

United States District Court
For the Northern District of California

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UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA
SAN JOSE DIVISION

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| JAMES RAFTON, TRUSTEE OF THE JAMES) | Case No.: 10-CV-01171-LHK |
| AND CYNTHIA RAFTON TRUST, ET AL.,) | |
| | ORDER DENYING IN PART AND |
| Plaintiffs,) | GRANTING IN PART DEFENDANTS' |
| v.) | MOTIONS TO DISMISS |
| | (re: docket #39 and #42) |
| RYDEX SERIES FUNDS, ET AL.,) | |
| | |
| Defendants.) | |

In this putative securities class action, Plaintiffs James Rafton, a Trustee of the James and Cynthia Rafton Trust, and James Darst, Jr., a Trustee of the James and Hillary Darst Trust (collectively "Plaintiffs"), allege that Defendants, several entities and individuals associated with the "Rydex Inverse Government Long Bond Strategy Fund" (the "Fund"), violated federal securities laws by misrepresenting who was an appropriate investor in the Fund and by failing to adequately disclose a "mathematical compounding effect" that would cause the Fund to deviate from its benchmark, the inverse price of the 30-Year U.S. Treasury Bond. Defendants include entities and officers responsible for issuing, managing, and distributing shares of the Fund ("Rydex Defendants"), and also individuals that are Independent Trustees of the Fund ("Independent Trustee Defendants"). The Rydex Defendants and the Independent Trustee Defendants have filed separate motions to dismiss, although each set of Defendants joins in the other's motion. The

1 Court held a hearing on Defendants' motions on December 16, 2010. For the reasons discussed
 2 below, the Rydex Defendants' motion to dismiss is DENIED and the Independent Trustee
 3 Defendants' motion to dismiss is DENIED IN PART and GRANTED IN PART.

4 **I. BACKGROUND**

5 For purposes of ruling on Defendants' motion to dismiss, the Court accepts as true well-
 6 pled allegations in Plaintiffs' Complaint and construes material facts in the light most favorable to
 7 Plaintiffs. *Marceau v. Blackfeet Housing Authority*, 540 F.3d 916, 919 (9th Cir. 2008).
 8 Accordingly, unless otherwise noted, the following background draws heavily from the allegations
 9 in Plaintiffs' First Amended Complaint ("FAC").

10 **A. The Parties and the Rydex Inverse Government Long Bond Strategy Fund**

11 Plaintiffs are trustees of Trusts that invested in the Rydex Inverse Government Long Bond
 12 Strategy Fund (the "Fund"). According to Plaintiffs, they purchased or acquired shares in the Fund
 13 between March 20, 2008 and December 19, 2008. However, the Plaintiffs allege a class period of
 14 March 19, 2007 to March 19, 2010. FAC ¶ 1.

15 Defendants are the Fund, PADCO Advisers, Inc. d/b/a Rydex Investments, Inc. (the Fund's
 16 manager and investment advisor), Rydex Distributors, Inc. (the Fund's distributor and principal
 17 underwriter), Richard M. Goldman (CEO of the Rydex Distributor), Carl G. Verboncoeur
 18 (President of the Fund), John O. Demaret (Chairman of Board of Trustees of Fund), Nick Bonos
 19 (Vice President of Fund), Michael P. Byrum (Chief Investment Officer of the Fund), and individual
 20 Trustees of the Fund (Corey A. Colehour, J. Kenneth Dalton, Werner E. Keller, Thomas F. Lydon,
 21 Patrick T. McCarville, and Roger Somers). *Id.* at ¶¶ 9-23.

22 The Fund is a mutual fund, similar to an "exchange-traded fund" ("ETF") that was designed
 23 to track a particular benchmark, and specifically to track the *inverse* price movements of the 30-
 24 Year U.S. Treasury Bond ("Long Treasury Bond"). *Id.* at ¶ 30. As an "inverse" fund, the Fund
 25 was designed to produce investment returns that are the opposite of the performance of the
 26 underlying benchmark, i.e., when the price of the benchmark decreases, the price of the fund
 27 should increase by the same percentage. *Id.* According to Plaintiffs, most inverse funds are
 28 designed to track a benchmark on a daily basis and reset daily. *Id.* at ¶ 31. With this daily re-

1 setting, such funds are subject to a “mathematical compounding effect” that leads a fund’s price to
2 deviate from the inverse movement of the benchmark for periods beyond a single day. *Id.* In a
3 two-day example, if a benchmark index starts at 100 and closes at 101 on the first day, and goes
4 back down to close at 100 on the second day, the benchmark is even over the two-day period, but
5 the Fund (assuming it also started at 100 and has met its daily goal) will have actually lost value
6 over the same two-day period. In this example, the calculation for the Fund is: 100 (start), 99 (end
7 of day one, dropping 1% from 100 to 99 as benchmark increased 1% from 100 to 101), 99.98 (end
8 of day two, increasing 0.99% from 99 to 99.98 as benchmark decreased 0.99% from 101 to 100).
9 The compounding effect is more pronounced in periods of high volatility, in which the benchmark
10 moves up and down in greater amounts. *Id.* at ¶ 32. Plaintiff’s central allegation is that, because of
11 this compounding effect, inverse funds are not appropriate for investors seeking to hold the
12 investment for longer than a single day. *Id.* at ¶ 33.

