

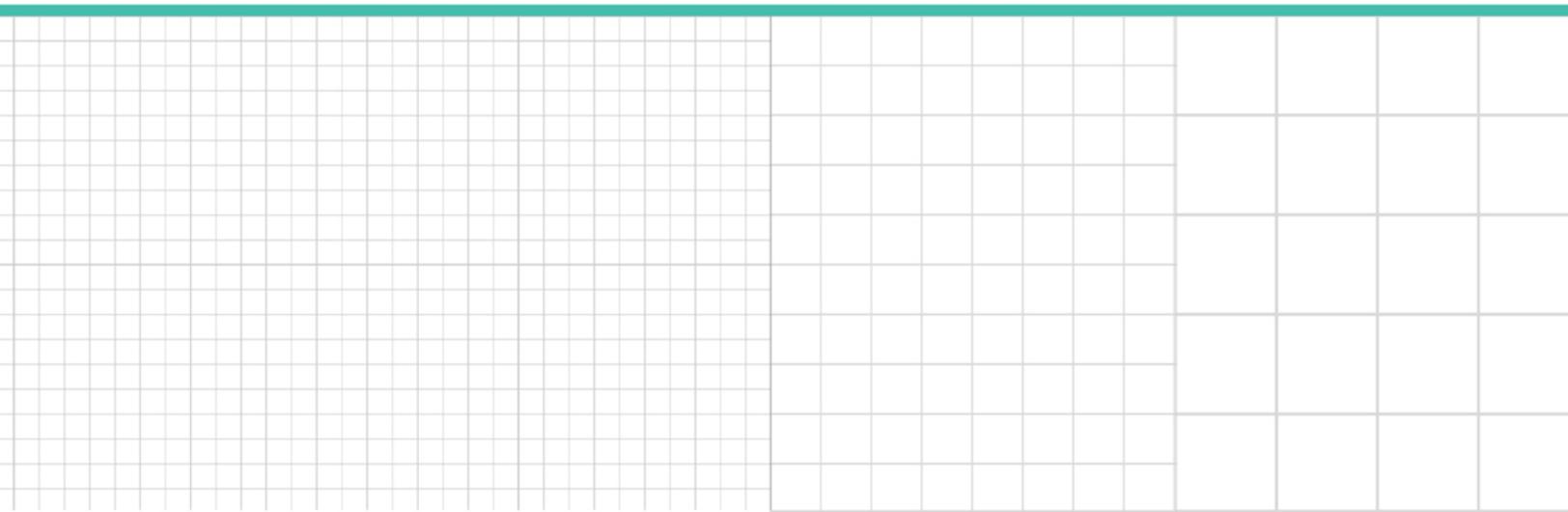


Professional Perspective

Litigating Section 11's Tracing Requirement: A Practitioner's View of a Powerful Defense

*Ken Cunningham, Grant Thornton, and
Bruce R. Braun and Neil H. Conrad,
Sidley Austin LLP*

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Contributed by [Ken Cunningham](#), Grant Thornton, and [Bruce R. Braun](#) and [Neil H. Conrad](#), Sidley Austin LLP

Introduction

To recover under Section 11 of the Securities Act of 1933, a plaintiff must be able to “trace” his or her shares to an allegedly false or misleading registration statement. When the Securities Act was enacted in 1933, satisfying this requirement was straightforward: an investor who purchased a security in a particular offering would receive an individualized paper certificate showing that the security was traceable to that offering and its registration statement.

But today, most issuers do not use individualized paper certificates; instead, they issue shares in electronic book-entry form, and securities are held in the name of third-party custodians—not in the names of the beneficial owners. These changes have made the tracing requirement much harder to satisfy in many situations, and courts are now grappling with this issue with increasing frequency.

In this article, we discuss how this issue arises at the motion-to-dismiss stage, class certification, summary judgment, and trial, and we summarize how courts have resolved tracing-based defense arguments. We also offer some observations about the best ways to present this issue to a generalist judge and some tips about discovery considerations in a case where a defendant has a potential tracing-based defense. Although tracing is highly technical, it can provide a powerful defense in many situations and should not be overlooked when faced with a Section 11 claim.

Statutory Background

Section 11 of the Securities Act of 1933, [15 U.S.C. § 77k](#), provides investors with the ability to hold issuers, officers, underwriters, outside auditors, and certain other enumerated individuals liable for damages caused by false or misleading statements in a registration statement. Because Section 11 covers only statements made in the registration statement, the plaintiff must prove that he acquired shares that were registered under the allegedly false or misleading registration statement.

