THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 56 No. 5 March 8, 2023

SECTION 11'S TRACING DOCTRINE GOES UP TO THE SUPREME COURT

The Supreme Court has agreed to hear an appeal in Pirani v. Slack Technologies, Inc., *a case where the Ninth Circuit rejected Defendants' argument that the SEC's recent rule change allowing a company to issue both registered and unregistered shares simultaneously when going public prevents* any *investor from bringing claims under the Securities Act of 1933 on the grounds that the judicially created "tracing" requirement cannot be satisfied. The authors caution that a reversal of the Ninth Circuit's decision could weaken significantly, and perhaps even vitiate, investors' rights to challenge misrepresentations made in connection with IPOs and other public offerings — rights that have existed since 1933.*

By John C. Browne and Lauren A. Ormsbee *

On December 13, 2022, the Supreme Court granted a request by Defendants in a case pending in California federal court recently take up the application of the Securities Act of 1933's "tracing doctrine" to direct listing initial public offerings after a shareholder plaintiff prevailed in the District Court and in the Ninth Circuit. In September 2022, Defendant Slack Technologies, Inc. ("Slack") filed a petition for a writ of certiorari on the issue of whether a new IPO mechanism will strip shareholders of any ability to enforce liability under the Securities Act. This case, *Pirani v. Slack Technologies, Inc.*, was first decided in shareholders' favor by Judge Susan Illston of the Northern District of California.[1] Upon appeal to the Ninth Circuit, defendants again sought to avoid all strict liability under the Securities Act by commingling both registered and unregistered shares in initial public offerings. A split panel of the Ninth Circuit rejected defendants' appeal,[2] a decision that the Circuit refused to hear en banc.[3] Now that the Supreme Court has granted certiorari,[4] the highest court will decide whether to side with defendants, a result that would erode nearly 100 years of Securities Act protections, all made possible by a dramatic and rapid rule change approved by the Securities and Exchange Commission at the end of 2020.

Between 2018 and 2020, the SEC revolutionized the way companies are permitted to go public, allowing them to avoid the traditional IPO format by issuing securities through a direct listing on one of the major stock exchanges.[5] While the new regulations have

[1] *Pirani v. Slack Techs., Inc.*, 445 F. Supp. 3d 367, 376 (N.D. Cal. 2020).

[2] *Pirani v. Slack Techs., Inc.*, 13 F.4th 940 (9th Cir. 2021).

[3] *Pirani v. Slack Techs., Inc.*, No. 20-16419, 2022 U.S. App. LEXIS 11846 (9th Cir. May 2, 2022).

[4] *Slack Techs., LLC v. Pirani*, No. 22-200, --- S.Ct. ----, 2022 WL 17586972, at *1 (Dec. 13, 2022) (Mem.).

[5] Exchange Act Release No. 90768 (Dec. 22, 2020); SEC Commissioners Caroline Crenshaw and Allison Lee voted against the 2020 rule approving the use of direct listings in

* *JOHN C. BROWNE and LAUREN A. ORMSBEE are partners at Bernstein Litowitz Berger & Grossmann LLP's New York City office. Their e-mail addresses are JohnB@blbglaw.com and Lauren@blbglaw.com.*

RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call 609-683-4450; fax 609-683-7291; write Subscriber Services, RSCR Publications, PO Box 585, Kingston NJ 08528; e-mail cri.customer.service@comcast.net; or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail sarah.s.himmelfarb@gmail.com. To submit a manuscript for publication contact Ms. Himmelfarb. ISSN: 0884-2426.

garnered praise from the world of corporate finance, they raise a significant question with far-reaching implications: did the SEC's rule changes overturn traditional notions of civil liability under the Securities Act?

An important case that has wound its way through the Northern District of California and the Ninth Circuit Court of Appeals has answered "no" to that question, upholding the status quo, and affirming the applicability of Section 11 of the Securities Act to direct listings in cases where the offering materials contained allegedly false or misleading statements and omissions. Now, that the Supreme Court has agreed to weigh in, and is poised to determine whether companies and their executives conducting direct listings can face *any* liability under the Securities Act for false and misleading statements made in the publicly filed registration statements associated with the direct listing.

