NOTE

DIRECT LISTINGS AND THE TRACING DOCTRINE: WHY CONGRESS OR THE SEC MUST INTERVENE

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In September 2021, the U.S. Court of Appeals for the Ninth Circuit in Pirani v. Slack Technologies *became the first circuit to have a say on whether an investor who purchases securities in a direct listing can establish standing to bring claims under Section 11 of the Securities Act of 1933. The Ninth Circuit's controversial ruling challenges fifty years of established jurisprudence and has the potential to deter companies from performing direct listings. This Note argues for Congress or the SEC to intervene by requiring or encouraging companies to adopt blockchain technology once they go public via a direct listing. The goal of this approach is to ensure that companies continue to use direct listings, while also preserving adequate investor protections.*

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I. INTRODUCTION

In any securities law regime, participants will inevitably search for loopholes within the law to avoid liability. After a controversial opinion by the U.S. Court of Appeals for the Ninth Circuit, direct listings might be a new way for firms to sidestep liability for material misrepresentations and omissions in offering materials.

On April 3, 2018, music streaming company Spotify Technology S.A. (Spotify) went public through a direct listing of its shares on the New York Stock Exchange (NYSE).[1] Less than a year later, Slack Technologies, LLC (Slack), a business software company, followed Spotify's lead and performed its own direct listing.[2] Unlike in a traditional Initial Public Offering (IPO), a company undergoing a direct listing does not issue new shares to raise capital. Instead, a direct listing's main purpose is to allow shareholders to sell their privately-owned shares on a public exchange.[3]

Irrespective of the method, a company that goes public can incur liability for wrongdoing. After the stock market crash of

[1] Michelle Castillo, *How Spotify's Direct Listing is Different From an IPO*, CNBC (Apr. 3, 2018, 12:55 P.M.), https://www.cnbc.com/2018/04/03/how-does-spotify-direct-listing-work.html [https://perma.cc/9CGE-GD5K].

[2] Maureen Farrell, *Slack Files to Go Public with Direct Listing*, WALL ST. J. (Feb. 4, 2019, 3:46 P.M.), https://www.wsj.com/articles/slack-files-confidentially-to-go-public-with-direct-listing-11549301336 [https://perma.cc/RDD8-MGBL].

[3] Ran Ben-Tzur & James D. Evans, *The Rise of Direct Listings: Understanding the Trend, Separating Fact from Fiction*, FENWICK (Dec. 5, 2019), https://www.fenwick.com/insights/publications/the-rise-of-direct-listings-understanding-the-trend-separating-fact-from-fiction [https://perma.cc/UHP2-X9QF] [hereinafter *The Rise of Direct Listings*].

1929, Congress passed the Securities Act of 1933[4] and the Exchange Act of 1934.[5] The Securities Act and the Exchange Act both "aim to protect investors through a mandatory disclosure regime."[6] The Securities Act sets out rules on the initial distribution of securities, and the Exchange Act governs the subsequent trading of those securities.[7] Companies that undergo an IPO or a direct listing are subject to several generic anti-fraud provisions, including Section 10(b) of the Exchange Act[8] and Section 17(a) of the Securities Act.[9] However, a plaintiff's most useful liability provision in the "going public" context is Section 11 of the Securities Act, since it imposes strict liability for material misstatements or omissions made in offering documents.[10] To balance its usefulness, plaintiffs must show that the securities they purchased were acquired "pursuant to the registration statement" to have standing and access to the strict liability standard.[11] This is known as the tracing requirement, and it ensures that only investors who bought shares pursuant to the challenged registration statement can sue.[12]

As this Note will explore, investors can easily satisfy the tracing requirement in IPOs, while it is nearly impossible to do so in a direct listing. This issue arose in *Pirani v. Slack Technologies*, in which an investor sued Slack after it conducted its direct listing for alleged material misrepresentations in its offering materials.[13] To the shock of

4 15 U.S.C. § 77a.

5 15 U.S.C. § 78a.

6 Benjamin J. Nickerson, *The Underlying Underwriter: An Analysis of the Spotify Direct Listing*, 86 U. CHI. L. REV. 985, 1005 (2019).

7 *Id.* at 988.

8 15 U.S.C. § 77q.

9 15 U.S.C. § 78j.

10 15 U.S.C. § 77k(a).

11 Barnes v. Osofsky, 373 F.2d 269, 271 (2nd Cir. 1967).

12 Boris Feldman, Sarah Solum & Doru Gavril, *Ninth Circuit on Strict Liability for Direct Listings*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 14, 2021), https://corpgov.law.harvard.edu/2021/10/14/ninth-circuit-on-strict-liability-for-direct-listings/ [https://perma.cc/9DEL-8Y2X].

13 Pirani v. Slack Technologies, Inc., 445 F. Supp.3d 367, 372–73 (N.D. Cal. 2020).

legal commentators,[14] both the District Court and the Ninth Circuit held that the plaintiff had the standing to sue even though he could not trace his shares to Slack's registration statement in the way in which the traditional tracing doctrine required.[15] In their respective opinions, both courts prioritized investor protection concerns over precedent, which a commentator argued would expand liability for direct listings beyond traditional IPOs, create inconsistencies within Section 11, and produce conflicts with other circuits' interpretation of Section 11.[16] This result has prompted predictions that the Supreme Court will reverse the decision.[17] The Supreme Court has agreed to hear Slack's appeal as of December 13, 2022.[18] The ramifications of reversing *Slack* are serious, as investors will no longer be able to successfully bring Section 11 claims in direct listings. Thus, neither result—upholding nor reversing *Slack*—is desirable.

This Note focuses on the adequacy of investor protections in the direct listing context. It argues that the judicial system is unequipped to fix the problem with the tracing requirement and urges Congress or the Securities and Exchange Commission (SEC) to re-examine Section 11 and to consider the use of blockchain technology to trace ownership of shares in direct listings.

Part II of this Note will discuss the mechanics of a direct listing and detail the regulatory developments allowing direct listings on public exchanges. Part III will analyze Section 11 of the Securities Act and the *Slack* decision. Part IV will make a case for Congress or the SEC to intervene by arguing that

14 *See* Feldman et al., *supra* note 12.

15 Pirani v. Slack Technologies, Inc., 445 F. Supp.3d 367, 376–83 (N.D. Cal. 2020); Pirani v. Slack Technologies, Inc., 13 F.4th 940, 946–49 (9th Cir. 2021).

16 *See* Feldman et al., *supra* note 12.

17 *Id.* ("*Slack* represents a significant departure in the imposition of strict liability in securities regulation . . . We believe this decision warrants reversal by the Supreme Court").

18 Jody Godoy, *U.S. Supreme Court to Hear Dispute Over Slack's Direct Stock Listing*, REUTERS (Dec. 13, 2022), https://www.reuters.com/legal/us-supreme-court-hear-dispute-case-over-slacks-direct-stock-listing-2022-12-13/ [https://perma.cc/2WUC-67JE].

the two worlds where the Supreme Court upholds or reverses the *Slack* decision are undesirable for investors, companies, and the legal system.

II. BACKGROUND ON DIRECT LISTINGS

This section begins by comparing the purpose and features of an IPO and a direct listing. It concludes by detailing the mechanics of a direct listing and the regulatory developments that allowed companies to utilize a direct listing on a public exchange.

A. IPOs and Direct Listings Generally

A company that goes public via an IPO does so primarily because it wants to raise capital,[19] which inevitably dilutes the positions of existing shareholders.[20] The availability of a public marketplace easily outweighs the loss in share value since investors can quickly sell their shares due to shares being more liquid, meaning the shares can be converted into cash without giving up time or selling them at a lower price.[21] Companies conducting IPOs face large costs because they must hire investment banks to be underwriters.[22] Underwriters perform vital functions including "underwriting,"[23] conducting "book building" by

[19] Brent J. Horton, *Spotify's Direct Listing: Is it a Recipe for Gatekeeper Failure?*, 72 SMU L. REV. 178, 182–83 (2019). An average company can raise $100 million, but some companies raise more—like Snap, Inc., which raised $3.4 billion in its IPO. *Id.* at 183.

[20] Nickerson, *supra* note 6, at 990.

[21] *See* Adam Hayes, *Understanding Liquidity and How to Measure It*, INVESTOPEDIA, https://www.investopedia.com/terms/l/liquidity.asp [https://perma.cc/4UDG-6E66] (last updated Mar. 29, 2022).

