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High Court Confirms Strict 'Tracing' Requirement of Section 11 of the Securities Act

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The U.S. Supreme Court recently decided the most significant securities law case of court's current term, *Slack Technologies v. Pirani*, a case raising substantial questions about the scope of private litigation under the Securities Act of 1933. In the decision below, the U.S. Court of Appeals for the Ninth Circuit had held—contrary to 50 years of Securities Act case law, including the Ninth Circuit's own prior rulings—that investors could assert Securities Act claims based on an allegedly misleading registration statement without showing that they purchased shares registered under the challenged registration statement. A Supreme Court decision affirming the Ninth Circuit's novel ruling could have radically expanded the scope of potential Securities Act liability. In a short unanimous opinion, however, the Supreme Court reversed the Ninth Circuit and confirmed that Section 11 of the Securities Act requires plaintiffs to "trace" the shares they purchased to the challenged registration statement. But the court did not decide whether Section 11's sibling provision, Section 12(a)(2), imposed a similar tracing requirement, instead remanding for the Ninth Circuit to decide that question in the first instance. Thus, while the court's decision in *Slack* confirmed an important limitation on Section 11 litigation, it left the door open to a potential expansion of liability in connection with the Securities Act's registration requirements under Section 12(a)(2) in the future.

Photo: Diego M. Radzinschi/ALM

Slack app on an iPhone screen.

The Securities Act's Private Rights of Action and the 'Tracing' Requirement

The Securities Act regulates public offerings of securities. Among other things, it requires companies offering securities to the public to register those securities with the SEC. To register securities for sale to the public, a company must file a registration statement with the SEC, comprised of two parts: a selling document or "prospectus" with detailed information about the company's business, which sellers must supply to anyone to whom they seek to sell the securities and certain additional exhibits and information that the company must file with the SEC but need not be supplied to purchasers. The Securities Act also prohibits false

or misleading statements or materially misleading omissions in registration statements. And Sections 11 and 12(a)(2) of the Securities Act provide investors who purchase securities offered under false or misleading registration statements with two distinct private rights of action against those who issued, offered, underwrote or sold the securities.

Under Section 11, "in case any part of the registration statement … contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security … may … sue" the issuer, the issuer's directors, any person who signed the registration statement, and the underwriters of the offering, among others. Under Section 12(a)(2), "any person who … offers or sells a security … by means of a prospectus … which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading … shall be liable … to the person purchasing such security from him … ."

While the Securities Act governs securities offerings, Sections 11 and 12(a)(2) apply both to purchases made directly in an offering and to subsequent purchases on the public secondary market. But, in many cases, it is difficult or impossible to determine whether shares purchased in the market were originally issued in any particular offering, For example, the public market may include indistinguishable shares issued under different registration statements—if a company has conducted multiple public offerings. Similarly, the public market may include both registered shares and unregistered shares sold to the public pursuant to an exemption from the registration requirement.

Under those circumstances, can an investor who purchased shares in the open market bring Securities Act claims? Judge Henry Friendly first answered this question over a half-century ago in *Barnes v. Osofsky*, holding that plaintiffs asserting Section 11 claims must either show that they purchased shares directly in the offering or otherwise "trace" their shares to the allegedly misleading registration statement, proving with that the shares they purchased were among the specific shares that had been sold in the offering at issue. In the 55 years between the Second Circuit's decision in *Barnes* and the Ninth Circuit's decision in *Slack*, every court of appeals to consider the question agreed that Section 11 required plaintiffs to trace their shares to the challenged registration statement.

The tracing requirement is not an insurmountable hurdle in Section 11 cases brought in connection with traditional IPOs. In an IPO, a company "goes public" by issuing new shares to be offered for sale to the public pursuant to a registration statement. Companies conducting IPOs engage investment banks to underwrite the offering, by purchasing the new registered shares and re-selling them to investors. Once a company's shares are publicly traded, holders of unregistered shares—typically founders, insiders and early-stage investors—may sell their shares to the public under various exemptions from the registration requirement. To avoid flooding the market with unregistered shares, however, IPO underwriters typically require holders of unregistered shares to agree not to sell their shares to the public during a "lock-up period" following the IPO (typically 90 to 180 days). Thus, during the lock-up period following an IPO, only shares registered under the IPO registration statement will be available for investors to purchase. Accordingly, any investor who purchases company stock during the lock-up period can arguably trace those shares to the IPO registration statement. After the lock-up period has expired and holders of unregistered shares are permitted to sell to the public, however, both registered and unregistered shares are traded in the open market, making it virtually impossible for an investor who purchases shares after the expiration of the lock-up period to trace those shares to the IPO registration statement. Thus, the practical effect of the tracing requirement in most cases has been to limit the potential class of Section 11 plaintiffs to those investors who purchased shares between the time of the IPO and the expiration of the lock-up period.

'Slack' and Direct Listings

The *Slack* case addresses the application of the tracing requirement to a "direct listing" of

securities, an alternative process for publicly listing shares that the SEC approved in 2018. In a direct listing, rather than issuing new shares, a company files a registration statement for a specified number of its existing shares, permitting the holders of those shares to sell them "directly" to investors, i.e., without an underwriter acting as intermediary. And, because there are no underwriters in a direct listing, there likewise are no lock-up periods imposed on holders of unregistered shares. Accordingly, both registered and unregistered shares are sold to the public simultaneously when the registration statement becomes effective. As a result, investors who purchase stock in a direct listing typically cannot determine whether they purchased registered or unregistered securities and, thus, cannot trace their shares to the registration statement.