Although the case has received relatively little attention, a decision in defendants' favor in *Pirani v. Slack Technologies, Inc.*, Supreme Court Docket No. 22-200 could have grave consequences for shareholders.

WHAT IS THE TRACING DOCTRINE?

At issue in *Slack* is a legal technicality called "tracing." This is a judge-made rule that an investor seeking to recover under the Securities Act for a material misstatement or omission in a registration statement must show that, in instances where securities are issued through successive registration statements, she purchased shares that were "pursuant to" (or traceable to) the deficient registration statement.[6]

Congress enacted the Securities Act in the wake of the 1929 stock exchange crash.[7] The Securities Act's "fundamental purpose . . . was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry."[8] In 1963, the Supreme Court noted that "It requires but little appreciation of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail in every facet of the securities industry."[9]

Section 11 imposes liability on parties involved in a securities offering if the registration statement contains a materially false statement or material omission, but does not require a showing of defendants' scienter or an affirmative showing of loss causation. Thus, Section 11 imposes strict liability against corporations even for innocent misstatements, reflecting the legal principle that "if one of two innocent persons must bear the loss, that person should bear it who has the opportunity to learn the truth and has allowed the untruths to be published and relied upon."[10]

However, Defendants do have several defenses to liability, at both the pleading stage and later in the case.

footnote continued from previous page…

primary offerings, opining that "the Commission has not candidly assessed the potential benefits and drawbacks of retail investor participation in primary direct listing IPOs," and stating that the Commission "should have engaged in a deeper debate and analysis to consider options for mitigating the risks to investors before approving today's order." (*available at* https://www.sec.gov/news/public-statement/lee-crenshaw-listings-2020-12-23).

[6] 15 U.S.C. § 77k(a); *see, e.g., Pirani v. Slack Techs., Inc.*, 13 F.4th at 948 ("Slack asks that the court apply Section 11 to direct listings in the same way it has in cases with successive registration statements, requiring plaintiffs to prove purchase of registered shares pursuant to a particular registration statement.") (citing *In re Century Aluminum Co. Secs. Litig.*, 729 F.3d 1104, 1106 (9th Cir. 2013)).

[7] 15 U.S.C.A. §§ 77 *et seq.*

[8] *SEC v. Cap. Gains Rsch. Bureau, Inc.*, 375 U.S. 180, 186-87 (1963).

[9] *Silver v. NYSE*, 373 U.S. 341, 366 (1963).

[10] Elisabeth Keller, *Introductory Comment: Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 Ohio State L.J., 330, 345 (1988).

One of those defenses is the argument that a representative plaintiff, or class of plaintiffs, lacks standing to bring Section 11 claims because they are unable to "trace" their securities to the specific public offering at issue.

When the Securities Act was passed, and for over 30 years following that date, the doctrine of tracing was not particularly relevant because each stock issuance had its own specific paper trail. However, the SEC, directed by Congress, changed the way sales were processed to avoid an avalanche of paper that threatened to slow down — or shut down — the markets. In response, the SEC implemented the book-entry system that eliminated the need for physical transfer of shares by bifurcating the process of legal sale. Brokers remain responsible for negotiating and settling trades, but their clearance is now the responsibility of an independent intermediary, usually the Depository Trust & Clearing Corporation ("DTCC"). Thus, there is no longer a path between the issuer and a security holder because "the book-entry system has severed the security holder's relationships to a particular security and to its issuer."[11]

The first court to apply a tracing requirement for Section 11 plaintiffs was the Second Circuit in an opinion written by esteemed Judge Henry Friendly in *Barnes v. Osofsky*.[12]

Barnes involved a Section 11 claim arising out of a secondary public offering of 200,000 common shares when there were already 1,019,574 of the issuer's common shares outstanding from a prior offering. A proposed settlement was limited to investors who had purchased shares in the secondary offering, and two investors objected, arguing that it would be impracticable to determine whether "old or new shares [we]re being acquired . . . ."[13]