13 **B. Plaintiffs’ Allegations Regarding the 2007, 2008 and 2009 Registration Statements**

14 The Fund sold four classes of shares: Advisor, Investor, A and C. *Id.* at ¶ 34. The shares
15 relevant to the putative class period were issued pursuant to a July 30, 2007 Registration Statement
16 and Prospectus (collectively “2007 Registration Statement”), a July 29, 2008 Registration
17 Statement and Prospectus (collectively “July 2008 Registration Statement”), and a July 29, 2009
18 Registration Statement and Prospectus (collectively “July 2009 Registration Statement”). *Id.* at
19 ¶ 35. According to Plaintiff, each of the Registration Statements contained substantially similar
20 untrue statements of material fact and/or omitted material facts, as “investors holding Fund shares
21 during the Class period lost money even though the benchmark price of the U.S. Treasury Long
22 Bond fell--precisely the type of period during which investors would have expected to make
23 money.” *Id.* at ¶ 38. For example, Plaintiffs allege that between March 20, 2008 and February 22,
24 2010, the price of the U.S. Treasury Long Bond fell by 4.91%, but the Fund price did not increase
25 and instead also fell by 11.29%. *Id.*

1 **1. The July 2007 and July 2008 Registration Statements**

2 The 2007 and 2008 Registration Statements for the Fund included information about Fund
3 Objective, Principal Investment Strategy, Investor Profile, and Understanding Compounding & the
4 Effect of Leverage. The July 2007 Registration Statement contains these statements:

5 **FUND OBJECTIVE**

6 The Inverse Government Long Bond Strategy Fund seeks to provide
7 total returns that inversely correlate to the price movements of a
8 benchmark for U.S. Treasury debt instruments or futures contracts
9 on a specified debt instrument. The Fund's current benchmark is the
10 inverse of the daily price movement of the Long Treasury Bond.
11 The Long Treasury Bond is the U.S. Treasury bond with the
12 longest maturity, which is currently 30 years. The price movement
13 of the Long Treasury Bond is based on the daily price change of the
14 most recently issued Long Treasury Bond.

15 If the Fund meets its objective, the value of the Fund's shares
16 will increase on a daily basis when the price of the Long Treasury
17 Bond decreases. When the price of the Long Treasury Bond
18 increases, however, the value of the Fund's shares should decrease
19 on a daily basis by an inversely proportionate amount (E.G., if the
20 price of the Long Treasury Bond increases by 2%, the value of
21 the Fund's shares should go down by 2% on that day).

22 **PRINCIPAL INVESTMENT STRATEGY**

23 Unlike a traditional index fund, the Fund's objective is to
24 perform, on a daily basis, exactly opposite its benchmark, the
25 Long Treasury Bond. As its primary investment strategy, the
26 Fund enters into short sales and swap transactions, and engages in
27 futures and options transactions. On a day-to-day basis, the Fund
28 holds U.S. Government securities or cash equivalents to
collateralize its short sales and derivative positions.

INVESTOR PROFILE

Investors who expect the value of the Long Treasury Bond
to go down and want investment gains when it does so. These
investors must also be willing to bear the risk of equal losses if
value of the Long Treasury Bond goes up.”

Id. at ¶ 39. Similarly, the July 2008 Registration Statement stated:

FUND OBJECTIVE

The Inverse Government Long Bond Strategy Fund seeks
to provide total returns that inversely correlate to the price
movements of a benchmark for U.S. Treasury debt instruments
or futures contracts on a specified debt instrument. The Fund's
current benchmark is the inverse (opposite) of the daily price
movement of the Long Treasury Bond. The Long Treasury Bond is
the U.S. Treasury bond with the longest maturity, which is
currently 30 years. The price movement of the Long Treasury
Bond is based on the daily price change of the most recently issued

1 Long Treasury Bond.

2 If the Fund meets its objective, the value of the Fund's shares
3 will increase on a daily basis when the price of the Long Treasury
4 Bond decreases. When the price of the Long Treasury Bond
5 increases, however, the value of the Fund's shares should decrease
6 on a daily basis by an inversely proportionate amount (e.g., if the
7 price of the Long Treasury Bond increases by 2%, the value of
8 the Fund's shares should go down by 2% on that day).

6 PRINCIPAL INVESTMENT STRATEGY

7 Unlike a traditional index fund, the Inverse Government
8 Long Bond Strategy Fund's objective is to perform, on a daily
9 basis, exactly opposite the daily price movement of the Long
10 Treasury Bond. The Fund employs as its investment strategy a
11 program of engaging in short sales and investing to a significant
12 extent in derivative instruments, which primarily consist of futures
13 contracts, interest rate swaps, and options on securities and futures
14 contracts. Under normal circumstances, the Fund will invest at
15 least 80% of its net assets in financial instruments with economic
16 characteristics that should perform opposite to fixed income
17 securities issued by the U.S. Government. This is a nonfundamental
18 investment policy that can be changed by the Fund
19 upon 60 days' prior notice to shareholders. On a day-to-day basis,
20 the Fund may hold U.S. Government securities or cash equivalents
21 to collateralize its short sales and derivative positions.

14 INVESTOR PROFILE

15 The Inverse Government Long Bond Strategy Fund is
16 intended for investors who expect the value of the Long
17 Treasury Bond to go down and want investment gains when it
18 does so. These investors must also be willing to bear the risk of
19 equal losses if the value of the Long Treasury Bond goes up.

