No. 20-16419

IN THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

FIYYAZ PIRANI,
Plaintiff and Appellee,
v.
SLACK TECHNOLOGIES, INC., ET AL.,
Defendants and Appellants.

On Interlocutory Appeal from the United States District Court for the Northern District of California, No. 3:19-cv-05857-SI (Hon. Susan Illston)

BRIEF OF THE CATO INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF DEFENDANTS AND APPELLANTS

Jennifer J. Schulp
Counsel of Record
Ilya Shapiro
Sam Spiegelman
CATO INSTITUTE
1000 Mass. Ave., N.W.
Washington, DC 20001
(202) 842-0200
jschulp@cato.org

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INTEREST OF *AMICUS CURIAE*[1]

The Cato Institute is a nonpartisan public policy research foundation founded in 1977 and dedicated to advancing the principles of individual liberty, free markets, and limited government. Cato's Center for Monetary and Financial Alternatives reveals the shortcomings of today's monetary and financial regulatory systems and identifies and promotes alternatives more conducive to a stable, flourishing, and free society. Cato's Robert A. Levy Center for Constitutional Studies helps restore the principles of constitutional government that are the foundation of liberty. Toward those ends, Cato publishes books and studies, conducts conferences, produces the annual *Cato Supreme Court Review*, and files *amicus* briefs.

This case interests *amicus* because the district court's erasure of Judge Friendly's tried-and-true "tracing" requirement for direct listings threatens to expand Section 11's jurisdiction beyond its intended boundaries, disincentivizing an alternative to a traditional initial public offering that shows wealth-creating potential. Cato's commitment to a free and prosperous market compels it to ask the Ninth Circuit to reverse the district court's order as it relates to Section 11.

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[1] Fed. R. App. P. 29 Statement: No counsel for either party authored this brief in whole or in part. No person or entity other than *amicus* made a monetary contribution to its preparation or submission. Pursuant to Ninth Circuit Local Rule 29(a)(2), all parties have been notified of the filing of this brief. Counsel for plaintiff-appellee withheld consent, so *amicus* has filed a motion for leave to file this brief.

INTRODUCTION AND SUMMARY OF THE ARGUMENT

Since the venerable Judge Henry Friendly elaborated the requirement in *Barnes v. Osofsky*, courts have held firm to the rule that in order to maintain an action under Section 11 of the Securities Act of 1933, a claimant must be able to "trace" their shares to the registered offering in which alleged misrepresentations or omissions were made. 373 F.2d 269 (2d Cir. 1967). Without a tracing requirement, imposition of Section 11's strict-liability standard would disregard the text's plain meaning and contravene the Securities Act's purpose. Moreover, the district court's singular departure from the tracing requirement for direct listings could hamper the use of direct listings and other nontraditional offering types permitted by the Securities Act, which have the potential to serve the needs of companies and investors in ways that traditional initial public offerings cannot.

The plain meaning of Section 11's text limits its application to "such securit[ies]" sold in a registered offering, restricting standing to shareholders who prove the securities they purchased were offered through a registration statement that included alleged misstatements or omissions. 15 U.S.C. § 77k. The customary tools of statutory construction bear this out.

Looking past the statute's language, the legislative and political history of the Securities Act shows that Section 11 was meant to impose strict liability for material misstatements. But for this demanding standard to work in accordance with, and not against, the Act's overarching purpose of necessary disclosure, Section 11's jurisdiction must be limited to shares purchased in a registered offering. To preserve market efficiency as the Securities Act intended, Section 11 cannot extend to *all* sales of an issuer's securities following a registered offering, whether or not those shares were a part of that offering. The tracing requirement ensures that Section 11 stays within these purpose-driven boundaries.

Congress and the Securities and Exchange Commission (SEC) have long determined that the cost imposed by attaching liability to disclosure is worth it—at least to an extent. But at some point the price tag is simply too great, and Section 11 draws that line by limiting the universe of plaintiffs who have standing to pursue claims.

In the direct-listings context in particular, strict liability without tracing could impose costs that outweigh benefits earned by going public, upsetting the cost-benefit balance Congress intended in the Securities Act. This imbalance could disincentivize early employees and investors—who benefit from direct listing—from contributing their time and money into startups.

ARGUMENT

Expanding Section 11 by removing the tracing requirement misapprehends both the words and purpose of the provision and threatens a strong incentive for early investments in startups that are crucial sources of economic and technological innovation.