The statute therefore requires the plaintiff to “trace” his shares to a particular offering made pursuant to a particular registration statement. If the plaintiff cannot prove that the shares for which he is seeking to recover were actually issued pursuant to the allegedly defective registration statement, the plaintiff has no claim under Section 11. This is true even though the plaintiff may have a claim under other provisions of the federal securities laws, such as Section 10(b) of the Securities and Exchange Act of 1934.

This tracing requirement is integral to Congress's decision to relax the liability requirements for a Section 11 claim, and plaintiffs who choose to proceed under Section 11 rather than Section 10(b) should be required to prove the traceability of their shares as the statute demands. Unlike with Section 10(b), Section 11 does not require the plaintiff to prove scienter or loss causation. Nor does it require proof of reliance unless the plaintiff acquired the security “after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement.” [15 U.S.C. § 77k\(a\)](#).

A strict tracing requirement counterbalances this lowering of the plaintiff's burden on the remaining elements of the claim. As one court explained, the “rigid application of the tracing requirement is a product of Congress’ 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).

To the extent changes to the system of securities holding have made the tracing requirement too difficult to satisfy in some circumstances, as some commentators contend, the solution is legislative—not judicial. See, e.g., *Krim v. pcOrder.com, Inc.*, [402 F.3d 489](#), 498 (5th Cir. 2005) (“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.”). And, in any event, an injured shareholder who cannot satisfy Section 11’s strict tracing requirement always retains the option of pursuing a Section 10(b) claim.

Factual Background

To properly analyze a potential tracing-based defense to a Section 11 claim, one must understand how securities are delivered, cleared, and settled in today’s modern system of securities trading. This is a substantial hurdle because many courts and practitioners—even sophisticated ones—are not aware of how the system actually works.

Dating back well before the enactment of the Securities Act in 1933, shares were issued in the form of paper certificates, and the settlement of stock transactions required the actual delivery of the physical certificates. The manual process for issuing, delivering, and transferring paper certificates was labor-intensive, expensive, and time-consuming, but it made tracing straightforward. A plaintiff bringing a Section 11 claim could rely on the paper certificate to establish that he acquired shares issued under a particular registration statement.

Over time, Congress realized that the paperwork created under this system was a significant drag on the capital markets, and it delegated to the SEC the responsibility of addressing the problem. The Depository Trust Company was created to address this paperwork crisis. DTC is jointly owned by its participating firms, such as brokerage firms and banks. Acting as a central depository for securities, DTC took custody of paper certificates and developed an “intermediated” or “indirect” system of holding securities.

In DTC’s intermediated system, typically one or more “global certificates” are issued by the issuer in DTC’s “street name”—that is, in the name of DTC’s partnership nominee, Cede & Co. Cede & Co. becomes the registered owner of these securities, and the global certificates are physically held either by DTC or a sub-custodian of DTC. A DTC participant’s position in the securities issue (that is, how many shares it owns) is commonly referred to as a “book-entry” position, reflecting the fact that the participant’s position is reflected only on the books and records of DTC rather than in the form of a paper certificate.

Each issue of securities held by DTC is given a CUSIP, which is an alphanumeric code used to identify the security. Securities of the same type (for example, common stock) issued by the same issuer, but in offerings made at different times, typically bear the same CUSIP. DTC holds all securities bearing the same CUSIP in street name in a fungible, aggregate bulk. This method of holding means that shares of the same security—issued at different times under different registration statements—are commingled at DTC because they are reflected only by a single, common CUSIP.

A securities intermediary, such as DTC, maintains securities accounts for its customers. Under this intermediated holding system, the customer does not have a direct interest in any specific security certificate held by the securities intermediary. Instead, the customer has a pro rata interest in the fungible, aggregate bulk of all the securities held in street name by the intermediary bearing the same CUSIP. In other words, the customer has a fractional interest in the total bulk holdings of DTC, but does not have a right to any specifically identifiable shares.

As many courts have recognized, the practical effect of this modern intermediated system is that, when securities are held as part of DTC’s fungible bulk, there is no way to identify specific shares owned by any DTC participant. See, e.g., *Kirkwood v. Taylor*, [590 F. Supp. 1375](#), 1379 (D. Minn. 1984) (“The DTC holds all certificates, both old and new, in its nominee name as pooled shares in a fungible mass for the benefit of all its members.”), *aff’d*, [760 F.2d 272](#) (8th Cir. 1985) (table decision).