[22] *See* Horton, *supra* note 19, at 185.

[23] *See* Nickerson, *supra* note 6, at 992–93. Underwriters facilitate the sale of securities to interested investors through two ways of underwriting. The first is known as "firm commitment underwriting," in which the underwriter purchases securities from the issuer at a discounted price, and then later resells them to buyers at the public offering price. *Id.* at 922. The other way is called "best efforts" underwriting, in which the underwriter does not purchase securities from the issuer but instead contractually

communicating with prospective investors to gauge interest and set the offering price,[24] actively marketing the issuer's shares in meetings with large institutional investors,[25] and assisting with the required filings.[26] Given that an underwriter's work is both time-consuming and risky, an issuer pays them a fee, which is referred to as the spread, or "the difference between the price that the dealer (underwriter) acquired the stock from the issuer [at] and the amount it receives when selling that same stock to the public."[27] The spread is normally around seven percent,[28] and it is normally the single largest cost for companies going public through an IPO.[29]

Another important feature of IPOs is the lock-up period. In IPOs, underwriters require pre-IPO investors to agree not to sell their shares for a specified period following the IPO.[30] Underwriters use lock-up periods to stabilize the stock's price immediately after the IPO. Without a lock-up, there is a risk that a company's shares would flood the market, lower the price, and harm the investors who bought shares during the IPO.[31]

Unlike in the IPO process, a company that goes public through a direct listing does not raise capital. Direct listings are used primarily for efficiency in both "market creation" and "financing flexibility."[32] Direct listings allow a company to create a market for existing shareholders to immediately sell

agrees to use its best efforts to sell as many securities as possible at the market price. *Id.* at 992–93.

24 Horton, *supra* note 19, at 184.

25 *Id.*

26 *Id.*

27 Robert B. Thompson, *Market Makers and Vampire Squid: Regulating Securities Markets After the Financial Meltdown*, 89 WASH. U. L. REV. 323, 335–36 (2011).

28 Ben-Tzur & Evans, *supra* note 3.

29 Horton, *supra* note 19, at 185 (showing that in average large IPOs, the underwriter fee was $37,000,000, or 83% of the total $44,350,000 cost).

30 Ben-Tzur & Evans, *supra* note 3.

31 Nickerson, *supra* note 6, at 993.

32 *See id.* at 995.

their shares,[33] allowing shareholders to avoid lock-up periods and the dilution of their shares.[34] In addition, the costs of going public via a direct listing are considerably lower than via an IPO, as "there are no underwriters and consequently no underwriting fees in a direct listing."[35] For example, Spotify's direct listing still utilized investment banks to assist in the process, but, because a direct listing requires less work from investment banks, the fee was less than half what it would have been with an IPO.[36] Lastly, direct listings allow a company to reap the benefits from having access to a public exchange. By being public, the company can raise capital on more favorable terms than an IPO because it does not need to underprice its stock,[37] and it can buy back its stock "at the market price, without negotiating privately with its investors."[38]

Ultimately, the primary motivation for conducting a direct listing is increased liquidity of existing shares. The companies best suited for direct listings are tech "unicorns"[39] that do not need to raise capital and want to provide a market for their investors.[40] Slack conducted its direct listing for this exact

33 Rupa Briggs, *Direct Listings: The IPOs of the New Decade or a Passing Phase?*, WHITE & CASE (Feb. 1, 2020), https://www.whitecase.com/sites/default/files/2020-03/direct-listings-ipos-new-decade-or-passing-phase.pdf [perma.cc/99WH-RVK8].

34 *Id.*

35 *Id.*

36 *See* Nickerson, *supra* note 6, at 998 (stating that Spotify paid $35 million for the financial advisors' fees, and that a J.P. Morgan Capital Markets report found that Spotify would have had to pay underwriters between $80 and $120 million if it went public through an IPO).

37 Horton, *supra* note 19, at 189.

38 Matt Levine, *Going Public to Buy Back Stock*, BLOOMBERG (Nov. 6, 2018), https://www.bloomberg.com/opinion/articles/2018-11-06/going-public-to-buy-back-stock [https://perma.cc/7SF7-D84W].

39 A "unicorn" is "a term used in the venture capital industry to describe a privately held startup company with a value of over $1 billion." James Chen, *Unicorn*, INVESTOPEDIA, https://www.investopedia.com/terms/u/unicorn.asp [perma.cc/MY9N-59GW] (last updated Mar. 29, 2021).

40 Horton, *supra* note 19, at 189.

purpose; in an interview with CNBC, Slack CEO Stewart Butterfield said:

> The big thing for us was—in a traditional IPO it's the company that's offering shares. You might raise, you know, a billion dollars or something like that. When you raise a billion dollars, you dilute existing shareholders by issuing new shares. So, we're not doing that. We are just opening it up for trading.[41]

B. Mechanics and Regulation of Direct Listings

1. Registration Statement Overview

When going public, a company is required to provide certain registration statements under the Securities Act and the Exchange Act. First, when a company performs an IPO, it is required to file a Form S-1 pursuant to the Securities Act.[42] Second, when a company lists shares on a public exchange pursuant to Section 12(b) of the Exchange Act, it must file a Form 10.[43] Lastly, if a company has already filed a Form S-1, it can file a shortened Exchange Act registration statement known as a Form 8-A.[44]

Here it is important to distinguish between a "pure" direct listing and the kinds of direct listings Spotify and Slack used. In a "pure" direct listing, a company is only required to file a Form 10 pursuant to the Exchange Act.[45] This is because there is "no inherent statutory obligation to register these shares under the Securities Act of 1933 [through a Form S-1],

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41 CNBC, *Slack CEO Explains Why the Company Chose Direct Listing Over IPO*, CNBC (Jun. 19, 2019), https://www.cnbc.com/video/2019/06/20/slack-ceo-explains-why-the-company-chose-direct-listing-over-ipo.html [https://perma.cc/7R63-BV63].

42 Horton, *supra* note 19, at 190.

43 *Id.*

44 *Id.*

45 John C. Coffee, Jr., *The Spotify Listing: Can an "Underwriter-less" IPO Attract Other Unicorns?*, THE CLS BLUE SKY BLOG (Jan. 16, 2018), https://clsbluesky.law.columbia.edu/2018/01/16/the-spotify-listing-can-an-underwriter-less-ipo-attract-other-unicorns/ [https://perma.cc/Q7L3-GUGN].

because the issuer is not making any sale."[46] Thus, a company's existing shares could begin trading immediately after the Form 10 becomes effective.[47] As the next section will cover, Spotify's and Slack's direct listings were not "pure" ones because they were required to do more than simply file a Form 10 by the SEC and NYSE.[48]

2. NYSE Rule Changes

In June 2017, the NYSE proposed changes to its listing requirement rules to allow companies to conduct a direct listing on its exchange.[49] Prior to the changes, the NYSE, pursuant to Section 102.01B, could list companies on a case-by-case basis if the company had a $100 million valuation and months of documented trading history in private markets.[50] The NYSE proposal sought to include the below italicized language to the text of Footnote (E) to Section 102.01B:

> (E) Generally, the Exchange expects to list companies in connection with a firm commitment underwritten IPO . . . However, the Exchange recognizes that some companies that have not previously had their common equity securities registered under the Exchange Act, but which have sold common equity securities in a private placement, may wish to list their common equity securities on the Exchange at the time of effectiveness of a registration statement filed solely for the purpose of allowing existing shareholders to sell their shares. *Similarly, some companies that have not previously had their common equity securities registered under the Exchange Act may wish to list immediately upon effectiveness of an Exchange Act registration statement without any concurrent IPO or Securities Act registration.* Consequently, the Exchange will, on a case by case basis, exercise

46 *Id.*

47 Horton, *supra* note 19, at 191.

48 *Id.*

49 *See* Securities Act Release No. 34-80933, 82 Fed. Reg 28200. (June 15, 2017).