I. SECTION 11'S TEXT LIMITS IT TO "SUCH SECURIT[IES]" SOLD THROUGH THE REGISTRATION STATEMENT

Section 11 of the Securities Act of 1933 reads, in relevant part:

> 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 . . . sue (1) every person who signed the registration statement; (2) every person who was a director of . . . or partner in the issuer at the time of the filing of the part of the registration statement to which his liability is asserted; (3) every person who, with his consent, is named in the registration statement as being or about to become a director . . .; (4) every accountant, engineer, appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement . . . (5) every underwriter with respect to such security . . .

15 U.S.C. § 77k(a). This statute affords strict liability against a host of potential defendants for untrue statements or omissions of material fact in a registration statement, limiting the right to sue to "any person acquiring such security." The question is what the statute means by "such security."

Two longstanding interpretative canons make clear that Section 11's text limits the right to sue to an individual who has purchased a security offered pursuant to the allegedly defective registration statement.[2] The most obvious is the "ordinary-meaning rule," in which "[w]ords are to be understood in their ordinary, everyday meanings. . ." Antonin Scalia & Bryan A. Garner, *Reading Law: The Interpretation of Legal Texts* 69 (2012). Here, given the antecedent reference in Section 11 to a "registration statement," "such" means "that or those" shares "having just been mentioned" implicitly in the preceding reference to a "registration statement." *Black's Law Dictionary* 1661 (Bryan A. Garner ed., 10th ed. 2014) (defining "such," in part, as "[t]hat or those; having just been mentioned"). While not stated explicitly, registered shares are mentioned implicitly because the existence of a registration statement by its nature requires to have been registered. This is "the more natural" reading of the statute, as Judge Friendly recognized in *Barnes*. 373 F.2d at 271.

Understanding "such security" to mean one offered pursuant to the registration statement is also consistent with the canon of construction that a term carries the same meaning throughout a statute, known as "the presumption of consistent usage." Scalia & Garner, *supra*, at 170. Several other references to "such security" in the Securities Act also only make sense if referring to a limited set of securities, and not other securities of the same corporation. For example, Section 5(c) prohibits the use of interstate instruments of communication to offer to sell "any

[2] Note that these canons of construction are in addition to the several others discussed in Opening Br. for Defendants and Appellants, 31–36, 39–42.

security," "unless a registration statement has been filed as to such security. . ." 15 U.S.C. § 77e(c). "Such security" there cannot mean *all* of that company's securities, but only those subject to the referred-to registration statement. This self-evident definition of "such security" repeats itself throughout the Act, and there is no textual (or other) reason to graft a different meaning to Section 11's use of "such security."

In light of these two canons, limiting Section 11 to shares offered through a registration statement gives the words their intended purpose, and the tracing requirement sees to this purpose in situations where the shares may have changed hands since the initial purchase.

II. LEGISLATIVE HISTORY AND POLITICAL CONTEXT SUPPORTS REQUIRING SECTION 11 CLAIMANTS TO TRACE THEIR SHARES TO A REGISTRATION STATEMENT

A. The Tracing Requirement Reflects the Courts' Role as Interpreters of the Law

Judge Friendly's holding in *Barnes v. Osofsky* that a claimant must trace their shares to the registration statement containing the alleged misstatement or omission ensures that Section 11 is applied as intended. Judge Friendly was faithful to the common understanding at its passage that the Securities Act should require disclosure necessary to eliminate (or greatly reduce) fraudulent offerings, without then punishing honest issuers by imposing potentially chilling costs in all circumstances. In other words, the Securities Act was intended to provide truthfulness to the extent necessary to ensure fairness, as Congress judged it, beyond which organic market forces control. Section 11's tracing requirement reserves its exacting liability standard for plaintiffs holding shares were registered on misstatements.

Section 11 is part of a comprehensive liability scheme, in which Section 10(b) of the Securities Exchange Act of 1934 casts a catch-all net against *intentional* misstatements or omissions. 15 U.S.C. § 78j(b). Section 10(b) is not tied to the registration statement, and its scope of potential plaintiffs is not so limited, but its liability is limited to *intentional* misstatements. Further, the Securities Act antifraud provisions, Sections 12(2) and 17, "are not limited to the newly registered securities," but require scienter) as well. *Barnes*, 373 F.2d at 272. For decades, these provisions have together worked to reduce the incidence of carelessness and fraud. There is no reason to believe they cannot continue to do so in the direct-listing context.

