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The Supreme Court Considers Whether Innovation in Direct Securities Listings Can Coexist with Long-Standing Investor Protections

Can investors pursue strict liability claims under the Securities Act of 1933 based on a materially false registration statement filed in connection with a direct listing of stock?

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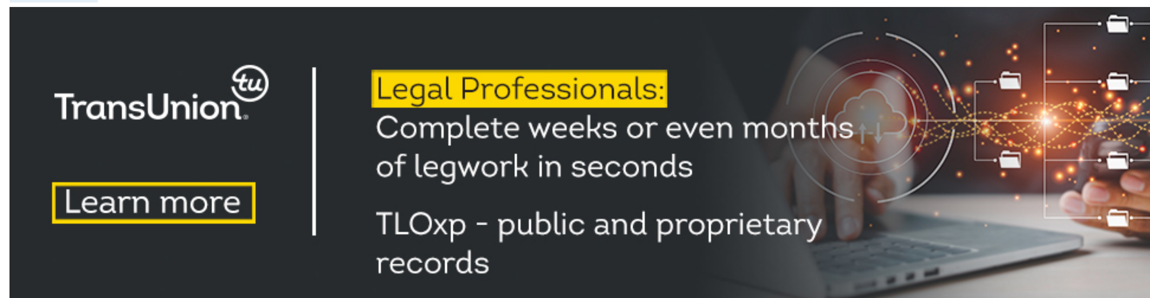
This summer, the Supreme Court will decide whether to uphold critical protections afforded to investors in public offerings since the Great Depression, in its review of the Ninth Circuit Court of Appeals' precedent-setting decision in *Pirani v. Slack Technologies, Inc.*, 13 F.4th 940 (9th Cir. 2021). The *Slack* case concerns the ability of investors to pursue strict liability claims under the Securities Act of 1933 based on a materially false registration statement filed in connection with a direct listing of stock.

Brief Background on Direct Listings

Direct listings, which avoid the need for a traditional, underwritten initial public offering (IPO) process, provide insiders and early-stage investors with maximum liquidity and a public market on which they may freely sell shares. Historically, to sell on the open market personal holdings of shares of a public company, such shareholders had to register their shares for resale through a *secondary* public offering. By contrast, with a shareholder direct listing, such shareholders are able to sell on the open market their shares—whether unregistered personal holdings or previously registered stock—following the filing of a registration statement. Direct listings have been attracting attention as a faster, cheaper, and more efficient way for companies to go public without the full complement (and costs) of a consortium of investment banks supporting the listing. For insiders, direct listings have the benefit of allowing the immediate sale of their previously received, unregistered shares where such sales would normally be heavily restricted under conditions prescribed by the U.S. Securities and Exchange Commission (SEC). Recent examples of companies that have gone public through direct listings are Spotify, Palantir, and Coinbase.

Five years ago, the SEC approved selling shareholder direct listings. In December 2020, the SEC expanded the use of direct listings by approving a new rule proposed by the New York Stock Exchange that permitted *primary* direct listings by companies seeking to raise capital. Under this new rule, companies can directly list their shares with, or in lieu of, a direct listing by company insiders. Notably, two of five SEC commissioners publicly criticized the SEC's approval of the rule as

rushed and failing to address "very real concerns regarding protections for investors." Such concerns included loss of the gatekeeper role and due diligence function provided by underwriter banks and a diminished ability for shareholders to recover damages from materially false offering materials. *See* Allison Herron Lee & Caroline A. Crenshaw, SEC Commissioners, Statement on Primary Direct Listings (Dec. 23, 2020).



The two dissenting commissioners' concerns are real. Direct listings complicate and potentially undermine the ability of investors to recover losses stemming from materially false offering materials due to the near impossibility of "tracing" their shares to a specific registration statement or prospectus, as required by the existing case law for liability under the Securities Act. Specifically, before allowing Securities Act claims to proceed, courts typically require plaintiffs to demonstrate that the shares they purchased were issued pursuant to a specific offering document by (1) showing they purchased on the offering date and at the offering price or (2) tracing the origin of the shares, a straightforward proposition when there is only one source for shares as in an IPO but extremely challenging or even impossible when multiple pools of new shares have been introduced to the market. Further, traditional IPOs are subject to "lockup" periods during which insiders may not sell their shares—thus preserving the ability to tie all traded shares to a sole registration statement. Direct listings, by contrast, are unencumbered by lockup periods and simultaneously sell both shares registered in the applicable offering document and unregistered shares previously granted to company insiders. These shares are fungible and instantly commingled when they begin trading. Accordingly, direct listings present the possibility (perhaps by design) of skirting the Securities Act's established liability regime through the inability of investors to definitively "trace" their purchases to the false registration statement when the market is flooded with shares from a variety of sources.

