44.7%	-47.5%	-50.9%	-54.8%	-59.0%	-63.4%
35%	-70%	-45.1%	-45.5%	-46.8%	-48.7%	-51.3%	-54.5%	-58.1%	-62.0%	-66.0%
40%	-80%	-49.0%	-49.4%	-50.5%	-52.3%	-54.7%	-57.7%	-61.1%	-64.7%	-68.4%

The foregoing tables are intended to isolate the effect of index volatility and index performance on the return of a leveraged fund. The fund's actual returns may be significantly greater or less than the returns shown above as a result of any of factors discussed above or under "Correlation Risk" in the Prospectus. App-505 (9/28/07 RS at SAI 20).

3