Judge Friendly's analysis looked to a legislative history replete with considered discussion of the limits of disclosure. Cutting to the quick, Judge Friendly held that the "broader reading" of Section 11 as applying to all purchasers, regardless of whether they could trace the purchase of their shares to the registration statement, "would be inconsistent with the over-all statutory scheme." *Id.* at 272. The one mention in the *Congressional Record* of the intent to apply Section 11 "regardless of whether [purchasers] bought their securities at the time of the original offer or at some later date," does not reduce or remove the requirement that a claimant prove their shares belonged to the closed set offered in the registration statement, it simply extends standing to secondary and tertiary purchasers of the same set of securities. 373 F.2d at 272–73 (internal citations omitted) (reasoning it "unlikely that the section developed to insure proper disclosure in the registration statement was meant to provide a remedy for other than the particular shares registered").

Courts considering Section 11's tracing requirement have widely followed Judge Friendly's requirement, despite difficulties faced by plaintiffs in tracing their securities. *See generally* Hillary A. Sale, *Disappearing Without a Trace, Sections 11 and 12(a)(2) of the 1933 Securities Act*, 75 Wash. L. Rev. 429 (2000) (survey of post-*Barnes* judicial treatment of the tracing requirement); *see also, e.g.*, *Bradley v. ARIAD Pharms.*, 842 F.3d 744, 755 (1st Cir. 2016); *Krim v. pcOrder.com, Inc.*, 402 F.3d 489, 495 (5th Cir. 2005). In *Krim*, for example, where the district court determined that all but one of the claimants could not trace their shares to the registration statement, the Fifth Circuit emphasized that because "Section 11's liability provisions are expansive—creating 'virtually absolute' liability . . . for even innocent material misstatements," "its standing provisions limit putative plaintiffs to the 'narrow class of persons' . . . who purchase securities that are the direct subject of the prospectus and registration statement." *Id.* (internal citations omitted).

One district court offered perhaps the best explanation for Congress's prerogative here:

> [R]igid application of the tracing requirement is a product of Congress['s] decision to balance the low-burden substantive proof [with a] high-burden standing requirement, and courts should not abrogate the congressional intent by expanding the 'virtually absolute' liability to claims of purchasers whose securities cannot be traced.

In re FleetBoston Fin. Corp. Sec. Litig., 253 F.R.D. 315, 347 (D. N.J. 2008). *See* Ken Cunningham et al., *Litigating Section 11's Tracing Requirement: A Practitioner's View of a Powerful Defense*, Bloomberg Law: Professional Perspective, 2 (2019) (quoting *FleetBoston*, adding "[the] tracing requirement is integral to Congress's decision to relax the liability requirements for a Section 11 claim" because the provision "does not require . . . [proof of] scienter or loss causation" or "proof of reliance"). In sum, courts have found consensus that even where it is difficult or infeasible for a claimant to trace their purchase, they should not intervene to determine a "fair" outcome.

B. Views Among Contemporary Lawmakers and Commenters Support Tracing

Congressional hearings ahead of the Securities Act's passage reveal that Congress was searching for a delicate balance of disclosure to reduce fraud and misinformation without pricing too many transactions out of the marketplace. Then-former FTC Commissioner Huston Thompson, in lead testimony before the House on his earlier version of what would eventually become the Securities Act, opined that "[t]he purpose and policy here is to protect, first of all, the purchaser of securities, and, second, honest business houses that are selling securities, with as little interference with business as possible." *Federal Securities Act, Hearing Before the Committee on Interstate and Foreign Commerce on H.R. 4314*, 73d Cong., Sess. 1, 12 (1933). Thompson made clear that the federal law would not include FTC approval of a registration based on the soundness of a security proposed to be offered (in contrast to state "blue sky" laws' typical merits-review process): "If you are to thrust upon the [FTC] the requirement to review and pass upon [every registration], you would slow up the business." *Id.* at 140.

Despite these assurances, Thompson's draft was rejected in part because it was *too* interventionist. Elisabeth Keller, *A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 Ohio St. L.J. 329, 339 (1988) (noting that "[a] considerable amount of criticism" rested on the "power to revoke any security . . . found not to be based upon sound principles," which "seemed to be at odds with the principle of regulation through disclosure rather than through substantive intervention.").

