Investor Alert

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"TRACEABILITY" DEVELOPMENTS IN SECURITIES LITIGATION

"Traceability" is generally a prerequisite to recovery under Section 11 of the Securities Act of 1933 (the "Securities Act"). Investors who purchase shares traceable to an IPO or secondary offering may be entitled to recover damages caused by false and misleading statements or omissions in the registration statement for that offering. Recoveries under Section 11 generally exceed those under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), which is also subject to a higher pleading burden. Thus, shares traceable to an offering generally have more "downside" protection against inadequate disclosures than shares purchased in the open market.

Already highly fact-specific, the judicially created doctrine of "traceability" is in flux, creating further uncertainty over which shares may be traceable to a given type of offering. This Investor Alert explores recent traceability developments in the context of direct listings and settlements and provides practical measures investors can take to minimize risk and ensure optimum participation in securities class action settlements.

The Securities Act and the Origin of Traceability

In the aftermath of the stock market crash of 1929, the Securities Act was enacted in 1933 as part of President Franklin D. Roosevelt's New Deal amid the Great Depression.[1] The purpose of the Securities Act was to foster transparency by providing investors with robust and uniform disclosures in connection with public offerings of securities.

[1] Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74.

To accomplish this goal, the Securities Act mandates the registration of securities offered to the public, with several notable exemptions, including private placements by the issuer under U.S. Securities and Exchange Commission Regulation D.[2] Any such registration statement, which must be filed with and approved by the SEC, is required to disclose information necessary for investors to assess the financial health and prospects of the issuer. Thus, in a traditional underwritten securities offering, a company issues new shares which are registered under the Securities Act, by means of a registration statement and sold to investors pursuant to an accompanying prospectus.

Importantly, the Securities Act armed investors with several private causes of action. Among them, Section 11 provides for the recovery of damages in connection with the purchase of securities on, or traceable to, a public offering in the event the registration statement contains material misstatements or omissions at the time the SEC declared it effective.[3] Because suits under Section 11 of the Securities Act are based in strict liability or negligence and are subject to a lower pleading burden, they generally command a premium over suits under Section 10(b) of the Securities Exchange Act.[4]

[2] *See* 17 C.F.R. §230.500–508.

[3] Section 12(a)(2) of the Securities Act additionally provides for the recovery of damages in connection with the purchase of securities pursuant to a false and misleading prospectus, which is also part of the registration statement, or false and misleading oral communication. 15 U.S.C. § 77l (a)(2).

[4] Data from Cornerstone Research estimates that from 2010-2019, median settlements as a percentage of damages were higher in cases alleging claims under the Securities Act than in cases alleging claims under only the Exchange Act: settlements valued at 7.4% of simplified statutory damages in Securities Act cases versus settlements valued at 4.6% of simplified tiered damages in Exchange Act cases. *Securities Class Action Settlements*, Cornerstone Research (2019).

Specifically, the Securities Act provides that "any person acquiring ***such security*** [from a defective registration statement] . . . may . . . sue . . . ." 15 U.S.C. § 77k (emphasis added). The traceability doctrine stems from a narrow interpretation of the term "such security." The Second Circuit was the first to interpret the phrase "such security." *See Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967). In *Barnes*, writing for the Court, Judge Friendly found "the difficulty, presented when as here the registration is of shares in addition to those already being traded, is that 'such' has no referent." *Id.* at 271. Judge Friendly weighed two possible readings of the phrase: a narrower reading, "acquiring a security issued pursuant to the registration statement;" and a broader reading, "acquiring a security of the same nature as that issued pursuant to the registration statement." *Id.*

Of the broader reading, Judge Friendly noted that it "would not be such a violent departure from the words that a court could not properly adopt it if there would good reason for doing so." *Id.* But Judge Friendly adopted the narrower reading after a review of the overall statutory scheme, language from the legislative history, *dicta* from within the Second Circuit, and a treatise and amicus brief from the SEC. *Id.* at 272-73. Other Circuits, including the Ninth Circuit, have followed suit in their interpretation: "Clearly, this limitation [on 'any person'] only means that the person must have purchased a security issued under that, rather than some other, registration statement." *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076, 1080 (9th Cir. 1999) (citing *Barnes*, 373 F.2d 269).