50 Nickerson, *supra* note 6, at 1001.

> discretion to list companies whose stock is not previously registered under the Exchange Act, where such a company is listing without a related underwritten offering (i) upon effectiveness of a registration statement registering only the resale of shares sold by the company in earlier private placements *or (ii) upon effectiveness of an Exchange Act registration statement without any concurrent IPO or Securities Act registration.*[51]

The italicized portions would have authorized a "pure" direct listing in which a company could begin trading its shares on the exchange after approval of a Form 10. Ultimately, the SEC rejected this change to provide investors more protections. Instead, the SEC required a company to file a Securities Act registration statement,[52] which subjects the issuer to Section 11 liability for material misstatements and omissions.[53] In their direct listings, Spotify and Slack both filed Securities Act registrations,[54] subjecting them to Section 11 liability and setting the stage for *Slack*.

3. Securities Act Rule 144

After Slack and Spotify filed the relevant registration statements, their shareholders could sell their securities immediately. This aligns with the general rule that, for a

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[51] E-mail from Martha Redding, Assoc. Gen. Couns., NYSE, to Brent J. Fields, Sec'y, SEC, at Exhibit 5 (Aug. 1, 2017), https://www.sec.gov/comments/sr-nyse-2017-30/nyse201730-2161992-157779.pdf [https://perma.cc/3ZWB-FKUJ] (emphasis added).

[52] Notice of Filing of Amendment No. 3 and Order Granting Accelerated Approval of Proposed Rule Change, Exchange Act Release No. 34-82627, 83 Fed. Reg. 5650 (Feb. 2, 2018) ("Amendment No. 3 revised the proposal to eliminate the proposed changes to Footnote (E) that would have allowed a company to list immediately upon effectiveness of an Exchange registration statement only, without any concurrent IPO or Securities Act of 1933 ('Securities Act') registration.").

[53] Horton, *supra* note 19, at 193.

[54] Spotify Technology S.A., Amendment No. 3 to Form F-1 Registration Statement (Form F-1) (Mar. 23, 2018); Slack Technologies, Inc., Form S-1 Registration Statement (Form S-1) (Apr. 26, 2019).

shareholder to sell securities on a public market, those securities must be registered with the SEC.[55]

However, Securities Act Rule 144 provides exemptions to this general rule. It allows the sale of unregistered, restricted, and control securities if five conditions are met.[56] Rule 144 is usually used by private shareholders who receive securities as part of an employee benefits package as compensation in exchange for start-up capital or as part of an M&A transaction.[57]

Rule 144 plays a critical role in direct listings and in *Slack*. In Slack's direct listing, only about 42% of its outstanding shares were registered pursuant to a registration statement, and the remaining 58% were exempt from registration under Rule 144.[58] Thus, after its direct listing, the market for Slack's shares included a mix of both registered and unregistered shares.[59] As Part III will explain, Rule 144 has a direct impact on an investor's ability to prove the tracing requirement under Section 11.

III. ANALYZING SECTION 11 AND THE SLACK DECISION

A. Section 11 of the Securities Act of 1933

Section 11 establishes a private cause of action for persons who acquired securities through a registration statement that contains false or misleading information. Section 11 provides, in relevant part:

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55 *See Rule 144: Everything You Need to Know*, UPCOUNSEL, https://www.upcounsel.com/rule-144 [https://perma.cc/G844-FAZL] (last updated Oct. 5, 2020).

56 *See id.*

57 *Id.*

58 Francis McConville, Alec Coquin & Charles Wood, *Slack's Direct Listing Tests Limits of Securities Act*, LAW360 (Dec. 10, 2019), https://www.labaton.com/hubfs/Law360%20-%20Slacks%20Direct%20Listing%20Tests%20Limits%20Of%20Securities%20Act.pdf [https://perma.cc/NB6S-EPCE].

59 *Id.*

> In case any part of the registration statement, when such part became effective, 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, either at law or in equity, in any court of competent jurisdiction, sue— (1) every person who signed the registration statement.[60]

To prevail on a Section 11 claim, prospective plaintiffs must show that they purchased the registered securities, that the defendant or defendants signed the registration statement, and that a "part of the registration statement for the offering contained an untrue statement of a material fact or omitted a material fact necessary to make the statements not misleading."[61]

Section 11 provides plaintiffs with a strict liability standard, meaning there is no requirement to prove scienter, reliance, or causation.[62] In the House report on the Securities Act, Congress "explicitly stated its intent to impose § 11 liability on those who are 'responsible for' the disclosure in registration statements"[63] because it wanted to ensure those who are responsible for the investment of other's people money are held to high standards of trusteeship. [64] Congress chose a strict liability standard because it believed it was

[60] 15 U.S.C. § 77k.

[61] Jay A. Dubow, Robert L. Hickok & Biance DeBella, *Divided Ninth Circ. Opens Floodgates for Direct Listing Investors to Assert Section 11 Claim*, TROUTMAN PEPPER (Dec. 1, 2021), https://www.troutman.com/insights/divided-ninth-circ-opens-floodgates-for-direct-listing-investors-to-assert-section-11-claim.html [perma.cc/ARP7-AQY3].

[62] *Id.*

[63] Nickerson, *supra* note 6, at 1021.

[64] SAM RAYBURN, FEDERAL SUPERVISION OF TRAFFIC IN INVESTMENT, H.R. REP. NO. 73-85, at 5 (1933) (explaining that the "essential characteristic [underlying § 11 liability] consists of a requirement that all those responsible for statements upon the face of which the public is solicited to invest its money shall be held to standards like those imposed by law upon a fiduciary").

consistent with the Securities Act's goal of creating a mandatory disclosure regime. However, to balance Section 11's imposition of strict liability, Congress and the courts developed the tracing requirement, which forces plaintiffs to "establish standing by showing that their shares were traceable to the challenged registration statement."[65]

The "tracing" requirement was created in *Barnes v. Osofsky*, and it relies on the interpretation of the phrase "acquiring such security" within Section 11.[66] In *Barnes*, the defendant produced a public offering of newly issued shares, and the plaintiffs sought the approval of a settlement for all shareholders, independent of whether each investor's shares were newly issued or previously acquired.[67] The district court reduced the settlement class to only those investors who acquired the newly issued shares because "Section 11 of the Securities Act of 1933 and its interpretation in this Circuit, preclude participation, by shareholders whose shares were not part of the public issue complained of, in a settlement of action maintained under that section."[68]

On appeal, Judge Friendly, writing for the U.S. Court of Appeals for the Second Circuit, identified two readings—a narrow and a broad view—of the phrase "acquiring such security."[69] The narrow reading defined the phrase as "acquiring a security issued pursuant to the registration statement," while the broad reading defined it as "acquiring a security of the same nature as that issued pursuant to the registration statement."[70] Ultimately, Judge Friendly chose to adopt the narrow reading based on the overall statutory scheme, language from the legislative history, dicta from within the Second Circuit, and an amicus brief from the

65 Feldman et al., *supra* note 12.

66 Paul C. Curnin & Christine M. Ford, *The Critical Issue of Standing Under Section 11 of the Securities Act of 1933*, 6 FORDHAM J. CORP. & FIN. L. 155, 159 (2001).

67 Barnes v. Osofsky, 254 F.Supp. 721, 722 (S.D.N.Y. 1966).

68 *Id.* at 726 (citing Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951)).

69 Barnes v. Osofsky, 373 F.2d 269, 271 (2nd Cir. 1967).

70 *Id.*

SEC.[71] However, Judge Friendly did note that the broad reading "would not be such a violent departure" from Section 11, and a court could adopt it "if there were good reason for doing so."[72]

Following *Barnes*, the Ninth Circuit also adopted the narrow reading of "acquiring such security" in *Hertzberg v. Dignity Partners, Inc.*, stating that a plaintiff "must have purchased a security issued under that, rather than some other, registration statement" to have standing under Section 11.[73] Thus, the narrow reading became the standard approach to Section 11 in the Ninth Circuit.[74] To assert a Section 11 claim, plaintiffs are required to show that they "purchased shares in the offering made under the misleading registration statement," or if they purchased shares in the aftermarket, they must "trace their shares back to the relevant offering."[75]

Overall, Section 11 is an extremely useful provision for plaintiffs because it gives them access to strict liability, but its applicability is severely limited by the standing requirements. As Part III.C will show, this dichotomy is the central issue in *Slack*.

B. Slack's Direct Listing

On June 20, 2019, Slack went public through a direct listing, and its shares began trading on the NYSE under the ticker symbol "WORK."[76] In preparing for the direct listing, Slack filed both a Form S-1 and a Form 424B4 prospectus.[77]

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71 *Id.* at 272–73.

72 *Id.* at 271.