Future Supreme Court justice Felix Frankfurter revised Thompson's draft to emphasize disclosure over preclearance, leading a drafting team that included eminent lawyer James Landis (who would serve as the second chairman of the SEC). Frankfurter wished to "save capitalism from the evil of capitalists," but rejected "more ambitious ideas for the social control of finance, such as . . . direct governmental control of securities issues." Adam C. Pritchard & Robert B.

Thompson, *Securities Law and the New Deal Justices*, 95 Va. L. Rev. 841, 848, 854 (2009).

Section 11 is part and parcel of that statutory scheme, which emphasized an "underling policy of disclosure" and took "care[] not to give any appearance that the government either approved or guaranteed the newly issued securities." *Id.* at 342–43. Landis spoke of Section 11 liability strictly in terms of the registration statement, and not in any broader reference to extra-textual fairness. *See generally* James M. Landis, "Speech Before the New York State Society of Certified Public Accountants," Oct. 30, 1933, https://bit.ly/2I1q4KK.

Landis was not alone in viewing Section 11 exclusively through the lens of an anchoring registration statement. During pre-enactment hearings in the House, it was observed that Section 11 would "accord a remedy to all purchasers who may reasonably be affected by any statements in the registration statement," but that "fundamentally, [Section 11] entitle[s] the buyer of securities sold upon a registration statement including an untrue statement or omission of a material fact to sue for recovery of his purchase price, or for damages." H.R. Rep. No. 85, 73d Cong., 1st Sess., 9 (1933). *See Barnes*, 373 F.2d. at 273 (reasoning that these quotes from the congressional record "can be read to relate only to the extension of liability to open-market purchasers of the registered shares"). Justice Ruth Bader Ginsburg, in considering Section 11's legislative history, noted that "[t]he point made by the

[House] Report, moreover, is that the civil liability sections are exacting." *Gustafson v. Alloyd Co.*, 513 U.S. 561, 600 n.4 (1995) (Ginsburg, J., dissenting). *See also* Krista L. Turnquist, *Pleading Under Section 11 of the Securities Act of 1933*, 98 Mich. L. Rev. 2395, 2405 (2000) (citing H.R. Rep. No. 85 at 10, where a participant remarked that "[t]he connection between the statements made and the purchase of a security is clear, and, for this reason, it is the essence of fairness to insist upon the assumption of responsibility for the making of these statements").

In view of Thompson's stage-setting, Frankfurter's balancing, and Landis's precision, it is clear that reformers in the 1930s sought greater regulation, but with specificity sufficient to cabin its effects within prescribed limits, with no room for courts to widen their scope.[3] In this light, a broad reading of Section 11 that would extend its jurisdiction to all securities sold in a post-registration period would indeed be a "violent departure from the words that a court could . . . properly adopt." *Barnes*, 373 F.2d at 271.

Legal commenters at the time recognized that new securities regulations were meant to compel disclosure without hampering the speculative impulse driving market growth. One contemporary scholar wrote that "the primary objective of the

[3] For a brief history of the timeline from Thompson's to Frankfurter's draft, see "431 Days: Joseph P. Kennedy and the Creation of the SEC (1934-1935), Politicians and Professors, Progressive Reform and the Securities Act," Securities and Exchange Commission Historical Society, https://bit.ly/2SAxvuD (last visited Oct. 8, 2020).

Act is preventive vigilance . . . to secure accuracy in information" so that "if one so desires, he can exercise his privilege to speculate." John C. Doerfer, *The Federal Securities Act of 1933*, 18 Marq. L. Rev. 147, 165 (1934). Reforms, then, should facilitate educated speculation through compelled disclosure, rather than reduce the incentives for speculation through preemptive controls. The then-director of the FTC's Securities Division echoed this sentiment, announcing in a speech in late 1933:

> It has been constantly reiterated by the President, by the Congress, and by the Federal Trade Commission that the Federal Government does not guarantee . . . the possibilities of [a security's] success, or the truth of [the issuer's] statements regarding it.

Baldwin B. Bane, "Address of Baldwin B. Bane, Chief, Securities Division of the Federal Trade Commission, on the Securities Act of 1933, Before the Bond Club of Philadelphia," Dec. 21, 1933, https://bit.ly/3lko5zO.

Section 11 without a tracing requirement would undermine the Securities Act's scheme of *necessary* disclosure—i.e., disclosure that does not unduly inhibit growth—by expanding the strict liability of Section 11 beyond the narrow set of plaintiffs entitled to pursue it.