And because there is no way to identify specific shares owned by any DTC participant, it is virtually impossible to trace shares to a registration statement anytime there have been multiple offerings of the same security. See, e.g., *In re Initial Public Offering Sec. Litig.*, [227 F.R.D. 65](#), 118 (S.D.N.Y. 2004), vacated on other grounds, [471 F.3d 24](#) (2d Cir. 2006), as amended, [483 F.3d 70](#) (2d Cir. 2007).

Key Questions

Given this backdrop, there are two key questions to ask at the outset of the case when assessing a potential tracing-based defense. Because these questions need to be analyzed early, and the ensuing answers will shape arguments throughout the case, defendants should strongly consider hiring an expert who understands the intricacies of the modern system of intermediated securities holding generally and of DTC in particular. In addition, an expert—hired early, before discovery begins—can help counsel craft a discovery plan to build the necessary factual record for class certification, summary judgment, and trial.

The first critical question to ask at the outset is whether the case involves an initial public offering or a secondary offering. If the case involves an initial public offering, and there have been no other offerings of the security, tracing is not an obstacle for the plaintiffs. Because all shares in such a market were issued under one, and only one, registration statement, all shares of the security are traceable to that single registration statement. This is true even if the shares are held as part of DTC's fungible bulk.

In such a situation, even though the plaintiff has only a pro rata interest in the total fungible bulk, everything in that bulk was issued under the same registration statement, so the plaintiff can readily satisfy Section 11's tracing requirement. (There are occasions when the shares of a security are traded before an initial public offering. Defendants should explore that wrinkle carefully. Pre-IPO trading of the security may create tracing hurdles for the plaintiffs.)

The second question to ask at the outset is whether the named plaintiffs participated directly in the offering or are aftermarket purchasers. (We refer to the "named plaintiffs" here because Section 11 claims are typically filed as putative class actions, and defendants should answer this question well before certification.)

An aftermarket purchaser is one who buys shares on the secondary market rather than directly from the issuer or an underwriter in the offering. For years, defendants often argued that aftermarket purchasers were categorically barred from recovering under Section 11 on the theory that the statute covers only initial purchasers. But many courts rejected that argument. See, e.g., *DeMaria v. Andersen*, [318 F.3d 170](#), 176-78 (2d Cir. 2003); *Lee v. Ernst & Young, LLP*, [294 F.3d 969](#), 976-78 (8th Cir. 2002).

The focus in most cases today is thus whether aftermarket purchasers can in fact trace their shares to the registration statement—not whether aftermarket purchasers are categorically excluded from protection under the statute. And, because aftermarket purchasers do not buy directly in the offering, they have a more difficult time satisfying the tracing requirement, as we explain in more detail below.

The answers to these two questions—whether the case involves a secondary offering and whether the named plaintiffs are aftermarket purchasers—will affect the way arguments are framed at different stages of the litigation.

Motion to Dismiss

If the case involves a secondary offering, defendants may have a strong argument to dismiss the case under [Federal Rule of Civil Procedure 12\(b\)\(6\)](#), depending on what exactly the plaintiffs allege regarding the traceability of their shares and the relevant law in the jurisdiction. For example, the Ninth Circuit has held that, when there have been multiple offerings of the security, the general allegation that the plaintiff's shares are "traceable" to the allegedly false or misleading registration statement is insufficient as a matter of law. *In re Century Aluminum Co. Sec. Litig.*, [729 F.3d 1104](#) (9th Cir. 2013).

The Ninth Circuit reasoned that, even accepting this allegation as true, “the obvious alternative explanation is that [the shares] could instead have come from the pool of previously issued shares.” Under the Supreme Court’s decisions in *Bell Atlantic Corp. v. Twombly*, [550 U.S. 544](#) (2007), and *Ashcroft v. Iqbal*, [556 U.S. 662](#) (2009), the complaint must plead facts “tending to exclude the possibility that the alternative explanation is true.” *Century Aluminum*, 729 F.3d at 1108.

The Ninth Circuit suggested facts that might satisfy this requirement, such as alleging that the plaintiffs purchased their shares directly in the secondary offering or bought their shares on the offering date at the offering price, but the plaintiffs in *Century Aluminum* failed to plead any such facts, and the court affirmed the dismissal of their complaint. The First Circuit reached the same conclusion in *In re Ariad Pharmaceuticals, Inc. Securities Litigation*, [842 F.3d 744](#), 755-56 (1st Cir. 2016), relying heavily on *Century Aluminum*.