73 Hertzberg v. Dignity Partners, Inc., 191 F.3d 1076, 1080 (9th Cir. 1999) (citing *Barnes*, 373 F.2d at 269).

74 *See In re* Century Aluminum Co. Sec. Litig., 729 F.3d 1104, 1106 (9th Cir. 2013).

75 *Id.*

76 Pirani v. Slack Technologies, Inc., 445 F. Supp.3d 367, 373 (N.D. Cal. 2020).

77 *Id.* A prospectus is a "formal written document that accompanies a new offering of a corporate security, meant to provide information to potential buyers of that security [and] contains detailed information on the business' history, financial state, [and] current business plans." *Prospectus*,

Together the Form S-1 and Form 424B4 constituted Slack's "offering materials" for the SEC.

As Part II explained, by choosing to use a direct listing, Slack did not issue new shares. Instead, Slack's direct listing allowed insiders and early investors to simply sell their existing shares on the NYSE. Since no new shares were issued, individuals holding existing shares were not subject to a lock-up period and could sell their shares immediately. However, due to SEC Rule 144, not all of Slack's existing shares were required to be registered with the SEC. In Slack's direct listing, the registration statement permitted the sale of 118,429,640 shares, while Rule 144 allowed 164,932,646 shares to be sold immediately and to be exempt from registration.[78] Thus, both registered and unregistered shares could be sold immediately on the NYSE. As Section III.C will show, the presence of both registered and unregistered shares severely complicates an investor's ability to prove the tracing requirement.

C. *Pirani v. Slack*

1. Facts of *Pirani v. Slack*

On June 20, 2019, Fiyyaz Pirani "(the plaintiff)" purchased 30,000 shares of Slack's Class A common stock at $40/share, and from June 21 to September 9, he bought approximately another 220,000 shares.[79] Pirani sued Slack in a securities class action and alleged that he and other investors in the same class suffered losses to the value of their shares due to misstatements or omissions of material facts within Slack's

LEGAL INFO. INST., https://www.law.cornell.edu/wex/prospectus [https://perma.cc/K2H2-JC4D] (last visited Feb. 27, 2022).

78 Nicolas Grabar, David Lopez, Jared Gerber & Les Silverman, *Cleary Gottlieb Discusses How Court Allowed Securities Liability for Slack's Direct Listing*, THE CLS BLUE SKY BLOG (May 4, 2020), https://clsbluesky.law.columbia.edu/2020/05/04/cleary-gottlieb-discusses-how-court-allowed-securities-liability-for-slacks-direct-listing/ [https://perma.cc/PZ8T-M9SF].

79 *Pirani*, 445 F.Supp.3d at 372.

offering materials.[80] Specifically, Pirani identified statements "regarding service outages and Slack's Service Level Agreements ('SLAs') in the case of such outages; competition from Microsoft Teams; scalability and purported key benefits; and growth and growth strategy."[81] Throughout 2019, Slack did experience service outages and other issues, and after their September 4, 2019 earnings announcement, Slack's share price dropped to below $25.[82]

In his complaint, Pirani asserted claims under Section 11, Section 12(a)(2), and Section 15.[83] Defendants moved to dismiss all of them.[84] This Note focuses solely on the Section 11 claim because it is the primary issue raised on appeal, and Pirani's Section 12 claim relied on him satisfying the tracing requirement, which relates back to the Section 11 issue.

2. District Court's Opinion

Ultimately, the district court denied the defendants' motion to dismiss. The court held that Pirani could trace his shares to Slack's registration statement and thus had standing under Section 11.

In evaluating the Section 11 claim, the district court stated that 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'" to have standing.[85] The court found that, while there exists prior case law on the tracing requirement, the precise issue here was one of first impression, since the tracing requirement had never been applied in a direct listing where there was a simultaneous sale of both registered and unregistered shares. Prior case law had instead dealt with successive registrations

[80] *Id.* at 372–73.

[81] *Id.* at 373.

[82] *Id.* at 374–75.

[83] *Id.* at 375.

[84] *Id.* at 375.

[85] *Id.* at 378 (citing *In re* Century Aluminum Co. Sec. Litig., 729 F.3d 1104, 1106 (9th Cir. 2013)).

where a company issued a secondary offering to the public and had multiple registration statements.[86] Here, Pirani challenged Slack's sole registration statement that authorized its direct listing.

The district court's opinion depended solely on whether the court used the narrow or the broad reading of "such security," since the choice directly impacted whether Pirani could show standing.

Under the narrow reading,[87] it would have been impossible for Pirani to satisfy the tracing requirement. The narrow reading requires a plaintiff to show that his shares were acquired pursuant to the registration statement, but in Slack's case, both registered shares under the direct listing and unregistered shares authorized for sale under SEC Rule 144 were sold to the public simultaneously.[88] Thus, Pirani had no way of knowing whether his purchased shares were registered or unregistered ones and therefore could not satisfy the stringent standard imposed by the narrow reading. The key fact that made tracing impossible under the narrow reading in Slack's direct listing was the simultaneous offering of unregistered and registered shares.[89]

Alternately, under the broad reading, Pirani could have proved standing if his shares had been of the same nature as those issued under the registration statement. Thus, despite not knowing whether his shares were registered or unregistered ones, Pirani could have satisfied this requirement because all of Slack's shares were identical securities.

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86 *See, e.g.*, *In re Century Aluminum*, 729 F.3d at 1107 (9th Cir. 2013); Lee v. Ernst & Young, LLP, 294 F.3d 969, 972 (8th Cir. 2002); Krim v. pcOrder.com, Inc., 402 F.3d 489, 491 (5th Cir. 2005).

87 *See supra* Section III.A; Barnes v. Osofsky, 373 F.2d 269, 271 (2nd Cir. 1967).

88 Pirani v. Slack Technologies, Inc., 445 F. Supp.3d 367, 379 (N.D. Cal. 2020). The court viewed Slack's common stock as becoming available from two simultaneous entry points. *Id.* One was the registration statement and the other was Rule 144. *Id.*

89 *Id.*

Ultimately, the district court adopted the broad meaning because it believed the narrow reading would interfere with the goals of the Securities Act.[90] The Securities Act provides for remedial penalties when registration statement requirements have been violated. However, due to Rule 144, certain shares are exempted from registration. Normally, transactions subject to registration requirements and those that are exempt from registration happen at different time periods, but in Slack's direct listing, both transactions—the sale of registered and unregistered or exempted shares—occurred simultaneously.[91] The district court thought the narrow reading of "'such security' in the context of Slack's direct listing would cause the exemption provision of Section 4 to completely obviate the remedial penalties of Section[] 11," which would lead to "absurd or futile results . . . plainly at variance with the policy of the legislation as a whole."[92] Here, the court identifies that the narrow meaning would eliminate civil liability under the Securities Act, which is contrary to the statute's goal of full and fair disclosure in securities issuances. Thus, the district court holds that this unique circumstance—a direct listing where registered shares become available for sale simultaneously with shares exempted from registration—warrants the broader reading of "such security."[93]

Slack illustrates the district court's willingness to relax the pleading requirements to prevent insulating direct listings from liability under the Securities Act. Based on precedent and the narrow reading of "such security," the court should have affirmed the defendants' motion to dismiss with respect to the Section 11 claims, but the district court's analysis did not end here. Instead, the court looked at policy concerns. It agreed with the plaintiff that this view of the tracing requirement would "eviscerate the rights afforded by Section 11 and allow companies to eliminate Section 11 liability by

90 *Id.* at 380.

91 *See supra* Section II.B.3.

92 *Pirani*, 445 F. Supp.3d at 380 (citing EEOC v. Commercial Office Prod. Co., 486 U.S. 107, 120 (1988)).

93 *Id.* at 381.

releasing non-registered shares into the market at the same time as registered shares."[94] Thus, the court ignored precedent because it believed that the adverse policy consequences that would result would be detrimental to investors. However, the court did certify its decision for interlocutory appeal to the Ninth Circuit.