C. The Securities Act Does Not Support a Special Rule for Direct Listings

Section 11 does not call for a special rule exempting direct listings from its carefully balanced liability scheme. The suggestion that removing the tracing requirement for the direct listing somehow *fulfills* the Securities Act's regulatory function is at odds with the limited availability of the strict liability remedy. Courts have time and again found that difficulties in tracing a security, in a traditional initial public offering, do not excuse the plaintiff from the requirement.

Accepting that the mechanics of tracing may be even more difficult in the direct listing context, Section 11 should still not be bent to a special circumstance. *See* Andrew Clubok et al., "Complex and Novel Section 11 Liability Issues of Direct Listings," Corporate Counsel, Dec. 20, 2019, https://bit.ly/3ogUIjU. The existing regulatory framework, which emphasizes a pro-growth disclosure regime, gives the direct listing its economic potential. Judicially altering Section 11's coverage for direct listings would undermine the Securities Act's underlying philosophy of necessary disclosure. Moreover, because the issuer in the direct listing is a mere facilitator and not a first-order beneficiary of the transaction, the threat of Section 11 liability as a disincentive to misstatements or omissions may serve less need in a direct listing. In traditional IPOs, there are several organic "reputational incentives" for issuers to "be candid in their capital raising, and to select underwriters with an even greater reputational stake in candor," with or without Section 11. Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous*

Disclosure Environment, 63 Law & Contemp. Probs. 45, 63 (2000). The same can be said for direct listings. Nicolas Grabar et al., "A Look Under the Hood of Spotify's Direct Listing," Harvard Law School Forum on Corporate Governance, Apr. 26, 2018, https://bit.ly/3khAjZI ("So while participants in a direct listing have plenty of reasons to exercise care in respect of disclosure, it is hard to see a strong argument that additional liability risk from Securities Act registration adds to those reasons.").

And just because the mechanics of a direct listing make it harder to sue under Section 11 does not mean that it is outside the scope of the federal securities laws. Where the purchased security cannot be traced to the relevant registration statement, with Section 10(b) as an alternative, Section 11 can still maintain the disclosure-efficiency balance despite its general unavailability to claimants who cannot trace their shares. *See* 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, 193 (2000) ("[T]here is no justification rooted in necessity, fairness or common sense to extend the protections of Section 11, which regulate disclosure in a registration statement, to purchasers in the secondary market who have a remedy under Section 10(b) and who never saw a registration statement."). If a change is warranted, Congress should be responsible for determining the circumstances for

Section 11 liability—a task Congress has not undertaken. *See* Opening Br. for Defendants and Appellants at 36–39.

III. REMOVING SECTION 11'S TRACING REQUIREMENT FOR DIRECT LISTINGS THREATENS A PROMISING OFFERING VEHICLE

Aside from Section 11's text and the Securities Act's overarching purpose, this court should also consider the economic potential that may be stymied if it affirms the district court's erasure of the tracing requirement in direct listings. The economic stakes are particularly high when external forces (*e.g.*, the courts) and not just natural market forces, work to restrain alternative public-offering vehicles. In an age when more and more firms look at the regulatory landscape and choose to remain private for longer, diversifying offering types and reversing this trend would benefit the broader American economy—not just financial-industry insiders. *See* "The IPO Is Being Reinvented," The Economist, Aug. 20, 2020, https://econ.st/3jzFmn7.

The erasure of the tracing requirement would threaten these developments, as any costs saved from avoiding underwriters and other IPO expenses could be replaced (or even overtaken) by the litigation costs of extending Section 11 standing to all post-offering purchasers.

A. Direct Listings Are a Viable Alternative to the IPO That Operate Within the Existing Regulatory Framework

Direct listings are valuable not just because they cater to so-called "unicorns"—highly valued private startups like Spotify and Slack—but also because to plenty of smaller and lesser-known companies, they hold the promise of reduced costs to go public without commensurate reductions in gains. A direct listing eschews the traditional underwriting process, avoiding the high costs of engaging an underwriting syndicate and avoiding the underwriter's role in setting the price at which the securities will be traded. Instead, "the market sets the price at the very first instance"—avoiding issuers' "leaving money on the table" in a mispriced underwritten offering. Joseph A. Grundfest, "What Are Direct Listings, How Do They Work, and Why Do They Matter?," Stanford Law School Blog, Jan. 10, 2020, https://stanford.io/3jE9QnW. *See also* Ambrus Kecskés, "Spotify's Direct Listing in the U.S. and Lessons from the U.K.," Columbia Law School: Blue Sky Blog, Mar. 1, 2018, https://bit.ly/2Thl2w9 ("Direct listings look promising, especially if they lower the cost of going public compared with staying private or selling to other firms.").

