

ORIGINAL
FILED
2008 MAR 19 P 2:48
RICHARD W. WIERKING
CLERK U.S. DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

E-filing

CRB

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA
SAN FRANCISCO DIVISION

CV 10 1171

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

[Redacted Name]

Plaintiff,

v.

RYDEX SERIES FUNDS; PADCO
ADVISORS INC. d/b/a RYDEX
INVESTMENTS, INC.; RYDEX
DISTRIBUTORS, INC.; RICHARD M.
GOLDMAN; CARL G. VERBONCOEUR;
JOHN O. DEMARET; NICK BONOS;
MICHAEL P. BYRUM; COREY A.
COLEHOUR; J. KENNETH DALTON;
WERNER E. KELLER; THOMAS F. LYDON;
PATRICK T. MCCARVILLE; ROGER
SOMERS; and DOES 1 through 25, inclusive,

Defendants.

No.

CLASS ACTION COMPLAINT

CLASS ACTION

DEMAND FOR JURY TRIAL

1 Plaintiff, individually and on behalf of all others similarly situated, alleges the following
2 upon information and belief, except for those allegations as to himself, which are alleged upon
3 personal knowledge. The allegations are based on counsel's investigation, documents filed with
4 the United States Government and Securities and Exchange Commission (the "SEC"), reports
5 and interviews published in the press, and information obtained by Plaintiff.

6 NATURE OF THE ACTION

7 1. This is a federal class action on behalf of all persons or entities who purchased or
8 otherwise acquired shares in the Rydex Inverse Government Long Bond Strategy Fund (the
9 "Inverse Long Bond Fund" or the "Fund"), pursuant or traceable to false and misleading
10 Registration Statements, and Prospectuses (collectively, the "Registration Statements") between
11 March 19, 2007 and March 19, 2010 (the "Class Period") and who were damaged thereby. The
12 Class seeks to pursue remedies under Sections 11, 12 and 15 of the Securities Act of 1933 (the
13 "Securities Act").

14 JURISDICTION AND VENUE

15 2. The claims asserted herein arise under and pursuant to Sections 11, 12(a)(2) and
16 15 of the Securities Act (15 U.S.C. §§77k, 77i, 77o).

17 3. This Court has jurisdiction over the subject matter of this action pursuant to
18 Section 22 of the Securities Act, 15 U.S.C. §77v, and 28 U.S.C. §§1331 and 1332(d).

19 4. Venue is proper in this District pursuant to 15 U.S.C. §77v and 28 U.S.C.
20 §1391(b). Several of the Defendants are found, inhabitants of, or transact business in this
21 District. In addition, many of the acts giving rise to the violations of law complained of herein,
22 including the dissemination to shareholders of the Registration Statements and Prospectuses,
23 occurred in this District.

24 5. In connection with the acts alleged in this Complaint, Defendants, directly or
25 indirectly, used the means and instrumentalities of interstate commerce, including, but not
26 limited to, the mails, interstate telephone communications and the facilities of the national
27 securities markets.

1 families and their legal representatives, heirs, successors or assigns and any entity in which
2 Defendants have or had a controlling interest.

3 24. The members of the Class are so numerous that joinder of all members is
4 impracticable. While the exact number of Class members is unknown to Plaintiff at this time and
5 can only be ascertained through appropriate discovery, Plaintiff believes that there are thousands
6 of members in the proposed Class. Record owners and other members of the Class may be
7 identified from records maintained by Registrant or its transfer agent and may be notified of the
8 pendency of this action by mail, using the form of notice similar to that customarily used in
9 securities class actions.

10 25. Plaintiff's claims are typical of the claims of the members of the Class as all
11 members of the Class are similarly affected by Defendants' wrongful conduct in violation of
12 federal law that is complained of herein.

13 26. Plaintiff will fairly and adequately protect the interests of the members of the
14 Class and has retained counsel competent and experienced in class and securities litigation.

15 27. Common questions of law and fact exist as to all members of the Class and
16 predominate over any questions solely affecting individual members of the Class. Among the
17 questions of law and fact common to the Class are:

18 (a) whether Defendants' acts as alleged herein violated Sections 11 and
19 12(a)(2) of the Securities Act of 1933;

20 (b) whether statements made by Defendants to the investing public in the
21 Registration Statements misrepresented or omitted material facts; and

22 (c) whether and to what extent the members of the Class have sustained
23 damages and the proper measure of damages.

24 28. A class action is superior to all other available methods for the fair and efficient
25 adjudication of this controversy since joinder of all members is impracticable. Furthermore, as
26 the damages suffered by individual Class members may be relatively small, the expense and
27 burden of individual litigation make it impossible for members of the Class to individually
28

1 redress the wrongs done to them. There will be no difficulty in the management of this action as
2 a class action.