3. Judge Restani's Majority Opinion

On interlocutory appeal, the Ninth Circuit, in a 2-1 split, affirmed the district court's decision, but on a different legal basis.[95]

Like the district court, the Ninth Circuit agreed that *Slack* was a case of first impression, given the use of a direct listing.[96] However, unlike the district court, Judge Restani did not adopt the broad meaning of "such security" and did not focus her analysis of "such security" by looking at legal precedent.[97] Instead, she analyzed NYSE Section 102.01B, Footnote E, the regulatory change that allows companies to perform a direct listing.[98] In her view, the NYSE rule requires a company to file a registration statement to perform a direct listing, and this same registration statement allows it to sell registered and unregistered shares;[99] she explained her reasoning thus:

> Slack's unregistered shares sold in a direct listing are "such securities" within the meaning of Section 11 because their public sale cannot occur without the only operative registration in existence. Any person who acquired Slack shares through its direct listing could do so only because of the effectiveness of its registration statement.[100]

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94 *Id.* at 379.

95 Pirani v. Slack Technologies, Inc., 13 F.4th 940, 943 (9th Cir. 2021).

96 *Id.* at 946.

97 *Id.* at 946–47.

98 *See supra* Section II.B.2 for an analysis of Section 102.01B, Footnote E.

99 *Pirani*, 13 F.4th at 948.

100 *Id.* at 947 (emphasis added).

Thus, the court found that there was no tracing issue because all of Slack's shares could be traced to the single registration statement required by Section 102.01B, Footnote E.

In addition, the court also found that the legislative history of Section 11 supported this interpretation. The House Conference Report on the Securities Act stated that "[Sections 11 and 12] entitle the buyer of securities sold *upon a registration statement* including an untrue statement or omission of material fact, to sue for recovery."[101] Here, Slack's registered and unregistered shares were sold "upon a registration statement" because their shares could only be sold to the public once the statement became effective. This view, according to the court, is consistent with the drafters' intention to put the responsibility of fair dealing upon those who make material statements relevant to the purchase or sale of a security.[102]

Slack pressed for the Ninth Circuit to apply precedent on successive registration statements, which adopts the narrow reading of "such security" and would require the plaintiff to prove he purchased registered shares pursuant to a particular registration statement.[103] Like the district court, Judge Restani disagreed because such an application would undermine the purpose of Section 11. Under Slack's interpretation, companies would be incentivized to perform a direct listing over an IPO simply from a liability standpoint, which would allow them to file "overly optimistic" registration statements since they know that "they would face no shareholder liability under Section 11 for any arguably false or misleading statements."[104]

Thus, the majority, like the district court, prioritized policy concerns over precedent but did so through a different path of legal argumentation. Under the Ninth Circuit's view, Pirani could establish standing despite not being able to trace his

101 SAM RAYBURN, FEDERAL SUPERVISION OF TRAFFIC IN INVESTMENT, H.R. REP. NO. 73-85, at 5 (1933) (emphasis added).

102 *Pirani*, 13 F.4th at 947–48.

103 *Id.* at 948.

104 *Id.*

shares back to Slack's registration statement because Slack could not perform a direct listing without the registration statement required by Footnote E.

4. Judge Miller's Dissenting Opinion

Judge Miller, in his dissent, reasoned that Slack's motion to dismiss should have been granted in full.[105]

Judge Miller disagreed with both the district court and the majority's interpretation of "such security." Miller argued that since *Barnes*, every Court of Appeals, including the Ninth Circuit in *Hertzberg*, had adopted the narrow reading of "such security."[106] In Judge Miller's view, this alone resolved the case because Pirani could not show that the shares he had purchased were issued under the misleading registration statement, and thus he lacked standing to bring his Section 11 claim.[107]

In responding to the majority, Judge Miller correctly identified that the majority adopts neither the broad nor the narrow reading of "such security," which was articulated by Judge Friendly in *Barnes*. Instead, the majority analyzed Section 11's text and the NYSE rules to define "such security" as any security "whose public sale cannot occur without the only operative registration in existence."[108] Judge Miller accurately noted that this definition has no "basis in the statutory text," and that there is no substantial difference between direct listings and IPOs to justify such a departure from precedent.[109] Miller argued that even though the registration statement was essential to Slack's direct listing, that fact did not imply that all shares—registered or unregistered—were "issued" under that registration statement. Instead, most of Slack's shares that began trading

105 *Id.* at 950 (Miller, J., dissenting).

106 *Id.* at 952.

107 *Id.*

108 *Id.*

109 *Id.*

were issued "well before the registration statement was filed."[110]

In addition, Judge Miller argued that the majority misunderstood Section 11's legislative history. The phrase from the House Report that the majority used "plainly refers to 'registered securities.'"[111] The phrase does not reference unregistered securities that must wait until a registration statement to become effective before they can be sold on an exchange.

Lastly, Judge Miller was not persuaded that the impossibility of proving tracing would be detrimental to plaintiffs because the registration statement is still subject to liability under Section 10(b) of the Securities Exchange Act.[112] More importantly, he argued that even if there are policy issues, courts have no basis for "changing the settled interpretation of statutory text," and any changes must be made by Congress.[113]

IV. THE ARGUMENT FOR INTERVENTION

Having examined the *Slack* decision, I now move on to my main argument: Congress ought to re-examine Section 11, especially as it pertains to direct listings. I argue in Section IV.A that the post-*Slack* world is undesirable for the financial community. Section IV.B details that a world where the Supreme Court reverses *Slack* is also unwanted. Finally, Section IV.C makes the case for Congress or the SEC to intervene and proposes blockchain as a solution.

A. The Majority's Policy-Motivated Decision Creates

110 *Id.* at 953. Here, Judge Miller made a distinction between shares that were issued and shares that were sold. Slack issued shares to shareholders well before the registration statement was filed, but the registered shares could only be sold once the registration statement became effective. *Id.*

111 *Id.* (citing Barnes v. Osofsky, 373 F.2d 269, 273 (2nd Cir.1967)).

112 *Id.* (explaining that companies are still liable for materially false statements made with scienter under Section 10(b)).

113 *Id.* at 953.

Significant Problems

The *Slack* majority's interpretation of "such security" within Section 11 creates three separate problems: (1) it misunderstands Rule 144 and expands liability for direct listings; (2) it creates inconsistencies within Section 11; and (3) it conflicts with other circuits' interpretations of the phrase.

1. The Majority Misunderstood SEC Rule 144 and Expanded Liability for Direct Listings Beyond IPOs

The majority, in holding that Section 11 applied to unregistered shares, misunderstood Rule 144. Traditionally, securities may be sold if they are registered under an effective registration statement or if they are exempt under Rule 144.[114] The majority held that Slack's registered and exempt shares were equivalent and that both types fell within the meaning of "such security" within Section 11 because neither could be sold until Slack's registration statement became effective.[115] However, the majority cites nothing from the Securities Act or Section 11 to support this view.[116] In fact, the opposite is true. Because its 165 million unregistered shares were exempt from registration, the sale of those shares did not rely upon any registration statement and thus the shares could be sold "before, during, or after a registration statement is declared effective."[117] Thus, Slack's unregistered shares are not covered by the phrase "such security" because they could be sold independent of the registration statement's timing. Neither the direct listing nor Slack's registration statement was necessary for these unregistered shares to be sold.

In addition, such a view of "such security" unintentionally expands Section 11 liability for direct listings beyond liability

114 *See supra* Part II.

115 *Pirani*, 13 F.4th at 948.

116 *Id.*

117 Feldman et al., *supra* note 12.

in IPOs. In an IPO, an issuer company faces liability only for the shares it sold pursuant to a registration statement.[118] The majority's holding in *Slack* means that a company faces Section 11 liability for shares registered pursuant to a registration and for any exempted securities sold simultaneously.[119] This means that a "company faces *strict liability for shares it did not even register for sale*" because they would be liable for the sale of exempt securities by third parties.[120] In addition to expanding liability beyond a traditional IPO, it makes little sense to impose liability on a company for the actions of a third party even in a direct listing.

Ultimately, expanding liability potentially threatens the viability of direct listings.[121] Direct listings are a useful tool since they "offer startups' self-starters and angel investors the chance to reap returns on their high-risk investments" by offering the liquidity of a public market and enabling them to sell shares at a market price.[122] However, because Section 11 gives prospective plaintiffs access to strict liability, companies may find that the harms caused by shareholder litigation will outweigh the value obtained from a direct listing.

2. The Majority's Interpretation of "Such

118 *See supra* Section II.A.