It seems apparent that an IPO is a one-size-does-*not*-fit-all model. One legal scholar noted that, "the primary motivation for a direct listing" is not capital-raising but rather "liquidity" for shareholders who seek "the ability of sell stock for cash *easily*." Brent J. Horton, *Spotify's Direct Listing: Is It a Recipe for Gatekeeper Failures?*, 72 S.M.U. L. Rev. 177, 188 (2019) (emphasis original). Direct listings make things easier for shareholders, primarily by allowing them to sell immediately, rather than locking up most shares for 180 days as is customary in an IPO. *Id.*

Shareholders also benefit by selling their shares at a market price, rather than at the initial price to the public set in an IPO. *A Current Guide to Direct Listings*, Gibson Dunn, Dec. 13, 2019, https://bit.ly/3jE4WIE. Direct listings also may allow issuers to "raise capital later on favorable terms" because while IPOs often "leave capital on the table, suffering from on average [20%] underpricing," firms whose stock is already publicly traded, suffer "essentially negligible" underpricing when they seek to later raise capital. *Id.* (quoting Kecskés, *supra*). Combined with the fact that direct listings avoid the costs of underwriter participation, it quickly becomes clear why many industry insiders view it with such promise. *See*, *e.g.*, Preston Brewer, "Analysis: Private Equity Eyes SPACs, Direct Listings Over IPO," Bloomberg Law, Nov. 4, 2019, https://bit.ly/3e1fu2c ("Meanwhile, turmoil at the top of the IPO market had fingers pointing all around: VC and private equity-backed unicorns going public are overvalued and overly mature, investment banks are mispricing shares and charging excessive fees, and IPO investors are expecting big post-IPO price pops. The IPO model is breaking down—and some in private equity see direct listings as a possible solution."); *see also* Guadalupe Gonzalez, "Spotify's CEO: The Traditional IPO Process Hasn't Evolved in Decades—That's 'Moronic,'" Inc., June 20, 2019, https://bit.ly/30MzKPV. While well-known unicorns are usually thought of as the primary candidates for direct listings, non-unicorns could also benefit from the direct listing's cost-saving. Direct listings offer startups' self-starters—the out-of-the-garage-era employees and angel investors—the opportunity to reap a greater return on their relatively high-risk investments, offering them the liquidity of a public market and enabling them to sell their shares at a market price.

In light of its economic promise, the direct listing has earned much industry attention, mostly positive—though with some caution. One law firm summed up the recent enthusiasm, albeit hyperbolically:

> Venture capitalists love them. CFOs are intrigued by them. Bankers want to hang out with them. Securities lawyers are fearless of them. And, accountants, well, they mostly roll their eyes at them. They are everywhere. Howling in the hills, whispering in the wind, psst!'ing from hastily revised pitch books. If you want to get into a Direct Listing seminar, you have to call on Tuesday morning between 9 and 9:15 am, at least a month out. The point is that Direct Listings are kind of a big deal.

The Direct Listing Craze, Cooley Go (blog), Cooley LLP, https://bit.ly/3kUmnES (last visited Oct. 29, 2020). Not all views are this lavish, but the consensus seems to be that direct listings shows promise for certain types of companies. *See* Alexander Panisch, "Spotify's IP-Faux: Direct Listings and the Future of Initial Public Offerings," Fordham J. Corp. & Fin. L., Apr. 19, 2018, https://bit.ly/3dajr4h ("Direct listings will likely be attractive to [] tech companies who, because [of] copious amounts of venture capital, don't need to raise more cash, but do need liquidity for their shareholders . . . . That said, private funding is cheaper and does not come with the same litigation risks."). The most forceful critiques of direct listings have come, as might be expected, from institutional investors who have much to lose from an offering mechanism in which share prices are crowdsourced rather than established (and kept artificially low) through the underwriting process. *See Petition of Council of Institutional Investors for Review of an Order, Issued by Delegate Authority, Granting Approval of a Proposed Rule* (Sept. 8, 2020), https://bit.ly/34zLvLV (lists objections to proposed rule to expand NYSE direct listings).