3 FACTUAL ALLEGATIONS

4 A. Inverse Funds.

5 29. The Inverse Long Bond Fund is a mutual fund that is similar to an exchange-
6 traded fund (“ETF”) in that it is designed to track a particular benchmark. Mutual funds and
7 ETFs both are regulated by the SEC under the Investment Company Act of 1940. “Inverse”
8 funds and ETFs are designed to move inversely with the benchmark or index, *i.e.*, when the price
9 of the benchmark increases, the price of the fund will decrease by the same percentage. Like
10 traditional ETFs, some inverse funds and ETFs track broad indices, some are sector-specific, and
11 still others are linked to commodities or currencies. Inverse funds and ETFs are often marketed
12 as a way for investors to profit from, or at least hedge their exposure to, downward moving
13 markets. In this case, the Inverse Long Bond Fund is supposed to be inversely correlated to the
14 price of the 30-year U.S. Treasury Bond and is designed to hedge against, or profit from, interest
15 rate increases.

16 30. Most inverse funds are designed to track a benchmark on a daily basis and “reset”
17 daily. Because of this, there is a mathematical “compounding” effect that causes a fund’s price
18 to deviate from the inverse movement of the benchmark for periods lasting longer than a single
19 day. Using a two-day example, if a benchmark index goes from 100 to close at 101 on the first
20 day and back down to close at 100 on the next day, an inverse fund tracking that benchmark
21 would lose 0.02%, even though the benchmark stays even over that period.

22 31. The compounding effect is especially pronounced during periods of high
23 volatility. For example if the benchmark index moves up to close at 110 the first day but then
24 back down to close at 100 on the next day, the inverse fund loses 1.82% over that two-day
25 period.

26 32. Because of this compounding effect, inverse funds are not appropriate trading
27 vehicles for investors seeking to hold the investment and obtain returns inverse to a benchmark
28 for longer than a single day.

1 **B. Rydex Inverse Government Long Bond Strategy Fund.**

2 33. The Inverse Long Bond Fund sold four classes of shares: Advisor, Investor, A and
3 C, under the ticker symbols RYJAX, RYJUX, RYAQX and RYJCX.

4 34. The Fund's shares were issued to investors pursuant to the following series of
5 Registration Statements and Prospectuses filed with the SEC and made effective during the Class
6 Period:

- 7 • Registration Statement filed pursuant to Form N-1A and Prospectus on July 30,
8 2007 (collectively "July 2007 Registration Statement");
- 9 • Registration Statement filed pursuant to Form N-1A and Prospectus on July 29
10 2008 (collectively "July 2008 Registration Statement"); and
- 11 • Registration Statement filed pursuant to Form N-1A and Prospectus on July 29,
12 2009 (collectively "July 2009 Registration Statement").

13 35. Each of the foregoing documents was negligently prepared and contained untrue
14 statements of material fact and/or omitted to state other facts necessary to make the statements
15 made not misleading, as described below. While the documents were not identical, they
16 contained many substantially similar untrue statements and were rendered misleading by
17 substantially similar omissions of material fact.

18 36. A reasonable investor would have viewed the undisclosed facts described herein,
19 jointly and severally, as having altered the total mix of available information.

20 37. As noted above, as it was marketed and sold, the Inverse Long Bond Fund is
21 supposed to be inversely correlated to the price of the 30-year U.S. Treasury Bond. However,
22 because of the undisclosed compounding effect present in this inverse fund, the Fund failed to
23 deliver the expected returns. To the contrary, investors holding Fund shares during the Class
24 Period lost money, even though the benchmark price of the 30-year U.S. Treasury Bond fell—
25 precisely the type of period during which investors would have expected to make money. For
26 example, between March 20, 2008 and February 22, 2010, the price of the 30-year U.S. Treasury
27 Bond fell by 4.91%. A reasonable investor, basing his understanding on the Registration
28 Statements, would expect the share price of the Fund to increase by the same amount over the

1 same period. However, due in large part to the compounding effect, the Fund price *fell* over the
2 same period by 11.29%. In other words, investors lost money over this time period despite the
3 fact that they anticipated a decrease in the price of the 30-year U.S. Treasury Bond and invested
4 in a security that promised to increase in value when the price of the 30-year U.S. Treasury Bond
5 declined.

6 38. The July 2007 Registration Statement states that:

7 "FUND OBJECTIVE

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

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

25 "PRINCIPAL INVESTMENT STRATEGY

26 "Unlike a traditional index fund, the Fund's objective is to
27 perform, on a daily basis, exactly opposite its benchmark, the
28 Long Treasury Bond. As its primary investment strategy, the
Fund enters into short sales and swap transactions, and engages in
futures and options transactions. On a day-to-day basis, the Fund
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 the
value of the Long Treasury Bond goes up." (Emphasis added)

1 39. Similarly, the July 2008 Registration Statement states that:

2 "FUND OBJECTIVE

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

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

20 "PRINCIPAL INVESTMENT STRATEGY

21 "Unlike a traditional index fund, the Inverse Government
22 Long Bond Strategy Fund's objective is to perform, on a daily
23 basis, exactly opposite the daily price movement of the Long
24 Treasury Bond. The Fund employs as its investment strategy a
25 program of engaging in short sales and investing to a significant
26 extent in derivative instruments, which primarily consist of futures
27 contracts, interest rate swaps, and options on securities and futures
28 contracts. Under normal circumstances, the Fund will invest at
least 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. This is a non-
fundamental investment policy that can be changed by the Fund
upon 60 days' prior notice to shareholders. On a day-to-day basis,
the Fund may hold U.S. Government securities or cash equivalents
to collateralize its short sales and derivative positions.