119 Feldman et al., *supra* note 12.

120 *Id.* The following example illustrates how liability is expanded in a direct listing. Assume there is a company that has one million registered shares and one million shares that are exempted from registration under Rule 144. Assume that the company's misrepresentations caused the share price to decrease by $5/share. If the shares were sold in a traditional IPO, the company would be liable for damages of $5 million because the only shares sold in the IPO were the registered ones. If the shares were sold like in Slack's direct listing, the damages would be $10 million because the company would be liable for the decrease in value in both registered and unregistered shares. The majority's view of "such security" specifically holds that registered and unregistered shares would fall within Section 11's protections. *See id.*

121 Motion of the CATO Institute for Leave to File as *Amicus Curiae* in Support of Defendants and Appellants at 3, Pirani v. Slack Technologies, Inc., 13 F.4th 940 (9th Cir. 2020) (No. 20-16419).

122 *Id.* at 5.

Security" is Inconsistent with Other Uses of the Phrase in Section 11

The phrase "such security" appears numerous times within the Securities Act[123] and specifically within Section 11, but the majority only analyzes it in the context of Section 11(a). In fact, the phrases "such security" and "such securities" appear in the Securities Act at least 61 times.[124] Through the Securities Act, "such security" refers to "a specific security (or type of securities) at issue in the relevant provision," but the majority's interpretation from Section 11(a) refers to "both to a specific type of security (registered securities) at issue *and* to other, similar (but exempt) securities."[125] Thus, the majority unintentionally expands the kinds of securities covered under Section 11(a) beyond what is envisioned by the Securities Act.

In addition, the majority's interpretation of "such security" from Section 11(a) conflicts with the phrase's use in Section 11(e), which details how damages are calculated.[126] Section 11(e) caps damages to the "difference between the amount paid for the security" and the "price at which *such security* shall have been disposed of in the market before suit."[127] Under Section 11(e), "such security" refers to the specific shares owned by a plaintiff and not some hypothetical equivalent. Damages can only be calculated if the plaintiff can identify the price at which her specific share was purchased and then the price at which it was sold.[128] The majority's reading of "such security" means that it becomes "impossible to calculate damages for a specific share" because such an

123 For example, Section 5, Section 11(e), and Section 12 all use the phrase "such security." *See* 15 U.S.C. § 77e; 15 U.S.C. § 77k; 15 U.S.C. § 77e.

124 Brief of *Amicus Curiae* Former SEC Commissioner Joseph A. Grundfest in Support of Defendants'-Appellants' Petition for Rehearing and Rehearing *En Banc* at 10–11, Pirani v. Slack Technologies, Inc., 13 F.4th 940 (9th Cir. 2021) (No. 204-16419) [hereinafter *Brief of Grundfest*].

125 *Id.* at 11.

126 Feldman et al., *supra* note 12.

127 15 U.S.C. § 77k(e) (emphasis added).

128 Feldman et al., *supra* note 12.

interpretation includes securities that are alike, instead of being limited to the specific shares purchased.[129]

Thus, the majority's new interpretation of "such security" is untenable because it contradicts the phrase's meaning in both the Securities Act and within Section 11.

3. The Majority's Interpretation Conflicts with Other Circuits' Interpretations of Section 11 Liability and with the Ninth Circuit's Own Precedent

The *Slack* decision chooses to adopt neither the narrow nor the broad reading of "such security." Other circuits have consistently interpreted the phrase "such security" using the narrow reading for the last fifty years.[130] The majority based its departure from precedent on *Slack* being a case of first impression and the case not involving successive registrations, but the majority did not explain why these distinctions matter.[131] As Judge Miller correctly pointed out in his dissent, these distinctions make no difference, because in both direct listings and successive registrations, there is a mix of registered shares and unregistered, exempt shares.[132] Thus, even though *Slack* was a case of first impression, the facts were not new at all, and plenty of prior cases have dealt with a mix of both registered and unregistered shares.

In addition, the *Slack* decision departs from the Ninth Circuit's own precedent. As explained in Section III.A, the Ninth Circuit adopted the narrow reading of "such security" in *Hertzberg*. The majority tried to avoid *Hertzberg* by attempting again to make a distinction between cases that

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129 *Brief of Grundfest*, *supra* note 124, at 12.

130 Feldman et al., *supra* note 12; *see also* Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp., 632 F.3d 762, 768 & n.5 (1st Cir. 2011); APA Excelsior III L.P. v. Premiere Techs., Inc., 476 F.3d 1261, 1271 (11th Cir. 2007); Rosenzweig v. Azurix Corp., 332 F.3d 854, 873 (5th Cir. 2003); Lee v. Ernst & Young, LLP, 294 F.3d 969, 975–78 (8th Cir. 2002); Joseph v. Wiles, 223 F.3d 1155, 1159–60 (10th Cir. 2000).

131 Feldman et al., *supra* note 12.

132 *Id.*

involve multiple registration statements, but like before, this distinction misses the point.

The *Slack* majority effectively eliminated the tracing requirement in the direct listing, which undermines the entire legal framework underlying Section 11.

B. Supreme Court Reversal is Imminent, but Slack's Reversal Could Threaten Investor Protections

As explained in Section IV.A.3, the Ninth Circuit's ruling "disrupts decades of predictable, well-established jurisprudence" and departs from other circuits' and the Ninth Circuit's own precedent.[133] Legal commentators believe this warrants the Supreme Court's review and reversal.[134] As of December 13, 2022, the Supreme court has agreed to hear Slack's appeal.[135] If the Supreme Court were to reverse *Slack*, its ruling would effectively prevent investors from bringing Section 11 claims in a direct listing context because it is impossible to trace shares due to the simultaneous offering of unregistered and registered shares.[136] Judge Restani feared this when she wrote in her majority opinion 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 statement in a direct listing for both registered and unregistered shares."[137] This result is undesirable for several reasons.

First, Section 11 is an important provision for investor protections. Both Judge Miller and several legal commentators have argued that other provisions of the federal securities laws, including Sections 10(b) and 14(a) of the

133 *Id.*

134 *See id.* ("*Slack* represents a significant departure in the imposition of strict liability in securities regulation. . . . We believe this decision warrants reversal by the Supreme Court.").

135 Godoy, *supra* note 18.

136 *See supra* Section III.C.

137 Pirani v. Slack Technologies, Inc., 13 F.4th 940, 948 (9th Cir. 2021).

Securities Exchange Act, can protect investors.[138] While these arguments have merit, Section 11 is important because it offers investors access to a strict liability standard, and the SEC intentionally chose to subject companies that performed direct listings to Section 11 liability when it approved the NYSE Section 102.01B, Footnote E (the provision that allowed companies to perform direct listings on the NYSE).[139] Thus, reversing *Slack* would run contrary to the SEC's specific intention to subject companies who conduct direct listings to Section 11 liability.

In addition, shareholders bear much more of the costs of going public in a direct listing compared to IPOs, thereby justifying access to Section 11 claims. As detailed in Part I, in an IPO, underwriters or banks get to buy a company's stock at a discount, while new investors "pay around half of the bankers' fees" since they bear the cost of that discount.[140] In a direct listing, the company bears the cost of all the bank's fees because no new shares are issued, which is directly passed onto existing shareholders. Thus, since investors in an IPO pay less costs and have access to Section 11 liability, it follows that investors in a direct listing also ought to have access to Section 11 because they pay more than IPO investors do.

Second, *Slack's* reversal would encourage companies to engage in riskier behavior. Because it would be impossible for investors to have standing for Section 11 claims, companies could file overly optimistic registration statements "knowing that they would face no shareholder liability under Section 11 for any arguably false or misleading statements," which would

138 *See* Brief of *Amici Curiae* Securities Industry and Financial Markets Association, Chamber of Commerce of the United States of America, and National Venture Capital Association in Support of Defendants-Appellants at 6, Pirani v. Slack Technologies, Inc., 13 F.4th 940 (9th Cir. 2021) (No. 20-16419).

139 *See* Nickerson, *supra* note 6, at 1001.

140 Tatum Sornborger, *Move Over IPOs: Unicorn Direct Listings May Be the New Mythical Beasts in Town*, 26 FORDHAM J. CORP. & FIN. L. 215, 233 (2021).

create a "loophole large enough to undermine the purpose of Section 11 as it has been understood since its inception."[141]

While there are business-related reasons for a company to choose a direct listing over an IPO, *Slack*'s reversal would certainly open the possibility for companies to abuse Section 11's current legal regime. In fact, one law firm has praised this feature of direct listings. Latham & Watkins, the law firm that acted as counsel to Spotify in their direct listing, proclaimed that an important advantage of performing a direct listing is "the potential to deter private plaintiffs from bringing claims under Section 11."[142] The firm's commentators, like Judge Restani, recognized that "few (if any) purchases will be able to trace their stock to the challenged registration statement" since "both registered and unregistered are immediately sold into the market in a direct listing."[143] Thus, while it is uncertain how companies will react to *Slack*'s potential reversal, there is great potential for law firms to advise companies about this legal loophole.