And to the market, in general, the more offering types the merrier. A diversity of offering types can better serve a diversity of issuers, who may have different capital structures or different goals. The Securities Act was by no means designed to limit issuers to one offering type. To the contrary, the Act's pro-disclosure, non-preclearance approach assumes any number of offering types, asking simply that issuers and their representatives be honest salesmen.

One investigation into the first major direct listing in 2018, Spotify, shows the direct listing interacted nearly seamlessly within the existing regulatory framework, and in a way that fulfilled the Securities Act's mission of reducing fraud and misinformation without hamstringing healthy, pro-growth incentives. Grabar et al., *supra*, at 14. Spotify was required to submit a concurrent registration statement, ensuring the issuer's role in distribution and obligating those providing the information to meet the requirements of the securities laws. *Id.* That direct listings serve a different purpose than a traditional IPO—focused on liquidity for existing shareholders rather than raising capital—means that they necessarily interact differently with the regulatory environment.

Further, the SEC appears to have no problem with the direct listing, if for no better reason than that it operates fully within the regulatory regime set forth in the Securities Act. SEC Chairman Jay Clayton remarked that "[i]f a direct listing is providing the same kind of fair information and fair access to the market as your more traditional underwritten IPO, who are we to judge if one is better than the other." Dave Michaels, "SEC's Clayton Says SEC Doesn't Judge Direct Listings," Wall St. J., Sept. 19, 2019, https://on.wsj.com/3lq8heF.[4]

Maintaining the existing regulatory scheme, including the liability limits built into Section 11, is crucial to bolstering the direct listing's chances. For direct listings

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[4] Neither does the NYSE, which earlier this year announced it would begin allowing direct listings that raised new capital, a rule change that the SEC then approved. *Order Granting Approval of a Proposed Rule Change, as Modified by Amendment No. 2, to Amend Chapter One of the Listed Company Manual to Modify the Provisions Relating to Direct Listings,* Securities Exchange Act of 1934, Release No. 89684 (August 26, 2020), https://bit.ly/2Hwoctu. (Note: The status of the capital-raise direct listing is still in flux as institutional investors have lodged their disapproval to the SEC. SEC Letter to John Carney, Senior Director of the NYSE, Aug. 31, 2020, https://bit.ly/31TO89x) NASDAQ concurs. Joshua Franklin, "Exclusive: Nasdaq Files with SEC for IPO Alternative to Raise Funds," Reuters, Aug. 25, 2020, https://reut.rs/3kPyDXu; *Notice of Filing of Proposed Rule Change to Allow Companies to List in Connection with a Direct Listing with a Primary Offering In Which the Company Will Sell Shares Itself In the Opening Auction On the First Day of Trading on Nasdaq and to Explain How the Opening Transaction for Such a Listing Will be Effected*, Securities Exchange Act of 1934, Release No. 89878 (September 15, 2020), https://www.sec.gov/rules/sro/nasdaq/2020/34-89878.pdf.

to be viable, they cannot be subject to liability risks under Section 11 that exceed those of an IPO, or the risk that they will be subject to judge-made adjustments to longstanding regulation. *See* Matt Levine, "Direct Listings Are a Thing Now," Bloomberg, Jan. 11, 2019, https://bloom.bg/3dX31wM ("Other tech companies considering going public won't think 'should we do that weird thing that Spotify did' but rather 'what are the pros and cons of direct listings compared to initial public offerings?'").

And even if this Court disagreed about the benefits of direct listings to the marketplace, compared to Congress, the SEC, and the exchanges, the courts are ill-equipped to determine the proper interplay between regulations and economic incentive in the context of Section 11. While direct listings are not designed to benefit from the tracing requirement inherent to Section 11 (if they were, they might have emerged in some form soon after Judge Friendly's 1967 ruling), it is inevitable that they would. Indeed, there is no way for a direct listing to serve its purpose *and* maintain easy traceability of the shares sold pursuant to its registration statement. "In a direct listing, some shares are sold under the registration statement while other are not." Benjamin J. Nickerson, *The Underlying Underwriter: An Analysis of the Spotify Direct Listing*, 86 U. Chi. L. Rev. 985, 1006–07 (2019). Plain and simple, and hardly nefarious.