"INVESTOR PROFILE

"The Inverse Government Long Bond Strategy Fund is
intended for 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 the value of the Long Treasury Bond goes up."
(Emphasis added)

1 40. These statements make clear that Defendants sold the Inverse Long Bond Fund as
2 a simple directional investment based on the price of long term U.S. treasury bonds that could
3 appropriately be held for long periods of time. Indeed, the 2007 and 2008 Registration
4 Statements provided information about *annual* returns for the Inverse Long Bond Fund and
5 hypothetical examples of fees that investors could expect to pay over *1-year, 3-year, 5-year, and*
6 *10-year periods*. The 2007 and 2008 Registration Statements state that the fee “[e]xamples
7 assume that you invest \$10,000 in the Fund for the time periods indicated and then redeem all of
8 your shares at the end of those periods.” By including this data and these examples, the 2007 and
9 2008 Registration Statements clearly imply that the Fund was an appropriate vehicle for long-
10 term investing.

11 41. The only warning regarding the effects of compounding contained in the 2007 and
12 2008 Registration Statements related to a “tracking risk” that stated only that the Fund “may” not
13 correlate with the performance of its benchmark:

14 “TRACKING ERROR RISK - Tracking error risk refers to the
15 risk that the Fund’s Advisor may not be able to cause the Fund’s
16 performance to match that of the Fund’s benchmark, either on a
17 daily or aggregate basis. Factors such as Fund expenses, imperfect
18 correlation between the Fund’s investments and those of its
19 benchmark, rounding of share prices, changes to the benchmark,
20 regulatory policies, high portfolio turnover rate and leverage all
21 contribute to tracking error. In addition, because each Fund, except
22 for the Mid-Cap 1.5x Strategy Fund, Russell 2000(R) 1.5x Strategy
23 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.”

24 42. Disclosures that merely state that the Fund’s performance “may” not or
25 “generally” will not correlate with the inverse of its index over a period of time greater than one
26 day are misleading given that it is *extraordinarily unlikely* that the Inverse Long Bond Fund’s
27 performance will ever correlate with the inverse of the price of the 30-year U.S. Treasury Bond
28 over time.

1 43. It is noteworthy that Defendants issued additional warnings about the effects of
2 compounding in relation to other funds, but failed to do so for the Inverse Long Bond Fund.
3 Defendants issued the 2007 and 2008 Registration Statements for the Inverse Long Bond Fund as
4 part of omnibus prospectuses totaling over 900 pages and covering over 30 separate funds. The
5 first 100 pages cover approximately 25 funds. For each fund, Defendants purported to identify
6 the particular risks “that may affect the value of its shares.” While a discussion of the effects of
7 compounding and leverage was included by reference in each of the funds utilizing leverage, this
8 discussion was not referenced in relation to the Inverse Long Bond Fund. *Compare, e.g.*, Russell
9 2000 1.5x Strategy Fund (“For more information about the effects of leverage, please see
10 ‘Understanding Compounding and the Effect of Leverage’”), *with* Inverse Long Bond Fund. The
11 discussion of compounding in relation to leveraged funds states:

12 “UNDERSTANDING COMPOUNDING & THE EFFECT OF
13 LEVERAGE

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

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

28 “EXAMPLE B: Assume you invested \$100 in Fund B, a fund
that seeks to return 200% of the performance of its underlying
index. If the index increases 10% on day one, the value of your
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.

“Because of the effect of compounding, in each case the value
of your investment declined even though the index went up 10% on

1 day one and down 10% on day two. However, the effect of
2 compounding was more pronounced when combined with leverage
(Example B).

3 “The examples demonstrate that over time, the cumulative
4 percentage increase or decrease in the net asset value of a fund may
5 diverge significantly from the cumulative percentage increase or
6 decrease in the multiple of the return of the index underlying a
7 fund's benchmark due to the compounding effect of losses and
8 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.”

9 44. This additional cautionary language alone would not have been sufficient to warn
10 investors that the mathematical compounding effect virtually guaranteed that the Inverse Long
11 Bond Fund would deviate from its benchmark over time. Nor would it have been sufficient to
12 warn investors that the compounding effect made the Fund an inappropriate investment for
13 investors who intended to hold it for longer than a single trading period. Nonetheless, the fact
14 that Defendants failed to include even this minimal warning in relation to the Fund highlights the
15 misleading nature of the 2007 and 2008 Registration Statements.

