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Judge: Rydex Inverse Fund Suit May Proceed

By Hannah Glover January 13, 2011

A federal judge in California has denied a motion to dismiss a case against **Rydex-SGI** in which plaintiffs claim the firm misrepresented the types of investors best suited for an inverse bond fund and failed to "adequately disclose" the "mathematical compounding effect" of the strategy, ultimately leading to investor losses.

The lawsuit, which was filed last March in the U.S. District Court for the Northern District of California, involves the Rydex Inverse Government Bond Strategy Fund. The lead plaintiff, James Rafton, trustee of the James and Cynthia Rafton Trust, owned the fund between March 20, 2008, and Dec. 19, 2008, and argues that the firm failed to explain to investors that the fund was best suited for day traders, not longer-term investors, says Alan Sparer, founding partner of the **Sparer Law Group** in San Francisco, which represents the plaintiffs.

Sparer called Judge Lucy Koh's Jan. 5 order "significant" because it could portend whether similar claims against other leveraged and inverse products will go forward.

A spokeswoman for Rydex-SGI declined to comment on the case, citing corporate policy.

The case adds to a series of class action lawsuits in which investors have complained that the risks associated with inverse or leveraged products were not made clear to investors. Direxion and ProShares were each slapped with similar claims related to leveraged exchange-traded funds in 2009. At the time, leveraged and inverse products also attracted the attention of regulators. Finra and the SEC issued alerts, warning investors about compounding and the effects on performance it can have in leveraged and inverse products.

Rydex-SGI, another major provider of leveraged and inverse ETFs at the time, sidestepped that series of cases. Last April, the firm scuttled 12 of its 14 leveraged and inverse ETFs, liquidating about $129 million in ETF assets.

The March 2010 Rydex-SGI case involves a long-term open-end mutual fund, not an ETF, but highlights the pitfalls of potentially incomplete disclosure. "One of the conclusions one could draw from the case is that the disclosures, according to this court, have to be tailored to a particular product," says Howard Suskin, a partner at **Jenner and Block.**

That could be especially critical as investor appetite for products that aim to tamp down volatility or protect against downside risk has encouraged firms across the industry to crank out alternative-flavored funds and ETFs that rely on more complex instruments or esoteric strategies. Among leveraged and inverse strategies alone, there are 25 open-end mutual funds and 165 ETFs, according to data from **Morningstar**.

"Every product is going to be somewhat unique and will possibly require unique disclosures specifically tailored to that product," says Suskin.

In her order regarding the Rydex case, Koh points to the fact that the firm levied certain sales charges for shares redeemed for cash within 12 or 18 months. Such fees could lead investors to believe that "an investment with a daily objective is also appropriate for long-term investment, especially where the particular investment at issue includes sales charges for shorter-term sales, but not for longer-term sales," Koh writes.

The fund has never carried a redemption fee, but certain share classes could be subject to brokerage commission trails, or contingent deferred sales charges (CDSC). Rydex–SGI offers in-kind redemption for other Rydex products, but Koh focuses on those investors who might want to exchange their shares for cash.

In terms of the objectives and strategies behind the fund, Rydex revised its disclosure regularly, plaintiffs note. In 2007 and 2008, the fund objective stated, "When the price of the Long Treasury Bond increases… the value of the fund's shares should decrease on a daily basis by an inversely proportionate amount." In 2008, the firm added disclosure to the principal investment strategy that "under normal circumstances, the fund would invest 80% of its net assets in financial instruments with economic characteristics that should perform opposite to fixed-income securities issued by the U.S. Government," and that the investment policy could be subject to change.

In 2009, Rydex-SGI added language to its July registration statement that said, "The return of each Fund for periods longer than a single day, especially in periods of market volatility, may be completely uncorrelated to the return of the Fund's benchmark for that longer period." The sticker also noted that the fund should be utilized only by "sophisticated investors or professional investment advisors" who understand leverage and shorting and intend to actively monitor their portfolios. In August and again in November, Rydex added further disclosure about understanding compounding and the effects of leverage, and stated that the fund is inappropriate for investors not tracking performance daily.

In her order, Koh sided with the independent trustee defendants' argument that the July 2009 disclosure should not be considered in the case, since the plaintiffs made the decision to buy the fund prior to the 2009 registration statement. As a result, that portion of the case has been dismissed.

Jeff Keil, principal with **Keil Fiduciary Strategies,** says the financial crisis exposed risks in various categories that even fund sponsors underestimated. "What was adequate disclosure pre-October, 2008, and in the events that happened subsequent to that, may have made a lot of companies reexamine disclosure. The model kind of changed."

As new products roll off the assembly line, the challenge becomes disclosing the risks in a concise manner and conveying those ideas in plain English. More complex products, Keil says, "that hedge away the volatility certainly make for predictable returns from an investment standpoint, but are more problematic from a disclosure standpoint."

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