Therefore, *Slack*'s reversal threatens the adequacy of investor protections and introduces the opportunity for companies to abuse the legal regime surrounding Section 11 in direct listings.

C. Congress and the SEC Ought to Re-Examine Section 11 as it Applies to Direct Listings

Sections IV.A and IV.B have shown that both worlds—one where the *Slack* decision continues to be good law and one where the Supreme Court reverses *Slack*—are undesirable for several reasons. Given this, Congress ought to intervene to "fix" Section 11 and the tracing requirement as it relates to direct listing. This section makes the argument by showing that courts do not have the tools to fix the issue and have

141 *Pirani*, 13 F.4th at 948.

142 *See* Andrew Clubok et al., *Complex and Novel Section 11 Liability Issues of Direct Listings*, CORPORATE COUNSEL (Dec. 20, 2019), https://www.lw.com/thoughtLeadership/section-eleven-liability-direct-listings [https://perma.cc/L9ZA-2VKY].

143 *Id.*

asked Congress to fix Section 11. It concludes by discussing potential solutions Congress can investigate.

1. Courts are Unequipped to Resolve the Problems with Section 11 and the Tracing Requirements and Have Asked Congress to Intervene

Over time, courts have identified several problems with the tracing requirement even outside the direct listing context. For example, in 2013, the district court in *In Re Century Aluminum* stated that tracing shares, in general, is "often impossible" because "many brokerage houses do not identify specific shares with particular accounts but instead treat the account as having an undivided interest in the house's position."[144] Slack's direct listing exacerbated the problems with the tracing requirement because it became entirely impossible for an investor like Pirani to trace his shares back to the registration statement.[145]

Plaintiffs have cited these problems with the tracing requirement; but while judges are sympathetic, they have refused to change the doctrine. For example, the plaintiffs in *Barnes* made the same argument as Pirani in *Slack* that it would be impossible for them to plead a Section 11 claim because they could not determine whether their shares had been issued under the challenged registration statement.[146] As explained previously, Judge Friendly ultimately rejected their argument, but he did note that their argument could suggest that it might be time "for Congress to re-examine [the Securities Act and the Exchange Act] in light of thirty years' experience."[147]

Overall, despite these issues, courts, until *Slack*, have continued to enforce the tracing requirement because it is "the condition Congress has imposed for granting access to the

144 *In re* Century Aluminum Co. Sec. Litig., 729 F.3d at 1107 (quoting Barnes v. Osofsky, 373 F.2d 269, 271–22 (2nd Cir. 1967)).

145 *See supra* Section III.C.2.

146 Barnes, 373 F.2d at 272.

147 *Id.* at 273.

'relaxed liability requirements' § 11 affords."[148] However, the strict liability standard has no value to plaintiffs if it is impossible to successfully plead facts that satisfy the tracing requirement.

Analyzing the *Slack* decision leads to two conclusions. First, the decision shows why courts are ill-equipped to fix the tracing doctrine. The majority's decision has been heavily criticized by various commentators.[149] However, these critics do not consider that "compared to Congress, the SEC, and the exchanges, the courts are ill-equipped to see through the complex interplay between regulations and economic incentives at work in Section 11."[150] Instead, it should be "up to lawmakers and regulators to alter Section 11, should they find that statute's balance is not being served for direct listings."[151] Judges are not in a position to rewrite the statute, especially in the direct listing context given that it is a novelty in the already extremely complicated process of a company going public.

Second, the strained majority opinion was, arguably, a byproduct of the problems with the tracing doctrine. *Slack* showed that Section 11 does not work in the direct listing context, and the majority, acknowledging these problems, used the unique circumstances of a direct listing to justify its departure from precedent because it believed that investors would be significantly harmed without access to Section 11.

Ultimately, the problems with the tracing requirement are not new. Judges are either forced to follow precedent (thereby disadvantaging plaintiffs) or depart from precedent (thereby facing criticism for "legal activism"). This is exactly what happened in *Slack*. The majority chose to depart from precedent and faced severe backlash from legal commentators, while the dissent recognized these issues but

148 *In re* Century Aluminum, 729 F.3d at 1107 (quoting Abbey v. Computer Memories, Inc., 634 F. Supp. 870, 875 (N.D. Cal. 1986)).

149 *See supra* Section IV.A.

150 Motion of the CATO Institute for Leave to File as *Amicus Curiae* in Support of Defendants and Appellants at 7, Pirani v. Slack Technologies, Inc., 13 F.4th 940 (9th Cir. 2020) (No. 20-16419).

151 *Id.*

concluded that the court had "no basis for changing the settled interpretation of the statutory text" and noted that it is Congress's responsibility to make new legislation or change the problems with old legislation.[152] Neither approach is desirable, and thus, Congress or the SEC must step in.

2. Congress and the SEC Should Intervene to Change Section 11 as it Applies to Direct Listings

i. The SEC and Congress Have Authority to Change Section 11's Bearing on Direct Listings

The problems articulated in Part IV are sufficient to raise SEC or Congressional review of the NYSE rules.

First, the SEC can only approve rule changes if it finds that the change would be "consistent with the requirements of this chapter and the rules and regulations issued under this chapter that are applicable to such organization."[153] The organization at issue here is the NYSE, a public exchange. Under Section 6(b)(5) of the Exchange Act, the SEC is required to ensure that exchange rules are

> designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.[154]

Thus, the SEC is tasked with creating exchange rules that both prevent fraudulent and manipulative acts and protect

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[152] Pirani v. Slack Technologies, Inc., 13 F.4th 940, 953 (9th Cir. 2021) (Miller, J., dissenting).

[153] 15 U.S.C. § 78s(b)(2)(C).

[154] 15 U.S.C. § 78f(b)(5) (emphasis added).

investors. Here, *Slack*'s reversal would invite companies to act fraudulently because they do not have to fear Section 11 liability and could invoke investor protection issues because investors cannot prove tracing in the direct listing context.

Second, assuming the Supreme Court reverses *Slack*, Congress is authorized to override the Supreme Court's decision because the reversal concerns a question of statutory interpretation.[155] While the traceability requirement is a judge-made doctrine, it is fundamentally based upon Section 11's text and, specifically, the phrase "such security." Thus, Congress is also warranted in changing this doctrine based upon the interpretation of a statute.

ii. Blockchain has the Potential to Fix Tracing Issues in Direct Listings

a. Background on Blockchain

Blockchain technology, known as distributed ledger technology, is a relatively new type of information technology that is used to record "transactions involving assets without the need for a central intermediary to track ownership of those assets in an authoritative ledger."[156] Blockchain's founder, an unidentified person under the alias "Satoshi Nakamoto," identified a problem. He noticed that business on the internet relied on financial institutions to serve as trusted third parties to process electronic payments, which generated costs in the form of fees.[157] Nakamoto believed this arrangement to be inefficient; he thought that an electronic payment system based on cryptographic proof would allow two parties to transact directly with each other, rather than relying on a third party.[158]

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155 An empirical study shows that, from 1975 to 1991, on average, each Congress had overridden about a dozen of the Supreme Court's statutory decisions. William N. Eskridge, Jr., *Overriding Supreme Court Statutory Interpretation Decisions*, 101 YALE L. J. 331, 335–36 (1991).

156 J. Travis Laster & Marcel T. Rosner, *Distributed Stock Ledgers and Delaware Law*, 73 BUS. LAW. 319, 319 (2018).

157 *See id.* at 320.