On appeal, the Second Circuit was asked to determine whether "the district court was right in ruling that § 11 extends only to purchases of the newly registered shares."[14] The Second Circuit affirmed the district court, concluding that the term "such security" in the Securities Act meant that a plaintiff had to show that she purchased shares in the specific offering that violated Section 11.[15]

Since 1967, courts cite *Barnes* and generally enforce a tracing requirement where there is more than one distinct offering at issue — most commonly two separate public offerings, only one of which is deficient under Section 11.[16] However, where there is a single offering or two equally tainted initial and secondary offerings, tracing should not come into play as all of the publicly traded shares are linked to the false and misleading statements and omissions in the offering materials.[17]

THE EMERGENCE OF DIRECT LISTINGS AND THE RESULTING LEGAL IMPLICATIONS

The evolutionary cycle of direct listings was exceedingly rapid. In February 2018, the SEC approved a rule change permitting early investors or insiders of certain private corporations to directly list their shares for resale on the New York Stock Exchange, thus bypassing the traditional IPO process.[18] Then, in December 2020, the SEC approved another broader rule change permitting private companies with a valuation of at least $250 million to issue new shares from the corporation and sell them directly to the public in direct listing IPOs.

In April 2018, audio streaming company Spotify completed the first direct listing under these new rules, and in June 2019, software company Slack completed the second major direct listing under this new regime.[19]

The public discussion surrounding direct listings initially focused on allowing early investors to monetize their shareholdings and, later, for supposedly well-capitalized companies to achieve an easier route to the public markets. But savvy corporate law firms noticed another "advantage" of direct listings — they could eliminate shareholder lawsuits under the Securities Act based on the tracing doctrine. In December 2019, attorneys from the law firm that advised Slack in its direct listing IPO[20] published an article noting that an

[11] Peter B. Oh, *Tracing*, 80 Tul. L. Rev. 849, 870 (2006).

[12] 373 F.2d 269 (2d Cir. 1967).

[13] *Id*. at 272 n.1.

[14] *Id*. at 271.

[15] *Id.*

[16] *See*, *e.g.*, *Century Aluminum*, 729 F.3d at 1107-08.

[17] Peter B. Oh, *Tracing*, 80 Tul. L. Rev. 849, 873 (2006).

[18] Order Granting Accelerated Approval of Proposed Rule Change by NYSE, 83 Fed. Reg. 5650, 5651 (Feb. 8, 2018).

[19] *See* Spotify Lists on NYSE as SPOT (Apr. 2, 2018), https://newsroom.spotify.com/2018-04-02/tomorrow/; Slack Goes Public with Direct Listing (June 21, 2019), https://www.goodwinlaw.com/news/2019/06/06_21-slack-goes-public.

[20] Latham & Watkins Represents Financial Advisors in Slack Direct Listing, *Technology unicorn is only the second company to use a direct listing approach to become public* (June 20,

"important advantage of the direct listing" was that it could prevent shareholder litigation under Section 11 of the Securities Act because it is "difficult (if not impossible)" to meet Section 11's tracing requirement in the context of a direct listing.[21]

THE *SLACK* CASE – EXAMINING TRACING IN THE CONTEXT OF DIRECT LISTINGS

The article proved prescient. The applicability of tracing to direct listings was put to the test when an action alleging violations of Section 11 was filed in September 2019 on behalf of investors who acquired Slack common stock "pursuant to or traceable to the Offering Materials issued in connection with the listing."

The District Court Finds That Tracing Is Satisfied, but Certifies the Novel Issue

In the District Court, defendants moved to dismiss on the grounds that neither the plaintiff nor any other Slack investor had Section 11 standing, arguing that case law requires "that a plaintiff's purchased shares must be traced to the defective registration statement, which is impossible to do here."[22]

The plaintiff agreed that it would be impossible to satisfy a strict application of the tracing requirement in a direct listing. This is because of a fundamental difference between a traditional IPO and a direct listing. In a traditional IPO, *all* of the shares in circulation following the IPO are registered pursuant to a registration statement filed by the company and approved by the SEC. The Wall Street banks acting as underwriters then impose a "lockup" period on insiders, which prevents them from selling their (unregistered) shares into the market for several months. Thus, any investor purchasing a company's shares during the lockup period knows with certainty the shares were issued pursuant to the registration statement — those are the only shares in circulation.