16 **C. The 2007 And 2008 Registration Statements Were False And Misleading.**

17 45. All of the above discussed disclosures were false and/or misleading because they
18 failed to disclose that:

- 19 • Inverse correlation between the Fund and the price of the 30-year U.S. Treasury
20 Bond beyond one-day holding periods would only occur in the rarest of
circumstances, and inadvertently if at all;
- 21 • Fund performance over time would inevitably diverge on an increasing basis from
22 the inverse of the performance of the price of the 30-year U.S. Treasury Bond;
- 23 • The Fund is unsuitable for investors who plan to hold it for longer than one
24 trading session, particularly in volatile markets;
- 25 • The Fund was not intended or appropriate for investors who do not actively
26 monitor and manage their portfolios on a daily basis; and
- 27 • Because of compounding, for periods longer than a day, the path or trend of the
28 benchmark is at least as important to the Fund's return as the cumulative return of
the benchmark over that period; and

- While the Fund appears to offer a straightforward way to profit from or hedge against decreases in the price of the 30-year U.S Treasury Bond, such objectives are not attainable through the Fund except in extraordinarily rare circumstances.

46. Perhaps most importantly, the 2007 and 2008 Registration Statements do not disclose that the Inverse Long Bond Fund is altogether inappropriate as a directional investment for periods longer than a single day. Defendants failed to disclose the virtual certainty that mathematical compounding would prevent the Inverse Long Bond Fund from achieving its stated investment objective over a period of time greater than one day. Disclosures that merely state the Fund's performance over a period of time greater than one day "may" not or "generally" will not equal the inverse of the price of the 30-year U.S. Treasury Bond over that same period are misleading given that compounding makes it virtually impossible for the Fund to track its benchmark over time.

47. Nor did the 2007 and 2008 Registration Statements disclose that, if held long enough, an investment in the Fund would almost certainly lead to losses regardless of the direction of the price of the U.S. Treasury Long Bond.

D. Red Flags Raised By FINRA And Others.

48. On June 11, 2009, FINRA issued Regulatory Notice 09-31, in which it "remind[ed] firms of their sales practice obligations in connection with inverse ETFs." FINRA noted that "[t]here also are mutual funds that are designed to provide inverse and leveraged performance relative to their benchmarks. These mutual funds may reset on a daily basis as well, and thus raise many of the issues discussed in this Notice on ETFs." In particular, FINRA admonished that sales materials related to leveraged and inverse funds "must be fair and accurate." FINRA further cautioned:

"Exchange-traded funds (ETFs) that offer leverage or that are designed to perform inversely to the index or benchmark they track—or both—are growing in number and popularity. While such products may be useful in some sophisticated trading strategies, they are highly complex financial instruments that are typically designed to achieve their stated objectives on a daily basis. **Due to the effects of compounding, their performance over longer periods of time can differ significantly from their stated daily objective. Therefore, inverse and leveraged ETFs that are reset daily typically are unsuitable for retail investors**

1 who plan to hold them for longer than one trading session,
2 particularly in volatile markets.

3 * * * *

4 “Most leveraged and inverse ETFs ‘reset’ daily, meaning that
5 they are designed to achieve their stated objectives on a daily basis.
6 **Due to the effect of compounding, their performance over
7 longer periods of time can differ significantly from the
8 performance (or inverse of the performance) of their
9 underlying index or benchmark during the same period of
10 time.**

11 * * * *

12 “This effect can be magnified in volatile markets. Using a
13 two-day example, if the index goes from 100 to close at 101 on the
14 first day and back down to close at 100 on the next day, the two-
15 day return of an inverse ETF will be different than if the index had
16 moved up to close at 110 the first day but then back down to close
17 at 100 on the next day. In the first case with low volatility, the
18 inverse ETF loses 0.02 percent; but in the more volatile scenario
19 the inverse ETF loses 1.82 percent. **The effects of mathematical
20 compounding can grow significantly over time, leading to
21 scenarios such as those noted above.**

22 “Suitability

23 “NASD Rule 2310 requires that, before recommending the
24 purchase, sale or exchange of a security, a firm must have a
25 reasonable basis for believing that the transaction is suitable for the
26 customer to whom the recommendation is made. This analysis has
27 two components. The first is determining whether the product is
28 suitable for any customer, an analysis that requires firms and
associated persons to fully understand the products and transactions
they recommend.

* * * *

“Communications With the Public

“NASD Rule 2210 prohibits firms and registered
representatives from making false, exaggerated, unwarranted or
misleading statements or claims in communications with the
public. Therefore, all sales materials and oral presentations used by
firms regarding leveraged and inverse ETFs must present a fair and
balanced picture of both the risks and benefits of the funds, and
may not omit any material fact or qualification that would cause
such a communication to be misleading.” (Emphasis added)

1 49. FINRA spokesman Herb Perone has stated: “Exotic ETFs, such as inverse,
2 leveraged and inverse-leveraged ETFs, **are extremely complicated and confusing products**,
3 and the marketing and sale of these products to unsophisticated retail investors is very much on
4 FINRA’s radar screen” (emphasis added).