District court cases reflecting the opposite view—that general allegations that a plaintiff’s shares are traceable to a secondary offering—are easy to find and have not been formally overruled in many circuits. See, e.g., *In re Municipal Mortg. & Equity, LLC Sec. & Derivative Litig.*, [876 F. Supp. 2d 616](#), 658 (D. Md. 2012); *In re Wachovia Equity Sec. Litig.*, [753 F. Supp. 2d 326](#), 373 (S.D.N.Y. 2011); *Northumberland Cty. Ret. System v. Kenworthy*, [2013 WL 5230000](#), at *6 (W.D. Okla. Sept. 16, 2003). But *Century Aluminum* and *Ariad Pharmaceuticals* provide strong support for rejecting this old way of thinking.

Class Certification

If the case is not dismissed on the pleadings, the next opportunity to develop a tracing-based defense is at class certification. No longer constrained by the pleadings, this is the first opportunity for defendants to develop and present a factual record about the difficulties of tracing in today’s modern system of intermediated securities holding. There are two primary lines of argument to explore at this stage: the named plaintiffs cannot satisfy Section 11’s tracing requirement and therefore cannot represent the class, and individualized inquiries regarding the traceability of the plaintiffs’ shares defeat the predominance requirement under Rule 23(b)(3).

The first line of argument is straightforward. It is a basic requirement that at least one named plaintiff must have standing to pursue each claim alleged. E.g., *Simmons v. Author Solutions, LLC*, [2015 WL 4002243](#), at *4 (S.D.N.Y. July 1, 2015). Absent a named plaintiff with standing, a class cannot be certified with respect to the claim. To have statutory standing under Section 11, the named plaintiff must prove that he can trace his shares to the relevant registration statement. And if the named plaintiff does not meet that burden at class certification, a class should not be certified.

The predominance argument requires more explanation and should be tailored to whether the named plaintiff is an aftermarket purchaser or someone who bought directly in the offering. Aftermarket purchasers generally cannot satisfy the predominance requirement because there is no method by which aftermarket purchasers can prove their shares are traceable on a class-wide basis. The only way to do it is to trace the aftermarket purchaser’s share through every step in the chain of custody all the way back to the issuer, which is a complex and inherently individualized process.

This sort of inquiry likely requires discovery from every broker or bank involved in the process, and is not worth the candle in many cases: If the security was ever held in DTC’s street name, it will be untraceable for the reasons discussed above.

There also is a predominance argument to be made against those who purchased directly in the offering. Unlike with aftermarket purchasers, direct purchasers will argue that there is a method of proof for satisfying the tracing requirement on a class-wide basis. They will argue that they purchased on the offering date at the offering price, a proposition capable of class-wide resolution.

The key response to this argument is that, if the security was held at DTC, the mere fact that someone purchased on the offering date at the offering price does not establish that the direct participant actually received a newly-issued share traceable to the allegedly defective registration statement. Even before delivery to the underwriter, the newly-issued shares may have been commingled in DTC’s fungible bulk.

In addition, if the underwriter owned preexisting shares of the same security, there is potentially a second level of commingling where newly- and previously-issued shares are commingled in the underwriters' accounts at DTC. Either way, the direct purchaser who buys from the underwriter cannot prove the share he received is in fact a newly-issued share simply by pointing to the date and price of the offering.

This complication requires the plaintiffs to offer evidence regarding the flow of shares as they passed through the chain of custody—from the issuer to the underwriters' accounts and through each other relevant DTC participant's account down to the beneficial owner (that is, the named plaintiff). This, too, is a complex and highly individualized process that will likely require discovery from every step in the chain of custody.

For both lines of argument, the key is developing a strong factual record during class discovery to support the tracing defense. In particular, defendants should confirm that the security was DTC-eligible (meaning that the security was eligible to be deposited at DTC), confirm that the named plaintiffs held their shares through DTC, and explore whether the underwriters had preexisting shares of the security in their accounts before the secondary offering.

Defendants should also consider whether third-party discovery is necessary, such as requesting documents or a deposition from DTC. One caution: many named plaintiffs will be unfamiliar with this terminology and the details of the modern intermediated system of securities holding, so defendants will need to be well-prepared before depositions to use documents to establish these facts. Many times the documents produced by the named plaintiffs will bear indicia of the modern system, such as the security's CUSIP or indications that the shares were held through or settled at DTC. These facts will go a long way in establishing the necessary record.