The District Court and Ninth Circuit Rulings

In *Slack*, the salient issue was whether an investor, Fiyyaz Pirani, who purchased shares sold as part of Slack's shareholder direct listing in June 2019, had standing to bring claims under the Securities Act for alleged material misstatements in Slack's registration statement. As part of Slack's direct listing, insiders sold into the market 118 million registered shares pursuant to the registration statement and 165 million unregistered shares under an exemption provided by SEC rules (i.e., Rule 144). Thus, more Slack shares were sold outside of the registration statement than pursuant to the registration statement. Because the registered and unregistered shares were fungible and became mixed upon listing, Pirani was unable to demonstrate conclusively at the pleading stage without any discovery that the shares he purchased were registered and thus traceable to the registration statement at issue.

In analyzing the traceability of Pirani's purchases to the registration statement, both the district court and the Ninth Circuit focused on the language of section 11 of the Securities Act, which provides, "In case any part of the registration statement . . . contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . may . . . sue" for damages. 15 U.S.C. § 77k. The statutory language "such security" is ambiguous, untethered to registered or unregistered shares.

The Ninth Circuit and the district court arrived at the same conclusion, but their analyses differed. The district court concluded that Pirani had standing because the securities he purchased, registered or unregistered, were "of the same nature" as the securities issued pursuant to Slack's registration statement. *Pirani v. Slack Techs., Inc.*, 445 F. Supp. 3d 367, 381 (N.D. Cal. 2020). The district court acknowledged that its reading departed from long-standing precedent, which limited Securities Act liability to shares acquired pursuant, or traceable to, the offering document in question.

Over a dissenting opinion, the Ninth Circuit majority affirmed the district court's determination, finding that Pirani could not have purchased his shares absent the issuance of Slack's allegedly false registration statement, qualifying the shares he purchased, whether registered or unregistered, as "such security" under the Securities Act. The majority noted—quite sensibly—that the same registration statement made it possible to sell both registered and unregistered shares to the public. As the majority explained, under New York Stock Exchange rules, a registration statement is a prerequisite for direct listings, and Slack shares could only be sold to the public once the registration statement became effective. The Ninth Circuit also distinguished traceability issues present with multiple, successive, or secondary stock offerings and associated registration statements because all the Slack shares in the direct listing were sold pursuant to Slack's *one and only* registration statement.

The Ninth Circuit reasoned that its holding was consistent with the legislative history of the Securities Act, enacted in the aftermath of the 1929 stock market crash to hold companies accountable for inaccurate statements when there is a clear connection between the statements made and the purchase of the security. In addition, the majority explained that if only registered shares were covered by section 11 in the direct listing context, the liability imposed by the statute for inaccurate statements or omissions in registration statements would be eviscerated. This is because the listings offer both registered and unregistered shares, making it difficult for investors to trace their purchases to a particular registration statement. The Ninth Circuit expressed concern that this practical immunity from Securities Act liability could encourage companies to file "overly optimistic registration statements . . . in order to increase their share price," creating "a loophole large enough to undermine the purpose of Section 11 as it has been understood since its inception." *Pirani*, 13 F.4th at 948.

The dissent rejected the policy considerations cited by the majority and contended that the issue presented was not novel. For the dissent, the shares offered in direct listings are analogous to successive offerings following an IPO. In support of this view, the dissent pointed to Congress's

limited application of the strict liability provisions of the Securities Act compared with the more liberal general antifraud provisions of the Securities Exchange Act of 1934, which allows a broader class of investors to hold accountable sellers of securities when they can demonstrate that the defendants acted with intent or knowledge of wrongdoing, i.e., scienter.

Arguments to the Supreme Court

In *Slack Technologies, LLC, fka Slack Technologies, Inc. v. Pirani*, No. 22-200 (U.S.), the defendants sought Supreme Court review of the Ninth Circuit's decision, supported by a host of amici in the business, academic, and legal communities. In December 2022, the Supreme Court agreed to hear the appeal. Briefing was completed in March 2023, and oral argument was held on April 17, 2023.

In their briefing before the high court, the defendants advance three primary arguments, which draw heavily on the Ninth Circuit's dissenting opinion.

First, the defendants argue that the Ninth Circuit's decision "rewrites" the Securities Act by eliminating the distinction between registered and unregistered shares. The defendants note that the Securities Act does not extend to the unregistered securities the majority found could be sold only due to the registration statement because unregistered shares can be sold outside of a registration statement under SEC Rule 144.

Second, the defendants contend that the policy reasons cited by the Ninth Circuit offer an insufficient rationale for abandoning more than five decades of precedent requiring traceability. According to the defendants, this holds true even if new developments in the marketplace would prevent investors from seeking a recovery—an argument the defendants observe was previously rejected in the context of secondary stock offerings.