Slack went public through a direct listing on June 20, 2019, through which 118 million registered shares and 165 million unregistered shares were offered to the public. When Slack's stock price fell below the initial offering price a few months later, a Securities Act class action lawsuit predictably followed. The plaintiff, Fiyyaz Pirani—an investor who bought 30,000 Slack shares on the day of the direct listing and 220,000 more over the next few months—asserted claims under Sections 11 and 12(a)(2) against Slack, its directors and officers, and the pre-listing shareholders who sold shares in the direct listing.

The defendants moved to dismiss the complaint, arguing that Pirani's complaint failed to state a claim because he did not plead that he purchased shares traceable to the registration statement. Indeed, Pirani conceded that he could not show that any particular shares he purchased were registered under the challenged registration statement. But Pirani argued that at least some of the shares he purchased must have been registered given the number of shares he purchased and the proportion of the listed shares that were registered. Alternatively, Pirani argued that, if it is practically impossible for a purchaser in a direct listing to meet the tracing requirement, then the tracing requirement should not be applied.

The district court denied the defendants' motions to dismiss, holding that Pirani had standing to sue under Sections 11 and 12(a)(2) regardless of whether he could show he purchased registered shares. Because application of the tracing requirement to a direct listing was a question of first impression, the district court certified its ruling for interlocutory appeal. The Ninth Circuit accepted the appeal, and on Sept. 21, 2021, a divided panel of the Ninth Circuit affirmed, holding that "Pirani has pled facts sufficient to establish statutory standing under Section 11." In doing so, the Ninth Circuit majority eviscerated the established understanding of the tracing requirement, concluding that "all of Slack's shares sold in this direct listing, whether labelled as registered or unregistered can be traced to that one registration [statement]." In reaching this conclusion, the panel majority relied heavily on policy considerations, in particular a concern that "interpreting Section 11 to apply only to registered shares in a direct listing context would essentially eliminate Section 11 liability for misleading or false statements made in a registration stating in a direct listing for both registered and unregistered shares."

Notably, while the Ninth Circuit justified its decision, in part, on the perceived negative consequences of applying the traditional tracing requirement to direct listings, its decision was not limited to the context of direct listings. By its terms, the Ninth Circuit's opinion could be read to obviate the tracing requirement entirely, thus radically expanding the scope of potential Securities Act liability. For example, under the Ninth Circuit's ruling, if a large public company raised funds by conducting a relatively small secondary stock offering and its stock price later declined within the one-year Securities Act limitations period, then every purchaser of the company's stock during that time could potentially have standing to assert Section 11 claims.

The Supreme Court's Opinion

The Supreme Court granted certiorari on the question "whether Sections 11 and 12(a)(2) of the Securities Act of 1933 require plaintiffs to plead and prove that they bought shares identified as

being registered in the registration statement they claim is misleading."

In a short unanimous opinion written by U.S. Supreme Court Justice Neal Gorsuch, the court reversed the Ninth Circuit's decision as to Pirani's Section 11 claims, holding that "to bring a claim under Section 11, the securities held by the plaintiff must be traceable to the particular registration statement alleged to be false or misleading." In contrast to the Ninth Circuit's heavy reliance on policy considerations, the Supreme Court focused on Section 11's statutory language. As noted above, if a registration statement contains a false or misleading statement, then any person who purchases "such security" may sue under Section 11. Reading the statutory language, the court concluded that "such security" referred only to a security issued pursuant to the allegedly misleading registration statement. The court also noted the extensive body of court of appeals decisions concluding that Section 11 liability extended only to shares that are traceable to an allegedly defective registration statement.

The court's decision recognizing Section 11's tracing requirement restores the long-standing rule in the vast majority of Securities Act cases that are brought in the context of traditional underwritten offerings: in IPO cases, only investors who purchased shares directly in the offering or purchased shares in secondary transactions during the lock-up period have Section 11 standing; in cases involving secondary offerings, only investors who purchased directly in the offering have Section 11 standing. In the context of a direct listing, the court's decision appears to foreclose Section 11 liability as a practical matter. Of course, purchasers in direct listings who believe that they were misled—like any other purchaser of securities—may bring claims under Section 10(b) of the Exchange Act, the securities law's general anti-fraud provision, provided that they can establish fraudulent intent and meet the heightened pleading requirements for federal securities fraud claims.

While the court reversed the Ninth Circuit's decision on the Section 11 claims, it did not decide whether a similar tracing requirement applies under Section 12(a)(2). The court noted that the Ninth Circuit's "decision to permit Pirani's Section 12 claim to proceed 'followed from' its analysis of his Section 11 claim." Thus, having determined that the Ninth Circuit's Section 11 analysis was flawed, the court vacated the Ninth Circuit's decision on the Section 12 claims and remanded for reconsideration in light of the court's holding as to the Section 11 claims.

Notably, the Supreme Court criticized the Ninth Circuit's "apparent belief that Section 11 and Section 12 necessarily travel together" and "cautioned that the two provisions contain distinct language that warrants careful consideration." Thus, the court appeared to invite the Ninth Circuit on remand to distinguish between the two provisions in examining whether Section 12(a)(2) requires tracing. If the tracing requirement were ruled inapplicable to Section 12, that could result in a significant expansion of the number of stockholders who would have standing to pursue Securities Act claims (which function as a form of strict liability because they do not require proof of scienter or reliance) against sellers, alleging the purchase was made pursuant to a misleading prospectus. Thus, while the Supreme Court's *Slack* opinion was a decisive unanimous victory for the defendants on the issues it decided, this is not the last we will hear from the courts on the potentially significant issues the plaintiffs raised concerning the scope of Securities Act liability.

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