18 *Id.* at ¶ 40. Both the 2007 and 2008 Registration Statements also included these statements:

19 TRACKING ERROR RISK - Tracking error risk refers to the
20 risk that the Fund's Advisor may not be able to cause the Fund's
21 performance to match that of the Fund's benchmark, either on a
22 daily or aggregate basis. Factors such as Fund expenses, imperfect
23 correlation between the Fund's investments and those of its
24 benchmark, rounding of share prices, changes to the benchmark,
25 regulatory policies, high portfolio turnover rate and leverage all
26 contribute to tracking error. In addition, because each Fund, except
27 for the Mid-Cap 1.5x Strategy Fund, Russell 2000(R) 1.5x Strategy
28 Fund, Europe 1.25x Strategy Fund, Japan 1.25x Strategy Fund and
Government Long Bond 1.2x Strategy Fund, is tracking the
performance of its benchmark on a daily basis, mathematical
compounding may prevent a Fund from correlating with the
monthly, quarterly, annual or other period performance of its
benchmark. Tracking error may cause the Fund's performance to
be less than you expect.

28 UNDERSTANDING COMPOUNDING & THE EFFECT OF LEVERAGE

1 It is important to understand the effects of compounding when
2 investing in any mutual fund, especially funds that use leverage as
3 part of their investment strategy. The impact of leverage on a fund
4 will generally cause the fund's performance to not match the
performance of the index underlying the fund's benchmark over a
period of time greater than one day. The following simple
examples provide an illustration:

5 EXAMPLE A: Assume you invest \$100 in Fund A, a typical
6 index fund that seeks to match the performance of its underlying
7 index. If the index increases 10% on day one, the value of your
8 shares in Fund A would be expected to increase \$10 (10% of \$100)
to \$110. The next day, if the index decreases 10%, the value of
your shares in Fund A would be expected to decrease \$11 (10% of
\$110) to \$99.

9 EXAMPLE B: Assume you invested \$100 in Fund B, a fund
10 that seeks to return 200% of the performance of its underlying
11 index. If the index increases 10% on day one, the value of your
12 shares in Fund B would be expected to increase \$20 (20% of \$100)
to \$120. The next day, if the index decreases 10%, the value of
your shares in Fund B would be expected to decrease \$24 (20% of
\$120) to \$96.

13 Because of the effect of compounding, in each case the value
14 of your investment declined even though the index went up 10% on
15 day one and down 10% on day two. However, the effect of
compounding was more pronounced when combined with leverage
(Example B).

16 The examples demonstrate that over time, the cumulative
17 percentage increase or decrease in the net asset value of a fund may
18 diverge significantly from the cumulative percentage increase or
19 decrease in the multiple of the return of the index underlying a
20 fund's benchmark due to the compounding effect of losses and
gains on the returns of the fund. It is also expected that a fund's use
of consistently applied leverage will cause the fund to
underperform the compounded return of twice its benchmark in a
trendless or flat market.

21 *Id.* at ¶¶ 42-44.

22 According to Plaintiffs, the 2007 and 2008 Registration Statements were false and
23 misleading because they failed to disclose that the Fund: would rarely, if ever, track the 30 U.S.
24 Treasury Bond for periods longer than one day; would inevitably diverge from the inverse
25 performance of the benchmark; was not suitable for investors holding the Fund for longer than a
26 single day; would, because of compounding, prevent the Fund from achieving its objective for
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1 periods longer than a day; and would be “altogether inappropriate as a directional investment for
2 periods longer than a single day.” *Id.* at ¶¶ 46-48.

3 **2. 2009 Regulatory Notices**

4 Plaintiffs point to two “red flags raised” in 2009. On June 11, 2009, the Financial Industry
5 Regulatory Authority (FINRA) issued a regulatory notice that “remind[ed] firms of their sales
6 practice obligations in connection with inverse ETFs [exchange-traded funds],” and noted that “due
7 to the effects of compounding,” the performance of inverse ETF’s (along with other highly
8 complex financial instruments) “can differ significantly from their stated daily objective.
9 Therefore, inverse and leveraged ETF’s that are reset daily typically are unsuitable for retail
10 investors who plan to hold them for longer than one trading session, particularly in volatile
11 markets.” *Id.* at ¶ 49.

12 On August 18, 2009, the Securities and Exchange Commission (SEC) and FINRA issued an
13 alert stating: “Leveraged and inverse ETFs typically are designed to achieve their stated
14 performance objectives on a daily basis. Some investors might invest in these ETFs with the
15 expectation that the ETFs may meet their stated daily performance objectives over the long term as
16 well. Investors should be aware that performance of these ETFs over a period longer than one day
17 can differ significantly from their stated objectives.” *Id.* at ¶ 52.

18 According to Plaintiffs, in response to these regulatory notices, certain Wall Street firms
19 (e.g., Edward Jones & Co., UBS, and Charles Schwab) halted the sale of leveraged and inverse
20 funds, or at least warned their clients to “proceed with extreme caution” when holding the funds for
21 longer than a day. *Id.* at ¶¶ 55-58.