In a direct listing, by contrast, there are no underwriters and no lockup period. So both registered shares sold pursuant to the registration statement *and* unregistered shares held by insiders become available for trading on public exchanges on the same day. Defendants argued (and plaintiff did not challenge) that because registered and unregistered shares are indistinguishable from one another the moment they began trading, it is impossible to know whether any given share was issued pursuant to the registration statement or began life as an unregistered share sold by an insider.[23]

Faced with this as an issue of first impression, Judge Illston in the Northern District of California noted that the traceability requirement developed out of a line of case law interpreting ambiguous language ("such security") in the Securities Act. Section 11 provides that in the event of a defective registration statement, "any person acquiring *such security*" may bring suit to recover damages. The term "such security" was first interpreted in *Barnes v. Osofsky*, the seminal Second Circuit decision that first established the tracing doctrine. Judge Friendly noted that the term could be read narrowly to mean that the security must be "issued pursuant to the registration statement," or more broadly to mean a security "of the same nature as that issued pursuant to the registration statement."[24]

While Judge Friendly adopted the narrow reading, he stated that it "would not be such a violent departure from the words that a court could not properly adopt [the broader meaning] if there were good reason for doing so."[25] Of course, in *Barnes*, Judge Friendly was not interpreting the Securities Act in the context of a direct listing — the very concept was more than 50 years in the future. Nonetheless, a strict application of the tracing requirement announced in *Barnes* and adopted in subsequent case law would to the newly created direct listings, in the words of the District Court in *Slack* "cause the elimination of civil liability under the Securities Act," a result that is at odds with the "central purposes" of the statute.[26]

---

footnote continued from previous page…

2019), https://ww.lw.com/news/latham-watkins/represents - financial advisers-in-slack-direct-listings (last visited November 5, 2022).

[21] Andy Clubok, et al., *Complex and Novel Section 11 Liability Issues of Direct Listings*, Corporate Counsel, Dec. 20, 2019, at 1.

[22] *Pirani v. Slack Tech., Inc.*, 445 F. Supp. 3d 367, 376 (N.D. Cal. 2020).

[23] Insiders can sell their unregistered shares after a company becomes public pursuant to an exemption from registration under SEC Rule 144. *See* 17 C.F.R. § 230.144. While the parties in *Slack* did not dispute the "impossibility" of differentiating the registered and unregistered shares, given modern recordkeeping, such a task does not appear to be impossible.

[24] 373 F.2d 269, 271 (2d Cir. 1967).

[25] *Id.*

[26] *Pirani v. Slack Techs., Inc.*, 445 F. Supp. 3d 367, 381 (N.D. Cal. 2020).

The District Court in *Slack* reviewed the legislative history of the Securities Act, finding it to be remedial in nature. It then noted that adopting the narrow reading of the term "such security" would lead to an absurd result plainly at odds with the intent and purpose of Section 11. For these reasons, the court denied Defendants' motion to dismiss and held that tracing could be established by purchasers of "a security of the same nature as that issued pursuant to the registration statement" — i.e., purchasers of either registered or unregistered securities.

The Ninth Circuit Agrees that Tracing Is Satisfied for All Shares in a Direct Listing

The District Court certified this issue for appeal to the Ninth Circuit. The *Slack* panel held in a split 2-1 decision that the broad remedial purpose of the Securities Act would be fatally undercut if companies could avoid Securities Act liability by simultaneously injecting registered and unregistered shares into the marketplace.

Accordingly, the majority (Chief Judge Sidley R. Thomas and Judge Jane A. Restani) held that simultaneously released shares sold in a direct listing, registered and unregistered, are actionable under the Securities Act, finding that "Slack's unregistered shares sold in a direct listing are 'such securities' within the meaning of Section 11 because their public sale [on the NYSE] cannot occur without the only operative registration in existence. Any person who acquired shares through [Slack's] direct listing could do so only because of the effectiveness of its registration statement."[27] Thus, purchasers of those publicly sold shares were purchasers of "such security" with standing to sue under Sections 11 and 12(a)(2) of the Securities Act.