Third, the defendants argue that the Ninth Circuit interprets "such security" in a unique way for direct listings when the statutory meaning already was settled, and this approach could create a proliferation of interpretations, contrary to Supreme Court guidance. The defendants further contend that the majority misread the legislative history to encompass unregistered shares. For support, the defendants note that Congress repeatedly has declined to modify the tracing requirement despite developments in the market. The defendants also warn of possible unintended consequences of the Ninth Circuit's decision, such as the potential expansion of section 11 liability, even outside the context of direct listings, to traditional IPOs until a second registration statement is issued.

Amicus briefs filed in support of the defendants' arguments by the U.S. Chamber of Commerce and other business associations emphasize the plain statutory text and body of case law requiring the tracing of shares to a registration statement. They also urge the Supreme Court to limit the role of courts to examining the statutory language rather than "rewriting" legislation and engaging in rulemaking that is properly under the purview of Congress and the SEC. Similarly, the Cato Institute, a libertarian think tank, cautioned against courts "usurp[ing] Congress's exclusive role in enacting securities laws" by eliminating the tracing requirement and expressed concern about the Ninth

Circuit's opinion "disincentivizing an alternative to traditional [IPOs] that shows the potential for economic growth and wealth creation." In addition, a brief filed by former SEC chairman Jay Clayton and Commissioner Dr. Joseph A. Grundfest criticizes the Ninth Circuit's reading of "such security" as "faulty" and "expansive" as compared with uses of that term in other contexts, the legislative history, and other appellate court rulings.

The plaintiff filed his response brief on February 27, 2023. In support of the Ninth Circuit's decision, the plaintiff argues that the tracing requirement has never been held to apply to an initial offering but only to successive offerings where multiple registration statements have been filed, which are not present in *Slack*. The plaintiff also highlights that resorting to policy and legislative history is appropriate where statutory language is unclear, emphasizing that the "principal purpose of the Securities Act was to regulate the issuance of securities for initial public sale, providing investors confidence that the information used to value those shares is truthful and accurate" in the wake of the 1929 stock market crash. The defendants' view of the Securities Act, according to the plaintiff, would "freakishly" provide a remedy to investors who randomly purchased registered shares, but not those investors who, through an arbitrary set of circumstances beyond their control, purchased unregistered shares.

As happened on the defendants' side, a host of high-profile amici lined up in support of the plaintiff. An amicus brief filed by a group of institutional investors similarly emphasizes that the Ninth Circuit's decision did not break new ground, given that the Securities Act is remedial in nature and always has aimed to protect investors from misstatements in offerings. As they explain, such protections are especially important in an emerging world of alternative offerings to traditional IPOs, such as direct listings and special-purpose acquisition companies (SPACs), where shares are commingled and cumbersome to trace. Further, the institutions stress that investors rely on the truth of registration statements and warn the Court that reversal of the Ninth Circuit's decision could embolden offerors to exploit the resulting liability loophole, to the detriment of investors and the markets at large. Likewise, an amicus brief filed by former commissioners and senior officials of the SEC argues that the history of the SEC's approval of direct listings showed that the SEC intended for all shares to be encompassed under the required registration statement "even though some or even all of the shares might be arguably exempt."

Notably, neither the SEC nor the U.S. Department of Justice has shared its view on this high-stakes litigation.

Outlook

The Ninth Circuit's ruling in *Slack* was a win for both investors and companies alike: a functional, pragmatic decision that effectuates the intent of the Securities Act and its time-tested liability regime that has helped make our nation's capital markets the gold standard of the world. The ruling underscores the importance of the judiciary taking a flexible and practical approach to ensure that investors remain protected as markets continually evolve. The decision's rationale would apply not only to selling shareholder direct listings like Slack but presumably also to the increasingly popular and recently authorized primary direct listings. Indeed, the underlying decisions by two federal

courts in the *Slack* litigation also validate serious concerns expressed by SEC commissioners when the SEC approved primary direct listings in December 2020, described above.

However, due to the Supreme Court's composition, the Court will likely strike down the decision. Depending on the Court's ruling, one of two outcomes is likely: Either direct listings will become an increasingly popular method for going public because investors would be without recourse for misleading registration statements, or direct listings will be shunned because they expose the seller to more liability than anticipated. Both of those outcomes could negatively affect the capital markets by either undermining investor confidence in the securities laws' protections or encouraging companies to remain private. In the absence of guidance from Congress and the SEC, there will certainly be interest in developing tracing technology. If that technology proves viable, investors may be hesitant to invest in unregistered shares, thereby diminishing the marketplace for direct listings.

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