That a novel offering type benefits from the longstanding regulatory regime it inhabits does not make it *malum pro se*. And so long as it is not *malum prohibidum* (i.e., at common law or equity), there is nothing the courts can or should do. If there is nothing illegal or inequitable afoot, such policy judgements are not the role of the courts. As the Fifth Circuit put it in *Krim*:

> [When] Congress enacted the Securities Act of 1933 it was not confronted with the widespread practice of holding stock in street name that Appellants describe as an impediment . . . to invoking Section 11. That present market realities, given the fungibility of stock held in street name, may render Section 11 ineffective as a practical matter in some aftermarket scenarios is an issue properly addressed by Congress. It is not within our purview to rewrite the statute to take account of changed conditions.

402 F.3d at 598. And so it should be left to the SEC and the exchanges, working with Congress, to determine what rules do and do not work for the marketplace. Erasing the tracing requirement for an offering type in which tracing is bound to be difficult (or even highly improbable) *due to the very nature* of that offering type threatens a promising alternative path to public trading for companies. who want to incentivize investment at their higher-risk stage of growth.

B. Even Without Congress's Intervention, the Free Market May Fashion New Means of Tracing

While Congress in pre-digital 1933 could not have anticipated offerings that would make it very difficult (or perhaps, impossible) to trace which shares were and were not purchased pursuant to the relevant registration statement, it is up to the modern Congress, weighing the political and economic costs and benefits, and *not* the courts, to change the law.

What Congress in 1933 *could* have anticipated is that other offerings besides the traditional IPO would emerge, and so created a law that would work for all kinds of offerings. The direct listing is not the first departure from the IPO paradigm, and it is unlikely to be the last. Indeed, there are already hints of permutations of the Spotify-type direct listing, including Palantir's, which featured a lock-up of a considerable number of shares, akin to a traditional IPO. Lizette Chapman et al., "Palantir's Long-Awaited Public Debut Frustrates Some Investors," L.A. Times, Oct. 4, 2020, https://lat.ms/2TyD7Ga. This should allay fears that the direct listing will begin to overtake all other offerings, and with it force Congress and the SEC to bow to its needs for the sake of market stability. Organic market forces (alongside stable regulations) seek efficiency through innovation. The traditional IPO has undergone the same market-based evolution, arriving today at a set of practices driven by both the securities laws and market participants' desires. For direct listings, for example, it is entirely possible that the tracing requirement will lead to discounted prices for directly listed shares that are intermingled with unregistered shares, because the market will naturally price in inherent tracing challenges.

Further, new technologies (and novel application of existing technologies) might well make it easier for claimants to trace the purchase history of their shares.

Blockchain, for example, may provide such a means, allowing ownership of a particular share to be traced from its issuance to its current holder. *See generally* Sean Belcher, *Tracing the Invisible: Section 11's Tracing Requirement and Blockchain*, 16 Colo. Tech. L.J. 145 (2018); *see also* Bruce G. Vanyo & Jonathan Rotenberg, "Blockchain Technology May Enable Tracing in Securities Act Litigation," Litigation Advisory, Katten Muchin Rosenman LLP, Mar. 22, 2018, https://bit.ly/35GrMcM ("Tracing, now virtually impossible, might be accomplished by the click of a button or the scan of a bar code on a stock certificate.").

Direct listings are a new, and developing, addition to the markets. If new means of tracing become pervasive, they could organically modify the incentive structure for alternative offering types like the direct listing, or perhaps Congress might want to step in. But in the interim, it is not for the courts to intervene and determine what they believe to be "fair" when an offering's design so happens to make claimants' tracing effort difficult or even infeasible.

CONCLUSION

For the foregoing reasons, as well as those presented by Defendant-Appellants, the Court should reverse the district court's ruling on the tracing question.

Respectfully submitted,

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/s/ Jennifer J. Schulp

Jennifer J. Schulp
Counsel of Record
Ilya Shapiro
Sam Spiegelman
CATO INSTITUTE
1000 Mass. Ave., N.W.
Washington, DC 20001
(202) 842-0200
jschulp@cato.org

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1. This brief complies with the type-volume limitation of 9th Cir. R. 29-2(c)(2) because it contains 6,115 words, excluding the parts exempted by Fed. R. App. P. 32(f).

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/s/ *Jennifer J. Schulp*
November 2, 2020

CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing with the Clerk of Court, who will enter it into the CM/ECF system, which will send a notification of such filing to the appropriate counsel.

/s/ *Jennifer J. Schulp*
November 2, 2020