In dissent, Judge Eric Miller disagreed, arguing that because the plaintiff "cannot show that the shares he purchased 'were issued under the allegedly false or misleading registration statement,' he lacks statutory standing to bring a section 11 claim."[28] Judge Miller acknowledged the policy concerns that partially fueled the majority decision, but cited the old trope that "they are no basis for changing the settled interpretation of the statutory text," and that the responsibility for clarifying the statutory language "lies in Congress."[29]

Defendants filed a strongly worded petition for rehearing and rehearing en banc on November 3, 2021, arguing that the Ninth Circuit's majority opinion departed from Supreme Court precedent and the opinions of eight courts of appeals, which defendants argued held that the tracing requirement must be strictly enforced. Defendants also contended that the policy implications of the majority opinion could have an impact broader than direct listing IPOs, postulating as to whether "Section 11 liability would extend *forever* unless an issuer sold new shares under a second registration statement."[30] Corporate interest groups sharply criticized the Panel decision, and several filed amicus briefs in support of the en banc petition, including the Cato Institute, the Securities Industry and Financial Markets Association, the Chamber of Commerce, and the National Venture Capital Association.[31]

On December 20, 2021, plaintiff opposed the petition for an en banc rehearing.[32] A group of 12 institutional investor U.S. public pension funds that collectively invest billions of dollars on behalf of hundreds of thousands of American workers, including firefighters, police officers, teachers, and healthcare workers, filed an amicus brief in support of plaintiff.[33] Plaintiff and the amici argued that the District Court and Ninth Circuit decisions were correctly decided.

On May 2, 2022, the Ninth Circuit panel issued a single-page order indicating that the panel voted by the same 2-1 margin as the opinion to deny the petition for rehearing and rehearing en banc. The order further noted that "the full court has been advised of the petition for

[27] *Pirani v. Slack Techs., Inc.*, 13 F.4th 940, 947 (9th Cir. 2021).

[28] *Id*. at 953 (citing *In re Century Aluminum Co. Secs. Litig.*, 729 F.3d 1104, 1106 (9th Cir. 2013)).

[29] *Id.*

[30] Petition for Rehearing and Rehearing En Banc, *Pirani v. Slack Techs., Inc.*, No. 20-16419, ECF No. 59 at 19 (Nov. 3, 2021) (emphasis in original). Defendants' use of "forever" was plainly hyperbolic as it failed to recognize the Securities Act's clearly defined one-year statute of limitations and three-year statute of repose. 15 U.S.C. §77m.

[31] Amici Curiae Briefs in support of Petitioner, *Pirani v. Slack Techs., Inc.*, No. 20-16419, ECF Nos. 62-63 (November 15, 2021). Former SEC Chairman Joseph Grundfest also submitted as amicus curiae brief in support of Slack. ECF No. 61.

[32] Plaintiff-Appellee's Respond to Defendants'-Appellants' Petition for Rehearing En Banc, *Pirani v. Slack Techs., Inc.*, No. 20-16419, ECF No. 69 (Dec. 20, 2021).

[33] Brief of Investor *Amici Curiae* in Opposition to Defendants'-Appellants' Petition for Rehearing En Banc, *Pirani v. Slack Techs., Inc.*, No. 20-16419, ECF No. 71 (Dec. 30, 2021). The authors of this article represented the institutional investor amici and authored the amicus brief on their behalf.

rehearing en banc, and no judge has requested a vote on whether to rehear the matter en banc."[34]