Finally, defendants should be prepared to persuade the court that it should engage with the tracing issue at the class certification stage. Several courts have declined to do so, reasoning that tracing is a "merits issue" that is more suitable for resolution at summary judgment or trial. E.g., *In re Smart Technologies, Inc. Shareholder Litig.*, [295 F.R.D. 50](#), 61-62 (S.D.N.Y. 2013).

These cases often rely on older cases—decided before *Wal-Mart Stores, Inc. v. Dukes*, [564 U.S. 338](#), 350-52 (2011), and *Comcast Corp. v. Behrend*, [569 U.S. 27](#), 33-34 (2013)—that attempted to enforce a wall between "merits" questions and class certification. The Supreme Court's more recent class-action decisions make clear that this way of thinking is not appropriate. As the Court explained in *Dukes*, the "rigorous analysis" required at the class certification stage will frequently "entail some overlap with the merits of the plaintiff's underlying claim. That cannot be helped. The class determination generally involves considerations that are enmeshed in the factual and legal issues comprising the plaintiff's cause of action." 564 U.S. at 351.

In light of the tracing requirement's importance to Section 11 and Section 11's relationship to other remedies provided by the federal securities laws, defendants have a strong argument that the court should not table the issue until a later stage of the proceedings.

Summary Judgment

Summary judgment of course represents another opportunity to develop and present the factual record discussed above. One especially helpful roadmap for doing so is laid out in *In re Puda Coal Securities Inc. Litigation*, [2013 WL 5493007](#) (S.D.N.Y. Oct. 1, 2013), in which the court granted summary judgment to the defendants because the named plaintiff failed to establish the traceability of his shares. Judge Forrest's opinion walks through the summary judgment record in detail, analyzing carefully the chain of custody of the named plaintiff's shares and explaining why shares that pass through DTC's fungible bulk become untraceable.

As the court explained, the "steps involving the [DTC] are fatal to traceability" because, once shares pass through DTC's fungible bulk, "they lose any specific identity." Importantly, although *Puda Coal* dealt only with an aftermarket purchaser, the court's reasoning applies with equal force to those who purchased directly in the offering if the newly-issued shares passed through DTC's fungible bulk before they were credited to the named plaintiffs' accounts. Discovery aimed at that

question is critical to setting up a strong summary judgment motion against named plaintiffs who participated directly in the offering.

Trial

Of course at trial defendants will not be able to rely on the case law discussed above and will need to present the defense from scratch. They will have to unpack and explain the legal requirement, the factual background concerning the modern system of intermediated securities holding generally, and the particular facts of the case showing that the named plaintiffs cannot trace their shares to the relevant registration statements—all at a level a jury will understand. This task is made all the more challenging by its novelty. As far as we know, no Section 11 case has been tried to verdict since the enactment of the Private Securities Litigation Reform Act of 1995. Presenting the tracing issue to a jury is therefore uncharted waters.

Relying on first principles, we think presenting the tracing defense at trial involves two major components. First, through testimony of the named plaintiffs, defendants will need to establish that the named plaintiffs either do not know how their shares are held (which is likely if the named plaintiff is an individual retail investor) or admit that their shares are held in DTC's street name (which is likely if the named plaintiff is an institutional investor, such as a major pension fund or hedge fund); that the named plaintiffs do not have paper certificates for their shares; and that the named plaintiffs' own documents—typically, trade confirmations and account statements—show only the CUSIP for the security, which does not tie to any particular registration statement.

Second, through the testimony of an expert witness, defendants will need to explain the modern system, why it exists, and the benefits of the system (so that jurors do not feel like the system is inherently unfair to investors), and then present the evidence that the shares are untraceable, either because the shares passed through DTC's fungible bulk or because the named plaintiffs' shares were commingled with preexisting shares in the account of an underwriter or other financial intermediary at some step along the chain of custody.

Aside from the presentation of the evidence at trial, defendants should strongly consider asking for a special verdict that requires the jury to find specifically that the named plaintiffs' shares are traceable to the relevant registration statement. This will force the jurors to focus specifically on an issue that might otherwise seem too technical and therefore relatively unimportant. It also will facilitate appellate review in the event of an adverse judgment.

Conclusion

As more and more Section 11 claims are filed, courts will grapple with this issue with increasing frequency. Although the issue is highly technical, tracing presents a powerful defense in many situations. The keys when litigating this issue are to explain why enforcing a strict tracing requirement under Section 11 protects the overall design of the federal securities laws and to present the complex, technical details about the modern intermediated system of securities holding in a simple, easy-to-digest manner.