158 *See id.*

Blockchain has two critical features: a distributed ledger and a method for updating that ledger by consensus.[159] A ledger is a "database of all recorded transactions related to the ownership of the asset tracked by the ledger."[160] In a distributed ledger system, all participants have copies of the same ledger, and each can see a record of every transaction that has occurred.[161] The core of blockchain's technology is the distributed ledger because, if used correctly, it would replace the need for third parties in transactions. Blockchain's distributed ledger functions properly because all participants work together to update it whenever a transaction takes place.[162]

This is where the second feature comes in; blockchain uses a concept called "proof of work" to verify transactions. Under this approach,

> a network participant must first perform the work necessary to assemble a series of proposed transactions into a group. Each group of proposed transactions is called a block, giving rise to the "block" in "blockchain." Each block is linked mathematically to the block posted immediately before it in time, giving rise to the term "chain" in "blockchain." Network participants who add blocks to the ledger are called "miners," and they receive a reward of newly minted bitcoins and transaction fees to compensate them for the work necessary to assemble and validate a new block.[163]

Once a miner assembles a new block, it sends it to the network, and if most other participants verify the solution, then the block will be added to the distributed ledger.[164] Thus, blockchain works through an incentive system where a miner's work will be "checked" by her peers and is motivated

159 *Id.*

160 *See id.* at 322.

161 *Id.*

162 *See id.*

163 *Id.* at 324.

164 *Id.*

by the reward of bitcoin, a type of digital currency used in blockchain.[165]

b. Blockchain Technology in Stock Ledgers and Application to Tracing in Direct Listings

A stock ledger is a type of ledger that shows all legally relevant transactions in a corporation's stock, including information on the date of the transaction, the number of shares acquired, and more.[166] Stock ledgers have normally been maintained centrally by corporations, but over time, corporations have outsourced this work to the Depository Trust Company (DTC), a central intermediary that holds over 75% of the shares of publicly traded companies.[167]

Delaware recognized the value of using blockchain technology in stock ledgers. In May 2016, Delaware's then-Governor Jack Markell announced the Delaware Blockchain Initiative, which expressly authorized using blockchain's distributed ledger to track ownership of a corporation's shares.[168] From its initial issuance, a share of stock would have an encrypted record of its ownership history, and using this record, stockholders could tell where the share came from.[169]

This alone has incredible potential in direct listings; applying blockchain to Slack's direct listing would have resolved *Slack*'s tracing issue entirely. If Slack were required to register their shares using blockchain, a network participant could determine where an investor's shares came

165 *Id.* at 324–25.

166 *Id.* at 325.

167 *Id.* at 325–26.

168 *Id.* at 327, 329. Delaware State enacted three blockchain amendments to Del. Code Ann. Tit. 8, §219, 224, 23 (2022). These amendments ensured that Delaware corporations could use blockchain technology to create distributed stock ledgers. *See id.* at 327–30.

169 Jonathan Rotenberg, *Blockchain Technology May Enable Tracing in Securities Act Litigation*, KATTEN (Mar. 22, 2018), https://katten.com/blockchain-technology-may-enable-tracing-in-securities-act-litigation-1 [https://perma.cc/333Z-FHBV].

from because that information would be contained within blocks. Thus, an investor like Pirani would have the potential to know whether his shares were registered or unregistered ones. If his shares were sold by an investor who was authorized to sell shares pursuant to Rule 144, then Pirani's shares would be unregistered ones, while if his shares were sold by an investor authorized to sell shares pursuant to Slack's registration statement, then Pirani's shares would be registered ones. Thus, if implemented correctly, blockchain could seemingly solve all problems with the tracing requirement, especially in the context of, but even beyond, direct listings.

c. Congress or the SEC Ought to Either Require or Encourage Blockchain-Based Stock Ledgers

Congress or the SEC have two possible approaches to introducing blockchain. Either they can require companies to register their shares using blockchain, or they can expressly authorize blockchain-based stock ledgers and let market forces push companies to adopt them.

The former approach would involve Congress or the SEC promulgating a rule requiring all of a company's publicly traded shares to be offered on a regulated blockchain platform. The principal benefit of mandatory regulations is that Congress or the SEC could specify and control how blockchain technology ought to be implemented to maximize its efficiency and usefulness.

However, this approach assumes that both Congress and the SEC fully understand blockchain and its ramifications. Even though Congress has made efforts to comprehend blockchain,[170] it would likely take months or years for either

[170] The Congressional Blockchain Caucus and its members advocate for the future of blockchain technology and urge Congress to put resources toward understand the technology. It was founded in 2016. *About*, CONG. BLOCKCHAIN CAUCUS, https://congressionalblockchaincaucus-schweikert.house.gov/about [https://perma.cc/LDD8-DRWF] (last visited Jan. 9, 2023).

Congress or the SEC to formulate coherent regulations for blockchain stock ledgers and even longer for companies to adhere to those regulations. Thus, while compulsory regulations are ideal in a vacuum, blockchain's complexity and the associated costs of research and implementation make such mandatory regulations a difficult option.

In addition, the SEC's past efforts to compel decimalization[171] create doubt about whether companies would be receptive to compulsory blockchain regulations. In 1997, Congress announced that it would direct the SEC to adopt rules mandating decimalization, and most U.S. markets planned to make the switch by 2000.[172] At the time, it was thought that decimalization had clear benefits, but it has since proven to be damaging to U.S. markets.[173] Blockchain regulations, like decimalization ones, would be a massive shift in market strategies, and companies may fear and oppose another government mandate given decimalization's history.[174] Thus, both blockchain's complexity and the SEC's past regulations regarding decimalization are serious obstacles to this method.

Although a mandatory blockchain regime has its issues, there is potential for market forces to encourage companies to adopt blockchain-based stock ledgers. An example of this latter approach is Delaware's blockchain initiative and amendments, which made it permissible for Delaware companies to use blockchain technology to maintain stock ledgers and communicate with shareholders.[175] After the blockchain amendments passed, it was up to Delaware corporations to begin researching ways to implement this

171 "Decimalization describes listing stock prices in penny increments rather than in the long-standing American method of 1/8th of a dollar increments." Sean Belcher, *Tracing the Invisible: Section 11's Tracing Requirement and Blockchain*, 16 COLO. TECH. L.J. 145, 168 (2017).

172 *Id.* at 168.

173 Decimalization made it significantly harder for small companies to find IPO underwriters, drastically increased market volatility, decreased liquidity, and increased the price-per-trade for investors. *Id.* at 169.

174 *See id.* at 169.

175 Laster & Rosner, *supra* note 156, at 330.

technology.[176] Given the benefits arising from a blockchain-based stock ledger,[177] market forces should push companies toward adopting the technology.

It is important to note that, even if corporations choose to adopt blockchain by themselves, any blockchain-based system will "require standardization from the market's self-regulatory bodies to be effective and sufficiently transparent."[178] This method would certainly be easier for Congress or the SEC to implement because Delaware has already paved the legal framework necessary for companies to use blockchain in stock ledgers. Congress or the SEC can model their regulations off of the Delaware General Corporation Law, which would be more straightforward to execute than the former approach. Indeed, while both approaches certainly have merit, Delaware chose to let market forces decide corporation's behavior, and this seems like the preferable option.

V. CONCLUSION

Overall, the controversial *Slack* decision is a byproduct of the problems with the tracing doctrine. The Supreme Court has already agreed to take the case, but regardless of the outcome, Congress and the SEC still ought to address the issue. Using blockchain technology would be an effective way for Congress and the SEC to ameliorate the tracing problems articulated in *Slack*, and blockchain's application to tracing could resolve decades of problems with the doctrine. If done successfully, investors will be adequately protected, and

176 *Id.* at 331.

177 An analysis of Delaware's blockchain initiative shows that a blockchain-based stock ledger would make property rights clearer, add transparency and greater accuracy to both proxy voting and dividend payments, and make securities lending records more accurate. *See* Andrea Tinianow, *Delaware Blockchain Initiative: Transforming the Foundational Infrastructure of Corporate Finance*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 16, 2017), https://corpgov.law.harvard.edu/2017/03/16/delaware-blockchain-initiative-transforming-the-foundational-infrastructure-of-corporate-finance/ [https://perma.cc/79XP-L8N4].

178 Belcher, *supra* note 171, at 170.

companies will not face superfluous liability. Both outcomes will encourage corporations like Slack to continue using direct listings. However, because blockchain is a new, complex technology, it will take time to fully understand and put in place regulations that optimize blockchain's efficiency and usefulness. If blockchain is ultimately unsuccessful, Congress or the SEC may be forced to abandon the tracing requirement in the direct listing context entirely and create a new legal regime for direct listings.

Ultimately, the status quo is undesirable, and change ought to take place. Further research into blockchain technology and its application to stock ledgers and tracing is a step in the right direction.