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Second Circuit Addresses Materiality of Alleged Omissions at the Pleading Stage

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Earlier this week, the United States Court of Appeals for the Second Circuit issued a noteworthy decision regarding the standard for judging the materiality of alleged omissions in a class action lawsuit brought under Section 11 of the Securities Act of 1933. In *In re ProShares Trust Securities Litigation*, 2013 WL 3779634 (2d Cir. July 22, 2013), the Second Circuit articulated a standard for pleading materiality that emphasizes the need to read disclosures as a whole and from a common sense perspective. *ProShares* will be of interest to defendants in many Section 11 cases alleging omissions of material fact.

Background

ProShares is a provider of exchange-traded funds (ETFs) that seek to achieve returns equal to specified multiples of a benchmark index or its inverse on a daily basis. From August 2006 through June 2009, ProShares ETFs were offered to investors through several registration statements, all of which disclosed that the ETFs pursued daily investment objectives and daily investment results through aggressive investment techniques that exposed the ETFs to “potentially dramatic” losses. The registration statements also disclosed that the ETFs were “speculative,” “volatile,” subject to “large losses” from small movement in market prices and involved a high degree of risk. Finally, the prospectuses disclosed that the ETFs could not pursue their stated objectives for beyond-a-day periods because mathematical compounding and leveraging prevented the ETFs from reaching those results. Despite these warnings, Plaintiffs alleged that the registration statements were inadequate because they failed to specifically disclose the magnitude and probability of loss for beyond-a-day investments.

The US District Court for the Southern District of New York dismissed the case, finding that “it was not possible to read the registration statements . . . without understanding that the ETFs were particularly risky and speculative and were intended to meet their stated goal only over the course of a single day.” *In re ProShares Trust Sec. Litig.*, 889 F. Supp. 2d 644, 656 (S.D.N.Y. 2012).

On appeal, Plaintiffs acknowledged that the prospectuses contained warnings that the value of long-term ETF investments “may diverge significantly” from the underlying indices. They argued, however, that the “diverge significantly” disclosure did not speak directly to “a divergence that results in actual, substantial loss.” More particularly, Plaintiffs maintained that the phrase “‘diverge significantly’ is not a synonym for ‘loss’” and does not include “large rapid losses.”

The Second Circuit Decision

The Second Circuit rejected Plaintiffs’ argument and affirmed the district court’s dismissal of the Complaint with prejudice. The Court began its analysis by reiterating the standard for adequately pleading a plausible Section 11 claim based on an alleged omission. “A complaint must pass two distinct hurdles: it must identify an omission that is (1) unlawful and (2) material.” Although the Court recognized that “materiality will rarely be dispositive in a motion to dismiss,” it made plain that “the materiality hurdle remains a meaningful pleading obstacle,” and it noted that “the Supreme Court has been ‘careful not to set too low a standard of materiality, for fear that management would bury the shareholders in an avalanche of trivial information.’” (quoting *Matrixx Initiatives, Inv. v. Siracusano*, 131 S.Ct. 1309, 1318 (2011)).

Writing for the Court, Judge Richard Wesley wrote: “Plaintiffs’ efforts to find a meaningful distinction between the words ‘diverge significantly’ and ‘actual loss’ strains the plain meaning of the former phrase . . . ‘Significant’ means large or important; in the context of the offering documents, ‘divergence’ means the opposite from one’s expectation. ProShares’ ‘significant divergence’ disclosures, fairly read, 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.” The Second Circuit concluded: “Because the ‘role of the materiality requirement is not to attribute to investors a child-like simplicity,’ we presume that a reasonable investor can comprehend the basic meaning of plain-English disclosures and will not credit Plaintiffs’ narrow reading of ‘diverge significantly.’”

In reaching its decision, the Second Circuit interpreted the “diverge significantly” disclosure in the context of the prospectus as a whole. The Court reiterated its well-established rule that, in evaluating a prospectus, it must be read “cover-to-cover,” “holistically” and with all defendants’ representations “taken together and in context.” After doing so, Wesley wrote: “[N]o reasonable investor could read these prospectuses without realizing that volatility, combined with leveraging, subjected that investment to a great risk of long-term loss as market volatility increased.”

Significance of *ProShares*

ProShares should be helpful to defendants faced with allegations that focus narrowly on alleged omissions where, reading the disclosures as a whole, the overall risk complained of was disclosed.

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