5 50. FINRA issued additional guidance on July 13, 2009 by way of a podcast on its
6 website. FINRA reiterated that most leveraged and inverse funds reset each day and are designed
7 to achieve their stated objective on a daily basis—but with the effects of compounding over a
8 longer time frame, results differ significantly.

9 51. On July 21, 2009, as reported by the *Wall Street Journal* in an article entitled
10 “Getting Personal, Edward Jones Drops ETFs,” Edward Jones & Co. halted the sale of its non-
11 traditional ETFs. Edward Jones called non-traditional ETFs “one of the most misunderstood and
12 potentially dangerous types of ETFs.”

13 52. On July 27, 2009, in a letter to wealth management clients, as reported by the *Wall*
14 *Street Journal* in an article entitled “Strange Traded Funds,” UBS said it would not trade ETFs
15 that use leverage or sell an underlying asset short. Similarly, on the heels of the FINRA Notice,
16 Ameriprise Financial and LPL Investment Holdings Inc. have also prohibited sales of leveraged
17 ETFs that seek more than twice the long or short performance of their target index. Wells Fargo
18 is now also reportedly reviewing its policy on non-traditional ETFs.

19 53. On July 30, 2009, the *Wall Street Journal* published an article entitled “Warning
20 Signs Up For Leveraged ETFs,” in which it was reported that Charles Schwab issued an unusual
21 warning on July 28 to clients who buy non-traditional ETFs that “while there may be limited
22 occasions where a leveraged or inverse ETF may be useful for some types of investors, it is
23 extremely important to understand that, for holding periods longer than a day, these funds may
24 not give you the returns you may be expecting. Proceed with extreme caution.” The disclosures
25 in the 2007 and 2008 Registration Statement simply do not rise to this “[p]roceed with extreme
26 caution” level of clarity.

27
28

1 54. On August 1, 2009, the *Wall Street Journal* quoted Morningstar's director of ETF
2 analysis, Scott Burns, who recently poignantly observed: "Hedges [like the Fund] aren't
3 supposed to become less trustworthy when you really need them."

4 **E. The 2009 Registration Statement And Supplements.**

5 55. The July 2009 Registration Statement is very similar in many respects to the 2007
6 and 2008 Registration Statements in that it continues to market the Inverse Long Bond Fund as
7 appropriate for long term investing in the expectation that the price of the U.S. Treasury long
8 bond will decrease:

9 "FUNDS OBJECTIVE

10 **"The Inverse Government Long Bond Strategy Fund seeks**
11 **to provide total returns that inversely correlate to the price**
12 **movements of a benchmark for U.S. Treasury debt instruments**
13 **or futures contracts on a specified debt instrument on a daily**
14 **basis.** The Fund's current benchmark is the daily price movement
15 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 Long Treasury
Bond.

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

23 "PRINCIPAL INVESTMENT STRATEGY

24 **"Unlike a traditional index fund, the Inverse Government**
25 **Long Bond Strategy Fund's objective is to perform, on a daily**
26 **basis, exactly opposite the daily price movement of the Long**
27 **Treasury Bond.** The Fund employs as its investment strategy a
28 program of engaging in short sales and investing to a significant
extent in derivative instruments, which primarily consist of futures
contracts, interest rate swaps, and options on securities and futures
contracts. Under normal circumstances, the Fund will invest at
least 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. This is a non-

1 fundamental investment policy that can be changed by the Fund
2 upon 60 days' prior notice to shareholders. On a day-to-day basis,
3 the Fund may hold U.S. Government securities or cash equivalents
4 to collateralize its short sales and derivative positions."

5 "INVESTOR PROFILE

6 "The Inverse Government Long Bond Strategy Fund is
7 intended for investors who expect the value of the Long
8 Treasury Bond to go down and want investment gains when it
9 does so. These investors must also be willing to bear the risk of
10 equal losses if the value of the Long Treasury Bond goes up."
11 (Emphasis added)

12 56. The 2009 Registration Statement, filed after the red flags raised by FINRA and
13 others, adds some additional cautionary language, but still misstates the risk by warning only that
14 Fund returns "may be" uncorrelated to the benchmark for periods longer than a single day:

15 "Certain of the Funds offered in this Prospectus are leveraged
16 funds and, in some cases, inverse funds, which have different
17 features than funds that are not leveraged or inverse. First, Nova
18 Fund, Mid-Cap 1.5x Fund, Russell 2000@1.5x Strategy Fund,
19 Europe 1.25x Strategy Fund, Japan 2x Strategy Fund, Weakening
20 Dollar 2x Strategy Fund, and Government Long Bond 1.2x
21 Strategy Fund pursue leveraged investment goals, which means
22 that these funds are riskier than alternatives that do not use
23 leverage because these funds magnify the performance of the
24 benchmark on the investment results. Second, the Inverse S&P
25 500 Strategy Fund, Inverse NASDAQ-100@Strategy Fund, Inverse
26 Mid-Cap Strategy Fund, Inverse Russell 2000@Strategy Fund,
27 Weakening Dollar 2x Strategy Fund, Inverse Government Long
28 Bond Strategy Fund, and Inverse High Yield Strategy Fund pursue
investment objectives that are inverse to the performance of their
respective underlying index, a result opposite of most other mutual
funds. Third, Nova Fund, Mid-Cap 1.5x Fund, Russell 2000@1.5x
Strategy Fund, Inverse S&P 500 Strategy Fund, Inverse NASDAQ-
100@Strategy Fund, Inverse Mid-Cap Strategy Fund, Inverse
Russell 2000@Strategy Fund, Weakening Dollar 2x Strategy Fund,
Inverse Government Long Bond Strategy Fund, Inverse High Yield
Strategy Fund, and Government Long Bond 1.2x Strategy Fund
pursue investment results on a *daily basis*. **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 Funds should be utilized only by sophisticated
investors or professional investment advisors who (a)
understand the risks associated with the use of *leverage*; (b)

1 **understand the consequences of seeking investment results on a**
2 **daily basis; (c) understand the risk of *shorting*; and (d) intend**
3 **to actively monitor and manage their investments on a daily**
4 **basis.** There is no assurance that the Funds will achieve their
5 objectives and an investment in a Fund could lose money. No
6 single Fund is a complete investment program.” (Emphasis added)

7 57. The 2009 Registration Statement describes as a “tracking risk” that the Fund
8 “may” not correlate with the monthly, quarterly or annual performance of its benchmark. Thus,
9 the mathematical near certainty that compounding will result in an increasing deviation from the
10 benchmark is misleadingly characterized as a mere possibility:

11 **“Tracking Error Risk** – Tracking error risk refers to the risk
12 that the Advisor may not be able to cause the Fund’s performance
13 to match or correlate to that of the Fund’s underlying benchmark,
14 either on a daily or aggregate basis. Factors such as Fund expenses,
15 imperfect correlation between the Fund’s investments and those of
16 its underlying index, rounding of share prices, changes to the
17 composition of the underlying index, regulatory policies, high
18 portfolio turnover rate and the use of leverage all contribute to
19 tracking error.

20 “In addition, because each Fund, except for the Europe 1.25x
21 Strategy Fund and Japan 2x Strategy Fund is tracking the
22 performance of its benchmark on a daily basis, mathematical
23 compounding may prevent the Fund from correlating with the
24 monthly, quarterly, annual or other period performance of its
25 benchmark. Tracking error may cause the Fund’s performance to
26 be less than you expect.”

27 58. Defendants easily could have included in the 2009 Registration Statement
28 additional warnings about the effects of compounding on its inverse funds similar to the warnings
29 for leveraged funds that it issued in 2007 and 2008. Instead, Defendants issued the 2009
30 Registration Statement for the Inverse Long Bond Fund as part of an omnibus prospectus
31 covering 26 different funds. For each fund, Defendants purported to identify the particular risks
32 “that may affect the value of its shares.” While a discussion of the effects of compounding was
33 referenced in each leveraged fund, this discussion was not referenced in relation to the Inverse
34 Long Bond Fund. For example, the discussion of the Russell 2000 1.5x Strategy Fund states that
35 “[f]or more information about the effects of leverage, please see ‘Understanding Compounding

1 and the Effect of Leverage.” The discussion of the Inverse Long Bond Fund contains no such
2 reference.

3 59. The discussion of compounding in relation to the leveraged Rydex funds
4 contained in the section “Understanding Compounding and the Effect of Leverage” is
5 functionally identical to the discussion in the 2007 and 2008 Registration Statements quoted in
6 Paragraph 44, *supra*.

7 60. On August 7, 2009, Defendants issued a supplement to the 2009 Registration
8 Statement (“August 2009 Supplement”) that consisted solely of three graphs to be added to the
9 section “Understanding Compounding and the Effect of Leverage.” All three graphs illustrate
10 how leverage and compounding working together can cause a fund to underperform its
11 benchmark over time. Again, none of the graphs illustrate how the same is true of an
12 unleveraged inverse fund like the Inverse Long Bond Fund.