This narrower reading became the basis for case law requiring plaintiffs to "trace their shares back to the relevant offering" in order to plead standing under Section 11. *See In re Century Aluminum Co. Sec. Litig.*, 729 F.3d 1104, 1106 (9th Cir. 2013). For example, in the Ninth Circuit, this means plaintiffs must either have "purchased shares in the offering made under the misleading registration statement," or purchased shares in the aftermarket "provided they can trace their shares back to the relevant offering." *Id.*

Direct Listings and the Tracing Conundrum

Given the different contexts in which unregistered shares can be sold on the secondary market without registration, such as with a direct listing or after post-lockup insider sales, or in which newly registered shares can be sold into an established market with shares registered securities under an earlier registration statement, such as with most secondary offerings, investors may need to know whether their shares are "traceable" to a specific registration statement. Sometimes this can be easily done by reviewing trading records or analyzing what shares were in the market at the time of a certain purchase.

However, in direct listings, both registered and unregistered shares enter the market at the same time, which issuers have and will claim makes it impossible to determine whether shares purchased on the day of the direct listing are traceable to the registration statement and prospectus when applying traditional case law on traceability.[5] However, considering an issue of first impression, on April

[5] This is because SEC Rule 144 provides an exemption from the Securities Act's registration requirements to those seeking to publicly resell securities received through private placements or other exempt offerings. 17 C.F.R. §230.144. To comply with Rule 144, the restricted or control securities must have been held by the acquirer for a certain length of time depending on the circumstances. For new public companies, *i.e.*, companies that have not been subject to SEC reporting requirements for at least 90 days, securities sold under Rule 144 must have been held for at least one year from receipt prior to resale to the public. If the company in question has been public for 90 days or more, this holding period is reduced to six months. Rule 144 thus allows the resale of unregistered securities into the secondary market. This can occur at the time of the IPO in the case of a direct listing where Rule 144 may permit or six to twelve months after a traditional IPO on expiration of a lockup agreement.

21, 2020, Judge Illston, in the Northern District of California, denied a motion to dismiss related to Slack Inc.'s direct listing predicated on the argument that plaintiffs could not establish traceability and thus standing. In so holding, Judge Illston reasoned that under the "unique circumstance" of direct listings, which have only been permitted by recent rule changes, the Securities Act and the term "such security" should be interpreted broadly to protect investors. *See Pirani v. Slack Techs., Inc.*, 445 F. Supp. 3d 367, 381 (N.D. Cal. 2020).

This is not the end of the debate on traceability in the context of direct listings. Investors considering purchasing securities in a direct listing should note that the Ninth Circuit has granted Defendants' request for an interlocutory appeal dealing with this issue. *See Pirani v. Slack Techs., Inc.*, No. 19-cv-05857-SI, 2020 WL 7061035 (N.D. Cal. June 5, 2020). Armed with this knowledge, investors considering purchases in a company going public through a direct listing should approach trade execution with an eye towards identifying a specific counterparty in possession of traceable shares. Sophisticated monitoring counsel can also work with investors and their investment manager, broker, and custodian bank in an effort to determine whether shares that have been purchased in a direct listing are traceable.

In any event, given the uncertainty surrounding traceability in the context of direct listings, investors should note that they may not benefit from the same recovery options as those available to investors in a traditional IPO context.

Settlement Arbitrage in "Split" Securities Class Actions?

Following the Supreme Court's decision in *Cyan, Inc. v. Beaver County Employees Retirement Fund*, 138 S. Ct. 1061 (2017), it is now without question that Section 11 claims may be brought in state court. Because state courts do not have jurisdiction to hear Exchange Act claims, which are sometimes brought with Securities Act claims, securities class actions are increasingly split between state court and federal court. Thus, it is now typical to see a state court class action brought under Section 11 of the Securities Act and a related federal court class action brought under Section 10(b) of the Exchange Act.

Further, because state court class actions tend to reach resolution before their federal court counterparts, it is increasingly common to see settlements of Section 11 claims in state court while defendants continue to litigate Exchange Act claims in federal court. This overlap may create opportunities for settlement arbitrage, in which an investor may be able to allocate more of its purchases during the relevant period towards a higher yielding settlement depending on the investor's ability to trace their shares to a specific offering.

As such, mechanically filing claim forms may result in missed opportunities and the inadvertent release of valuable claims. Sophisticated monitoring counsel can advise investors on the range of options at their disposal based on a detailed analysis of their trading, the traceability of their shares, and the class definitions in the overlapping state and federal securities class actions, among other factors.

Conclusion

As companies continue to find new and creative ways to raise capital through offerings, the laws enforcing transparency for investors become more complex, and lawyers must also become more creative to ensure their clients are maximizing their return on investment. Whether with direct listings or when submitting claim forms, investors should note the opportunities and risks created by the evolving "traceability" doctrine and seek advice from experienced counsel.

Labaton Sucharow's lawyers are available to address any questions you may have regarding these developments. Please contact the Labaton Sucharow lawyer with whom you usually work or the contacts below.

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