THE SUPREME COURT ACCEPTS THE CASE FOR REVIEW

As expected, the *Slack* defendants challenged the Ninth Circuit decision in a petition for a writ of certiorari to the Supreme Court on August 31, 2022. In defendants' brief, and in the four amicus briefs filed on October 3, 2022, by the U.S. Chamber of Commerce and the Securities Industry and Financial Market Association, the Cato Institute, the Washington Legal Foundation and Stanford Law School professor Joseph Grundfest,[35] Slack and its supporters argue that the Ninth Circuit ruling will have an impact beyond that of direct listings and "dramatically expands the list of shareholders who can sue in strict liability under Sections 11 and 12 and will generate substantial uncertainty about — and needless lawsuits over — when those statutes apply."[36]

While the defense group complains of far greater consequences should the Ninth Circuit decision stand, they provide only a limited and singular example of how *Slack* could impact tracing for aftermarket purchasers in traditional IPOs where insiders sell shares following a lockup.[37]

In response, plaintiff, on November 2, 2022, responded that not only is the Ninth Circuit decision not in conflict with any other circuit court, but that defendants' petition "does not present an important social or political issue, nor are the capital markets suffering or likely to do so in the future because of theNinth Circuit's decision." Therefore, "there are in fact no compelling reasons to grant the Petition."[38]

A group of institutional investors again filed an amicus brief in support of plaintiff and against the Petition for Writ of Certiorari and the defense group amici, arguing similarly that while "[t]he [defense amicus] briefs present unrealistic 'the sky is falling' scenarios," "[t]he Ninth Circuit's opinion invites no catastrophic consequence; it simply maintains the long-embraced protections provided by Congress." As the investor amici argued, "Section 11 requires only that companies describe their business to investors honestly. If Defendants' amici fret that honesty has a price, the Investor Amici respectfully submit that is a price worth paying."[39]

On December 13, 2022, the Supreme Court granted defendants' petition.[40] It is worth noting that, while the SEC has not formally weighed in on the litigation, the SEC has acknowledged and tacitly endorsed the District Court and Ninth Circuit outcomes. In 2020, prior to adopting its December 2020 rule change expanding direct listings to shares issued directly by the corporation in an IPO, the SEC acknowledged investor concerns of losing the ability to avail themselves of the Securities Act's protections, and noted that the District Court's opinion in *Slack* "ruled in favor of allowing the plaintiffs to pursue Section 11 claims," and that the SEC "does not believe that the proposed rule change to permit [expanded direct listings] poses a heightened risk to investors."[41]

It is clear that the Slack decision has struck a nerve with corporate America. It has been sharply criticized by corporate interest groups and in client alerts published by large defense firms. What is also clear is that if the Supreme Court overturns the Ninth Circuit decision, shareholders may see a weakening of the most important enforcement tools available to them for decades, the strong remedial powers of the Securities Act. ■

---

[34] *Pirani v. Slack Techs., Inc.*, 2022 U.S. App. LEXIS 11846 (9th Cir. May 2, 2022).

[35] All briefs can be found on the docket for Case No. 22-200 on www.supremecourt.gov/docket/docket.aspx.

[36] Petition for Writ of Certiorari, *Slack Techs., Inc. v. Pirani*, No. 22-200, at 14. *See also* Amicus Briefs in support of Petition for Writ of Certiorari.

[37] Specifically, defendants argue that *Slack* may be held to satisfy tracing when shareholders purchase identical aftermarket public shares six months or more following an IPO, after which point the IPO lockup against private insider sales expires and unregistered shares are commingled with registered shares in the public markets. Petition for Writ of Certiorari, at 14.

[38] Brief for Respondent in Opposition to Petition for a Writ of Certiorari, *Slack Techs., Inc. v. Pirani*, No. 22-200, at 1.

[39] Brief for Investor Amici Curiae in Opposition to Petition for a Writ of Certiorari, *Slack Techs., Inc. v. Pirani*, No. 22-200, at 2-3. The authors of this article represented the institutional investor amici and authored the amicus brief on their behalf.

[40] *Slack Techs., LLC v. Pirani*, No. 22-200, --- S.Ct. ----, 2022 WL 17586972, at *1 (Dec. 13, 2022) (Mem.).

[41] Order Approving a Proposed Rule Change by NYSE, 85 Fed. Reg. 54233, 54454 (Sept. 1, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-09-01/pdf/FR-2020-09-01.pdf.