13 61. On November 17, 2009, Defendants issued another supplement to the 2009
14 Registration Statement (“November 2009 Supplement”) that added more warnings regarding all
15 of Rydex’s leveraged and inverse funds. The November 2009 Supplement states, in part:

16 **“The Funds generally are intended to be used as short-term**
17 **trading vehicles. The Funds are not intended to be used by, and**
18 **are not appropriate for, investors who do not intend to actively**
19 **monitor and manage their portfolios.** Each of the Inverse Funds
20 pursues daily investment goals that are inverse to the performance
21 of its benchmark, a result opposite of most mutual funds. The
22 Daily Leveraged Funds are different from other mutual funds, in
23 that they pursue **daily leveraged** investment goals. The Weakening
24 Dollar 2x Strategy Fund pursues both daily leveraged and daily
25 inverse investment goals. The Daily Leveraged Funds and
26 Leveraged Funds are riskier than alternatives that do not use
27 leverage, because they magnify the performance of the benchmark
28 on an investment. **Finally, because the Daily Leveraged Funds**
and Inverse Funds seek daily leveraged and daily inverse
investment results, respectively, the return of a Daily
Leveraged or Inverse Fund for a period longer than a full
trading day will be the sum of the series of daily leveraged or
inverse returns for each trading day during the relevant
period. As a consequence, especially in periods of market
volatility, the path or trend of the benchmark during the longer
period may be at least as important to the Daily Leveraged
Fund's or Inverse Fund's return for the longer period as the

1 cumulative return of the benchmark for the relevant longer
2 period. Further, the return for investors that invest for periods of
3 less than a full trading day or for a period different than a trading
4 day will not be the product of the return of the Daily Leveraged
5 Fund's or Inverse Fund's stated goal and the performance of the
6 target index for the full trading day.

7 "The Funds are not suitable for all investors. The Funds
8 should be utilized only by investors who (a) understand the
9 risks associated with the use of leverage, (b) understand the
10 consequences of seeking daily leveraged investment results,
11 (c) understand the risk of shorting and (d) intend to actively
12 monitor and manage their investments. Investors who do not
13 meet these criteria should not buy the Funds. There is no assurance
14 that the Funds will achieve their objectives and an investment in a
15 Fund could lose money. No single Fund is a complete investment
16 program" (some emphasis added).

17 62. In addition, the November 2009 Supplement added some tables that illustrated the
18 effects of leverage, compounding and volatility on hypothetical returns relative to a benchmark.
19 Like the August 2009 Supplement, all of the tables included in the November 2009 Supplement
20 deal with leveraged funds and not with unleveraged inverse funds like the Inverse Long Bond
21 Fund.

22 **F. The 2009 Registration Statement Was False And Misleading.**

23 63. Although Defendants disclosed more information in the 2009 Registration
24 Statement and Supplements than in earlier Registration Statements, the 2009 version was false
25 and/or misleading because it still failed to disclose that:

- 26 • Inverse correlation between the Fund and the price of the 30-year U.S. Treasury
27 Bond over time would only occur in the rarest of circumstances, and inadvertently
28 if at all;
- Fund performance over time would inevitably diverge on an increasing basis from
the inverse of the performance of the price of the 30-year U.S. Treasury Bond; and
- The Fund is unsuitable for investors who plan to hold it for longer than one
trading session, particularly in volatile markets;

64. Like earlier Registration Statements, neither the 2009 Registration Statement nor
the Supplements disclose that the Inverse Long Bond Fund is altogether inappropriate for periods
longer than a single day. Defendants continued to omit the material fact that mathematical

1 compounding would prevent the Inverse Long Bond Fund from achieving its stated investment
2 objective over a period of time greater than one day. Finally the understatement that the Fund is
3 “generally intended to be used as [a] short-term trading vehicle[]” is not sufficient to warn
4 investors as FINRA did that inverse funds like the Fund “are unsuitable for retail investors who
5 plan to hold them for longer than one trading session.”

6 COUNT I

7 Violations Of §11 Of The 1933 Act Against All Defendants

8 65. Plaintiff repeats and realleges each and every allegation contained above. For
9 purposes of this Count, Plaintiff expressly excludes and disclaims any allegation that could be
10 construed as alleging fraud or intentional or reckless misconduct, as this Count is based solely on
11 claims of strict liability and/or negligence under the Securities Act.

12 66. This Count is brought pursuant to Section 11 of the 1933 Act, 15 U.S.C. §77k, on
13 behalf of the Class, against all Defendants.

14 67. The Registration Statements for the Inverse Long Bond Fund were false and
15 misleading, contained untrue statements of material facts, omitted to state other facts necessary to
16 make the statements made not misleading, and omitted to state material facts required to be stated
17 therein.

18 68. The Trust is the issuer of the shares sold via the Registration Statements. The
19 Individual Defendants are signatories or authorizers of the Registration Statements. As the
20 issuer, the Trust is absolutely liable for the material misstatements in and omissions from the
21 Registration Statements.

22 69. The Manager, Rydex Investments, was responsible for the contents and
23 dissemination of the Registration Statements.

24 70. The Distributor, Rydex Distributors, Inc., was responsible for the contents and
25 dissemination of the Registration Statements.

26 71. The Individual Defendants were responsible for the contents and dissemination of
27 the Registration Statements. Each of the Individual Defendants signed or authorized the signing
28 of the Registration Statements and/or were identified in the Prospectuses.