22 **3. The July 2009 Registration Statement and Supplements**

23 The July 2009 Registration system includes substantially similar language in terms of Fund
24 Objective, Investment Strategy, and Investor Profile. However, the July 2009 Registration
25 Statement included this additional cautionary language: “[t]he return of each Fund for periods
26 longer than a single day, especially in periods of market volatility, may be completely uncorrelated
27 to the return of the Fund’s benchmark for that longer period.” The Statement also stated: “The
28 Funds should be utilized only by sophisticated investors or professional investment advisors who

1 (a) understand the risks associated with the use of leverage; (b) understand the consequences of
2 seeking investment results on a daily basis; (c) understand the risk of shorting; and (d) intend to
3 actively monitor and manage their investments on a daily basis.” *Id.* at ¶¶ 59-61.

4 On August 7, 2009, Defendants issued a supplement to the July 2009 Registration
5 Statement, adding three graphs to the section on “Understanding Compounding and the Effect of
6 Leverage.” *Id.* at ¶ 64. On November 17, 2009, Defendants issued another supplement adding
7 more warnings, stating that the Fund is “not intended to be used by, and are not appropriate for,
8 investors who do not intend to actively monitor and manage their portfolios” and that “the path or
9 trend of the benchmark during the longer period may be at least as important to the Daily
10 Leveraged Fund’s or Inverse Fund’s return for the longer period as the cumulative return of the
11 benchmark for the relevant longer period.” *Id.* at ¶ 65.

12 According to Plaintiffs, even with these additional warnings, the July 2009 Registration
13 Statement is still false and misleading because it failed to disclose that: the inverse correlation
14 between the Fund and the 30-year U.S. Treasury Bond would only occur in the “rarest
15 circumstances, and inadvertently if at all;” the Fund performance over time would inevitably
16 diverge from the inverse performance of the 30-year U.S. Treasury Bond; and the Fund is
17 “unsuitable” for investors who plan to hold it for longer than one day. *Id.* at ¶ 67.

18 II. LEGAL STANDARDS

19 A motion to dismiss for failure to state a claim under Rule 12(b)(6) tests the legal
20 sufficiency of a complaint. To withstand a motion to dismiss, a plaintiff must “plead enough facts
21 to state a claim that is plausible on its face.” *Bell Atlantic v. Twombly*, 550 U.S. 544, 555 (2007).
22 Generally, a court may not consider material outside of the complaint without converting the Rule
23 12(b)(6) motion into a summary judgment motion. *See Levine v. Diamantheset, Inc.*, 950 F.2d
24 1478, 1483 (9th Cir. 1991). A court may, however, consider exhibits submitted with the complaint
25 and matters that may be judicially noticed pursuant to Fed. R. Evid. 201. *Hal Roach Studios, Inc.*
26 *v. Richard Feiner & Co.*, 896 F.2d 1542, 1555 at n. 19 (9th Cir. 1989). For example, the court may
27 consider the full text of the relevant documents to determine whether the plaintiffs have alleged
28 material misrepresentations or omissions without converting the motion into one for summary

1 judgment . *See In re Stac Electronics Sec. Litig.*, 89 F.3d 1399, 1405 n. 4 (9th Cir. 1996). “Leave
2 to amend should be granted unless it is clear that the complaint’s deficiencies cannot be cured by
3 amendment. *Lucas v. Dep’t of Corrections*, 66 F.3d 245, 248 (9th Cir. 1995).

4 III. DISCUSSION

5 The Rydex Defendants and the Independent Trustee Defendants have separately moved to
6 dismiss. The Rydex Defendants move to dismiss on the grounds that the Fund’s disclosures
7 contained no actionable misstatements or omissions. The Independent Trustee Defendants move to
8 dismiss on the grounds that Plaintiffs’ claims are time-barred, that Plaintiffs have not suffered
9 compensable damages, and that Plaintiffs have failed to plead requisite elements for certain of the
10 securities claims. Plaintiffs have filed oppositions to both motions.

11 A. Rydex Defendants’ Motion to Dismiss Section 11 and Section 12(a)(2) Claims

12 Claims under Sections 11 and 12(a)(2) of the Securities Act contain roughly parallel
13 elements. Moreover, unlike securities fraud claims pursuant to section 10(b) of the Securities
14 Exchange Act of 1934, 15 U.S.C. § 78a *et seq.*, plaintiffs bringing claims under sections 11 and
15 12(a)(2) need not allege scienter, reliance, or loss causation. Section 11 of the Securities Act
16 focuses on misstatements or omissions in registration statements. Section 11 creates a private
17 remedy for any purchaser of a security if “any part of the registration statement, when such part
18 became effective, contained an untrue statement of a material fact or omitted to state a material fact
19 required to be stated therein or necessary to make the statements therein not misleading.” 15
20 U.S.C. § 77k(a). To establish a claim under Section 11, a plaintiff must allege: (1) that the
21 registration statement contained an omission or misrepresentation, and (2) that the omission or
22 misrepresentation was material, “that is, it would have misled a reasonable investor about the
23 nature of his or her investment.” *See Rubke v. Capitol Bancorp, Ltd.*, 551 F.3d 1156, 1161 (9th
24 Cir. 2009); *see also In re Stac Elec. Sec. Litig.*, 89 F.2d at 1404 (9th Cir. 2006).

25 Section 12(a)(2) of the Securities Act establishes liability for persons who offer or sell
26 securities by means of prospectuses or oral communications that include untrue or misleading
27 statements or omissions. *See* 15 U.S.C. § 77(a)(2). A plaintiff must establish that he or she
28 purchased shares directly in the offering pursuant to the prospectus alleged to be misleading.

1 *Moore v. Kayport Package Express, Inc.*, 885 F.2d 531, 535 (9th Cir. 1989). Similar to a Section
2 11 claim, a claim under Section 12(a)(2) does not require a showing of intent or knowledge, as
3 even negligent misrepresentations or material omissions are actionable.

4 Unless the allegations sound in fraud, the heightened pleading requirements of the Private
5 Securities Litigation Reform Act of 1995 (PSLRA) do not apply to Section 11 or Section 12
6 claims. *Rubke*, 551 F.3d at 1161. Allegations of non-fraudulent conduct only need satisfy the
7 ordinary pleading standards of Rule 8. *See Sparling v. Daou (In re Daou Sys.)*, 411 F.3d 1006,
8 1027 (9th Cir. 2005). Scierter is not required for liability under Section 11 or Section 12;
9 defendants are “liable for innocent or negligent material misstatements or omissions.” *See Kaplan*
10 *v. Rose*, 49 F.3d 1363, 1371 n.9 (9th Cir. 1994). Moreover, where the adequacy of the disclosures
11 is at issue, Defendants must make a “stringent showing” that “reasonable minds could not
12 disagree” that the disclosures were not misleading. *See Livid Holdings Ltd. v. Salomon Smith*
13 *Barney, Inc.*, 416 F.3d 940, 947 (9th Cir. 2005) (dismissal on the pleadings based on sufficient
14 cautionary language “requires a stringent showing: There must be sufficient ‘cautionary language
15 or risk disclosure [such] that reasonable minds could not disagree that the challenged statements
16 were not misleading.’”).

17 **1. Misrepresentations or Omissions**

18 Plaintiffs’ allegations do not sound in fraud, and Defendants do not argue otherwise.
19 Accordingly, the notice pleading standard of Rule 8 governs. In the instant action, Plaintiffs have
20 sufficiently alleged both a material misrepresentation and an omission of material fact. Plaintiffs
21 have adequately alleged that Defendants: 1) marketed their Fund as a way to profit from a decline
22 in the value of the 30-year U.S. Treasury bond, but did not specify that the Fund was only
23 appropriate for investors who thought the value of the 30-year Treasury bond would fall *that day*
24 and discouraged investors from selling shares over the shorter term with sales charges for shares
25 sold within a year or eighteen months of purchase; and 2) did not disclose that the daily tracking of
26 the Fund *necessarily* implicates a mathematical compounding effect that will lead to deviation
27 from the benchmark, and instead only made a general statement that “tracking error” is “possible”
28 or “may” occur. The Court finds that, in the context of ruling upon a motion to dismiss under the

1 liberal Rule 8 pleading standard, Plaintiffs have stated a claim under Section 11 and Section
2 12(a)(2) of the Securities Act by alleging that Defendants' disclosures regarding an appropriate
3 investor for the Fund and the inherent risk of compounding were misleading. *See Fecht v. The*
4 *Price Co.*, 70 F.3d 1078, 1081 (9th Cir. 1995) (adequacy of disclosure is mixed question of law and
5 fact not usually resolved as a matter of law unless issue is "so obvious that reasonable minds could
6 not differ"). Thus, the Rydex Defendants' motion to dismiss is denied.

7 Specifically, Defendants argued that they repeatedly disclosed: 1) the Fund's daily
8 investment objective; and 2) the potential effects of compounding over time. Defendants did
9 disclose the daily objective of the Fund. However, disclosing the daily objective of the Fund is
10 insufficient, at least at the pleading stage, to overcome Plaintiffs' allegations that they were misled
11 by Defendants into thinking that the Fund was an appropriate long-term investment. *See Miller v.*
12 *Thane Int'l, Inc.*, 519 F.3d 879, 886 (9th Cir. 2008) (finding that the district court committed clear
13 error in dismissing securities claims where defendants' disclosures were "literally accurate," but
14 were presented in a context and manner that misled investors); *compare Brody*, 280 F.3d at 1006
15 (dismissing securities claim under heightened PLSRA pleading standard where plaintiffs only
16 alleged "incomplete" disclosures as opposed to misleading disclosures). Defendants marketed the
17 Fund as appropriate for "[i]nvestors who expect the value of the Long Treasury Bond to go down
18 and want investment gains when it does so" and for investors that want "benefits" in a "rising
19 interest rate environment." In addition, investors were subject to a sales charge if they sold shares
20 within a year or eighteen months of purchase. Although Defendants argue that investors could
21 have transferred their shares into other Rydex funds without these sales charges, investors could
22 not sell their shares for cash within a year or eighteen months without paying the sales charges. An
23 investor with the "total mix" of information is not necessarily unreasonable in believing that an
24 investment with a daily objective is also appropriate as a long-term investment, especially where
25 the particular investment at issue includes charges for shorter term sales, but not for longer term
26 sales. *See Brody*, 280 F.3d at 1006 (a statement that is "literally true" may still be misleading if it
27 presents a false impression of the nature of the security).
28

1 Moreover, Defendants overstate the extent of their disclosures on compounding. In their
2 briefing before the Court, Defendants refer to the “inherent,” “readily apparent,” “undeniably
3 clear” effect and risk of compounding on *any* investment with a daily benchmark. The Fund’s
4 actual disclosures were more general and ambiguous, referencing “tracking error risk” and using
5 conditional language that mathematical compounding “may” prevent a Fund from correlating with
6 the benchmark. This is more than a dispute over adverbs. Plaintiffs allege that Defendants failed
7 to disclose the magnitude of the risk they faced by holding the Fund for longer than a single day
8 because of the inevitable effect of compounding. *See Miller*, 519 F.3d at 886; *see also In Re Daou*
9 *Systems*, 411 F.3d at 1019-21 (finding that plaintiffs satisfied the heightened pleading standards of
10 a claim under 10(b) where defendants misleadingly understated magnitude of risk in investing in
11 defendant company).