1 78. Plaintiff brings this Count pursuant to Section 12(a)(2) of the Securities Act, 15
2 U.S.C. §771(a)(2), on behalf of himself and other members of the Securities Class against the
3 Fund, the Issuer, the Manager and the Distributor.

4 79. Each of the Defendants named in this Count offered and sold securities, namely
5 shares of the Inverse Long Bond Fund, to Plaintiff and other members of the Class by means of
6 the August 2007 Prospectus, the August 2008 Prospectus and the August 2009 Prospectus
7 (collectively, the "Prospectuses"), or controlled a person who offered and sold shares of the Fund
8 by means of the Prospectuses.

9 80. As detailed above, the Prospectuses contained untrue statements of material fact,
10 and/or omitted to state material facts necessary in order to make the statements, in the light of the
11 circumstances under which they were made, not misleading. Each of the Defendants named in
12 this Count owed Plaintiff and the other members of the Class who purchased shares of the
13 Inverse Long Bond Fund pursuant to the Prospectuses the duty to make a reasonable and diligent
14 investigation of the statements contained in the Prospectuses to ensure that such statements were
15 true and that there was no omission to state a material fact required to be stated in order to make
16 the statements contained therein not misleading. Each of the Defendants named in this Count, in
17 the exercise of reasonable care, should have known of the misstatements and omissions contained
18 in the Prospectuses as set forth above.

19 81. Plaintiff and other members of the Class did not know, nor in the exercise of
20 reasonable diligence could have known, of the untruths and omissions contained in the
21 Prospectuses at the time they purchased shares of the Inverse Long Bond Fund.

22 82. By reason of the conduct alleged herein, each of the Defendants named in this
23 Count violated Section 12(a)(2) of the Securities Act. As a result of such violations, Plaintiff and
24 other members of the Class sustained substantial damages in connection with their purchases of
25 shares of the Fund. Accordingly, Plaintiff and other members of the Class who hold such shares
26 have the right to rescind and recover the consideration paid for their shares with interest thereon,
27 less the amount of income received thereon, upon the tender of the shares. Plaintiff and members
28 of the Class hereby tender any and all shares that were damaged by Defendants' violation of

1 Section 12(a)(2) of the Securities Act. Plaintiff and other members of the Class who have sold
2 their shares seek damages to the extent permitted by law.

3 83. Less than three years elapsed between the time that the securities upon which this
4 Count is brought were offered to the public and the time the original Complaint in this
5 consolidated litigation was filed. Less than one year elapsed between the time that Plaintiff
6 discovered or reasonably could have discovered the facts upon which this Count is based and the
7 time the original Complaint in this consolidated litigation was filed.

8
9 **COUNT III**

10 **Violations Of §15 Of The Securities Act Against The Manager And The Individual
Defendants**

11 84. Plaintiff repeats and realleges each and every allegation contained above. For
12 purposes of this Count, Plaintiff expressly excludes and disclaims any allegation that could be
13 construed as alleging fraud or intentional or reckless misconduct, as this Count is based solely on
14 claims of strict liability and/or negligence under the Securities Act.

15 85. Plaintiff brings this Count pursuant to Section 15 of the Securities Act, 15 U.S.C.
16 §77o, on behalf of himself and other members of the Securities Class against the Manager and
17 the Individual Defendants.

18 86. As alleged in Counts I and II, the Trust, the Manager, the Distributor and the
19 Individual Defendants violated Sections 11 and 12(a)(2) of the Securities Act.

20 87. In addition, the Manager was a control person of the Trust by virtue of its
21 responsibilities for providing investment advisory and management services to the Trust,
22 selecting the securities for the Fund's portfolio, and handling the Trust's day-to-day business.
23 Therefore, the Manager had the power to control the general affairs of the Trust.

24 88. Each of the Individual Defendants was a control person of the Trust, the Manager,
25 and/or the Distributor. As a trustee, director and/or senior officer of the Trust and/or the
26 Manager, each of the Individual Defendants had the power to control the general affairs of the
27 Trust, the Manager, and the Distributor.

28

1 **PRAYER FOR RELIEF**

2 WHEREFORE, Plaintiff prays for relief and judgment, as follows:

- 3 A. Determining that this action is a proper class action and certifying Plaintiff as
4 class representatives under Federal Rule of Civil Procedure 23;
- 5 B. Awarding compensatory and/or rescissionary damages in favor of Plaintiff and the
6 other Class members against all Defendants, jointly and severally, for all damages sustained as a
7 result of Defendants' wrongdoing, in an amount to be proven at trial, including interest thereon;
- 8 C. Awarding Plaintiff and the Class their reasonable costs and expenses incurred in
9 this action, including counsel fees and expert fees; and
- 10 D. Granting such equitable/injunctive or other relief as deemed appropriate by the
11 Court.

12 **JURY DEMAND**

13 Plaintiff hereby demands a trial by jury.

14 Dated: March 19, 2010

15
16
17
18
19
20
21
22
23
24
25
26
27
28