12 In any event, Defendants have not satisfied the “stringent showing” necessary to establish
13 that their disclosures and cautionary language were sufficient as a matter of law. *See Livid*
14 *Holdings Ltd.*, 416 F.3d at 947. Accordingly, the Rydex Defendants’ motion to dismiss for lack of
15 actionable misrepresentation or omission is denied.

16 **2. Materiality**

17 To succeed on their Section 11 and Section 12(a)(2) claims, Plaintiffs are also required to
18 establish that the omission or misrepresentation was material, “that is, it would have misled a
19 reasonable investor about the nature of his or her investment.” *See Rubke*, 551 F.3d at 1161.
20 Defendants, at this stage, do not challenge the materiality of the alleged misrepresentations and
21 omissions. Accordingly, whether Plaintiffs’ “reasonably” relied on the alleged misrepresentations
22 and omissions (i.e., whether the misrepresentations/omissions were “material”) is not yet ripe for
23 review and will likely be an issue for summary judgment. *See Siracusano v. Matrixx Initiatives,*
24 *Inc.*, 585 F.3d 1167, 1177-78 (9th Cir. 2009) (question of “materiality” usually within “province of
25 trier of fact”); *see also Fecht*, 70 F.3d at 1081 (9th Cir. 1995) (adequacy of disclosure and
26 materiality are mixed questions of law and fact not usually resolved as a matter of law).

1 **B. Independent Trustee Defendants' Motion to Dismiss**

2 **1. Whether Plaintiffs Section 11 and Section 12(a)(2) Claims are time-barred?**

3 Claims brought under Sections 11 and 12(a)(2) of the Securities Act of 1933 are barred
 4 “unless brought within one year after the discovery of the untrue statement or the omission, or after
 5 such discovery should have been made by the exercise of reasonable diligence.” 15 U.S.C. § 77m.
 6 Plaintiffs must file their claims “within one year of actual notice *or inquiry notice* of an untrue or
 7 misleading statement.” *In re Stac Elec. Sec. Litig.*, 89 F.3d 1399, 1411 (9th Cir. 1996). The
 8 Supreme Court has set a high bar for establishing inquiry notice as a matter of law in securities
 9 cases. In *Merck & Co. v. Reynolds*, the Supreme Court ruled that “the limitations period does not
 10 begin to run until the plaintiff thereafter discovers or a reasonably diligent plaintiff would have
 11 discovered ‘the facts constituting the violation.’”¹ As courts in this District have reasoned, the
 12 determination of inquiry notice is “fact intensive” and is usually not appropriate at the pleading
 13 stage. *See, e.g., In re Bare Escentuals, Inc. Sec. Litig.*, 2010 U.S. Dist. LEXIS 103612 (N.D. Cal.
 14 Sept. 30, 2010) (“the court finds that resolution of the limitations issue is not appropriate at the
 15 pleading stage, but must be determined once an evidentiary record has been developed.”).

16 Plaintiffs filed suit in March 2010. Thus, it is Defendants’ burden to establish that
 17 Plaintiffs did discover or could have discovered the allegedly untrue statement or omission before
 18 March 2009. The Independent Trustee Defendants argue that: 1) the Registration Statements and
 19 Prospectuses themselves, along with the Fund’s Annual Reports, put Plaintiffs on notice of the
 20 alleged misrepresentations and omissions; and 2) “well-publicized” news articles put plaintiffs on
 21 notice of the facts underlying their claims years before they filed suit. The Court is not persuaded.

22 As noted above, it was not obvious from the disclosures in the Registration Statements and
 23 Prospectuses that a fund with a daily benchmark would be inappropriate or highly risky (because of
 24 compounding, as Plaintiffs allege) for periods longer than a day. The Annual Reports include
 25 graphs showing a deviation, but it is not clear that compounding is the cause of that deviation. In
 26 other words, those graphs did not clearly give Plaintiffs notice of the misrepresentations they allege

27 _____
 28 ¹ Although the Court recognizes that *Merck* analyzed inquiry notice in the context of the
 heightened pleading standards of a 10(b) securities violation, the same doctrine of inquiry notice is
 applicable to securities claims under Section 11 and Section 12(a)(2).

1 here. Nor do the three news articles cited by Defendants, as a matter of law, place plaintiffs on
 2 inquiry notice. *See In re Wells Fargo Mortg. Backed Certificates Litig.*, 712 F. Supp. 2d 958, 967
 3 (N.D. Cal. April 22, 2010) (despite substantial press coverage regarding mortgage-backed
 4 securities, the court could not “conclude that this press coverage put plaintiffs on notice of their
 5 claims as a matter of law.”). The articles did not discuss the specific Fund at issue here, and
 6 Plaintiffs dispute whether the articles were “widely available.”

7 Accordingly, Defendants have failed to overcome the especially high hurdle in establishing
 8 inquiry notice as a matter of law. Thus, the Independent Trustee Defendants’ motion to dismiss for
 9 lack of timeliness is denied.

10 **2. Whether Plaintiffs have suffered “compensable damages?”**

11 Under the Securities Act:

12 if the defendant proves that any portion or all of such damages
 13 represents other than the depreciation in value of such security
 14 resulting from such part of the registration statement,
 15 with respect to which his liability is asserted, not being true or
 16 omitting to state a material fact required to be stated therein or
 17 necessary to make the statements therein not misleading,
 18 such portion of or all such damages shall not be recoverable.

19 15 U.S.C. §77k(e). This concept of “loss causation” means that there must be “a causal connection
 20 between the material misrepresentation and the loss.” *See Dura Pharmaceuticals, Inc. v. Broudo*,
 21 544 U.S. 336, 342 (2005). Loss causation, i.e., a showing that the omission caused the security to
 22 fall in value, is distinct from “transaction causation,” which involved a showing that the omission
 23 caused the plaintiff to enter into the transaction (buy the stock) in the first place. Lack of loss
 24 causation is an affirmative defense (i.e., not an element of a claim), but courts have sometimes
 25 dismissed securities claims on the pleadings where the lack of loss causation is clearly apparent
 26 from the face of the complaint and judicially noticeable documents. *See, e.g., In re DNAP*
 27 *Securities Litigation*, 2000 U.S. Dist. LEXIS 13482, 2000 WL 1358619, *3 (N.D. Cal. 2000).

28 Here, Defendants argue that, unlike traditional stocks, mutual funds and exchange traded
 funds are not traded on the public market, and instead are priced according to their “net asset
 value” (NAV), which is equal to (Assets - Liabilities) / Shares Outstanding. Thus, according to
 Defendants, only the Fund’s investments (its assets and liabilities) can affect its price, not its

1 disclosures. Under what Defendants refer to as the “broad” view of this argument, even if
2 Defendants did fail to disclose who was an appropriate investor for the Fund and the nature of the
3 compounding effect, those omissions are immaterial because they could not affect the Fund’s price.
4 In other words, Plaintiffs cannot show (and can never show) loss causation with this type of Fund.

5 This argument has recently been rejected by another judge in this District, and for good
6 reason. *See In re Charles Schwab Corp. Secs. Litig.*, 257 F.R.D. 534, 550 (N.D. Cal. 2009) (in a
7 case involving securities claims under Section 11, 12(a)(2), and 15, holding that plaintiffs did not
8 need to plead loss causation at the motion to dismiss stage and, in any event, that plaintiffs could
9 establish “loss causation” by proving that the “materialization of the concealed risk caused the
10 loss.”). If Defendants are correct that disclosures are immaterial to mutual funds/exchange traded
11 funds, then there can never be a Section 11 or Section 12(a)(2) claim of misrepresentation or
12 material omission against such funds. That would lead to the absurd result that such funds could
13 even *intentionally* misrepresent material facts with impunity.

14 At oral argument on December 16, 2010, Defendants also presented a narrower version of
15 their “loss causation” argument, stating that, at least in this case, the risk of compounding was
16 never concealed and so could not have “materialized” to cause Plaintiffs’ loss. Although the
17 determination of the affirmative defense of loss causation is more appropriate on a motion for
18 summary judgment, the Court finds that Plaintiffs have plausibly alleged loss causation in as much
19 as Plaintiffs allege that their loss in this case was caused, or exacerbated by, the “materialization”
20 of the concealed/undisclosed risk that holding the Fund for longer than one day would inevitably
21 lead to a failure of the Fund to track the inverse performance of the 30-year U.S. Treasury Bond.
22 Defendants may be correct that Plaintiffs will have a hard time establishing loss causation with this
23 type of fund. *But cf. In Re Daou Systems Inc.*, 411 F.3d at 1025 (“a plaintiff is not required to
24 show that a misrepresentation was the sole reason for the investment’s decline in value in order to
25 establish loss causation.”). The only point decided here is that Plaintiffs should have the
26 opportunity to make that showing.

27 Accordingly, the Independent Trustee Defendants’ motion to dismiss for failure to establish
28 loss causation is denied.

3. The Claim under Section 15 of the Securities Act

Section 15 of the Securities Act makes any person who controls a person who violates certain sections of the Act (11 or 12), liable jointly and severally “with and to the same extent as the controlled person.” *In re Daou Systems*, 411 F.3d at 1029-30. To state a claim under Section 15, plaintiff must establish (1) a primary violation of the pertinent federal securities laws, and (2) that defendants exercised actual power or control over the primary violator. *See Howard v. Everex Systems, Inc.*, 228 F.3d 1057, 1065 (9th Cir. 2000). “Whether [the defendant] is a controlling person is an intensely factual question, involving scrutiny of the defendant’s participation in the day-to-day affairs of the corporation and the defendant’s power to control corporate actions.” *Id.*

Plaintiffs have satisfied the first prong by establishing an underlying Section 11 and Section 12(a)(2) violation. Defendants submit that Plaintiffs’ allegations regarding “control” (i.e., that Defendants are high level officers and signed registration statements) are merely conclusory and do not satisfy the heightened pleading standard of *Twombly* and *Iqbal*. However, Defendants extend this argument about a heightened pleading standard too far. It is certainly “plausible” that high level officers (like the Independent Trustees) who signed the Registration Statements were in a position to exercise control over the Fund and its disclosures. *See Howard*, 228 F.3d at 1065 (in order to establish a prima facie case for control person liability, “it is not necessary to show actual participation or the exercise of actual power); *see also In re Charles Schwab*, 257 F.R.D. at 550 (denying motion to dismiss Section 15 claims because “[i]t is a plausible inference, for example, that individuals who were officers of the fund (and other Schwab entities, in some cases) and who signed the registration statements were in a position to exercise power and control over Schwab Investments.”).

Accordingly, the Independent Trustee Defendants’ motion to dismiss the Section 15 claim is denied.

1 **4. Whether Plaintiffs lack standing regarding claims relating to the July 2009**
2 **Registration Statement and the 2007 and 2008 “Advisor,” “Investor” and**
3 **“C Class” shares?**

4 Plaintiffs acquired shares in the Fund between March 20, 2008 and December 19, 2008.
5 But the 2009 Registration Statement was not issued until July 2009. Thus, Defendants argue that
6 Plaintiffs do not have standing to bring Section 11 and 12(a)(2) claims because their shares were
7 not purchased “pursuant to” the July 2009 Registration Statement. Plaintiffs acknowledge that
8 they did not purchase shares pursuant to the 2009 Registration Statement, but argue that the
9 misrepresentations and omissions from the 2007, 2008, and 2009 Registration Statements are all
10 “part of the same common nucleus of operative fact.” As courts in this District have held, a named
11 plaintiff has standing only to the extent the claims are based on documents that governed their own
12 purchases. *See, e.g., In re Wells Fargo Mortg. Backed Certificates Litig.*, 712 F. Supp. 2d 958, 963
13 (N.D. Cal. April 22, 2010) (“Although plaintiffs have alleged that the Prospectuses and Prospectus
14 Supplements contained some similar false statements or omissions, the case law is clear that a
15 named plaintiff has standing under Section 11 only as to the documents that governed his own
16 purchase of securities.”); *see also In re Wells Fargo Mortgage-Backed Certificates Litig.*, 2010
17 U.S. Dist. LEXIS 124498 (N.D. Cal. Oct. 19, 2010) (“Multiple courts have rejected an extension of
18 this ‘common registration’ theory to situations where, as here, Plaintiffs’ claims rely on separate
19 disclosures or omissions made for each Offering.”). Thus, the Court agrees with Defendants that
20 Plaintiffs lack standing to bring claims pursuant to the July 2009 Registration Statement, especially
21 since the July 2009 Registration Statement includes a different set of disclosures and additional
22 warnings about the effect of compounding on the Fund. Accordingly, the Independent Trustee
23 Defendants’ motion to dismiss the Section 11 and 12(a)(2) claims pursuant to the July 2009
24 Registration Statement is granted.

25 Similarly, Defendants contend that Plaintiffs only bought “A Class” shares of the Fund, and
26 thus Plaintiffs have no standing to bring claims based on the other three types of shares (Advisor,
27 Investor and C Class) pursuant to the July 2007 and July 2008 Registration Statements. Plaintiffs
28 respond that they have standing to assert claims on behalf of investors of the “Advisor,” “Investor,”
 and “Class C” shares because courts have allowed purchasers of one class of securities to represent

1 purchasers of another class of securities when the alleged harm stems from the same improper
 2 conduct or the same issuance. *See In re Juniper Networks Secs. Litig.*, 264 F.R.D. 584, 594 (N.D.
 3 Cal. 2009) (“plaintiffs with a valid securities claim may represent the interests of purchasers of
 4 other types of securities in a class action where the alleged harm stems from the same allegedly
 5 improper conduct”). The Court finds that Plaintiffs have the better argument because all four types
 6 of shares were issued pursuant to the July 2007 and July 2008 Registration Statements, which
 7 included the same disclosures for the A Class shares as for the Advisor, Investor, and C Class
 8 Shares. *See In re DDi Corp. Sec. Litig.*, 2005 U.S. Dist. LEXIS 28216, *23 (C.D. Cal. July 20,
 9 2005) (holding that named plaintiffs, who had bought common stock, could represent investors
 10 who bought convertible notes because both were traceable to same issuance).

11 Accordingly, the Independent Trustee Defendants’ motion to dismiss for lack of standing as
 12 to the Advisor, Investor, and C Class shares is denied.

13 IV. CONCLUSION

14 For the reasons described above, the Rydex Defendants’ motion to dismiss [dkt. #39] is
 15 DENIED. The Independent Trustee Defendants’ motion to dismiss [dkt. #42] is DENIED with
 16 respect to the arguments regarding lack of timeliness, loss causation, control liability, and standing
 17 as to the Advisor, Investor, and C Class shares issued pursuant to the July 2007 and July 2008
 18 Registration Statements. The Independent Trustee Defendants’ motion to dismiss is GRANTED
 19 with respect to the claims under the July 2009 Registration Statement for lack of standing.

20 **IT IS SO ORDERED.**

21
 22 Dated: January 5, 2011

23 
 24 LUCY H. KOH
 25 United States District Judge
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 27
 28