

## ***Morrison*, the Restricted Scope of Securities Act Section 11 Liability, and Prospects for Regulatory Reform**

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I. INTRODUCTION .....	3
II. THE MICRO-STRUCTURE OF INITIAL PUBLIC OFFERINGS AND THE AFTERMARKET	
TRADING PROCESS .....	8
<i>A. The Initial Distribution</i> .....	8
<i>B. The Opening Cross</i> .....	11
<i>C. Aftermarket Trading</i> .....	13
III. <i>MORRISON</i> AND THE INTERNATIONALLY DISTRIBUTED, U.S.-LISTED IPO.....	20
<i>A. Morrison’s Holding and the Supreme Court’s Rationale</i> .....	22
<i>B. The Congressional Response</i> .....	25
<i>C. Morrison and the Securities Act</i> .....	26
<i>D. Morrison’s First Prong: The Domestic Exchange Test</i> .....	28
<i>E. Morrison’s Second Prong: The Domestic Transaction Test</i> .....	32
IV. THE SECTION 11 TRACING REQUIREMENT .....	38
<i>A. Section 11</i> .....	39
<i>B. The Law and Logic of Tracing</i> .....	41
<i>C. Practical Implications of the Tracing Requirement</i> .....	45
V. <i>MORRISON’S</i> IMPLICATIONS FOR SECTION 11 TRACING.....	48
<i>A. Morrison and the Rule Against Extraterritorial Application</i> .....	50
<i>B. The Narrow Construction of Implied Private Rights of Action</i> .....	51
<i>C. The Structure of the Securities Statutes</i> .....	53
<i>D. Section 11’s Text</i> .....	54
<i>E. Section 11’s Legislative History</i> .....	56
VI. POLICY IMPLICATIONS AND POTENTIAL REGULATORY RESPONSES .....	56
<i>A. The Domestic Distribution Requirement</i> .....	59

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*B. Undertakings Not to Challenge the Right to Assert Section 11 Claims*..... 63

    1. *CUSIP Reform*..... 64

    2. *Legislative Reform* ..... 67

VII. CONCLUSION ..... 67

## I. INTRODUCTION

Section 11 of the Securities Act of 1933<sup>1</sup> (Securities Act), subject to significant qualifications, imposes strict liability on issuers for material misrepresentations or omissions in registration statements declared effective by the Securities and Exchange Commission (SEC or Commission). It also creates a sliding scale form of negligence liability applicable to underwriters, accountants, the issuer's directors, and other enumerated defendants.<sup>2</sup> Section 11 liability is the source of many of the largest class action securities recoveries in history,<sup>3</sup> and, if plaintiffs satisfy section 11's requirements, it can serve as the most plaintiff-friendly provision of the federal securities laws.<sup>4</sup>

The operation of section 11 liability is, however, exceptionally complex,<sup>5</sup> and the Supreme Court's recent decision in *Morrison v. National Australia Bank Ltd.*<sup>6</sup> interacts with the scope of section 11 in a manner that has yet to receive close attention from scholars, regulators, or courts.<sup>7</sup> Careful examination of the mechanics of the initial public offering (IPO) process suggests that *Morrison* implies a potentially significant reduction in the scope of section 11 liability in any IPO in which listing on a U.S. exchange follows an initial distribution that includes even a small number of shares sold in transactions that are non-domestic under *Morrison*.

In a firm commitment underwriting of shares qualified for listing on a U.S. exchange, issuers must complete initial distributions to a minimum of 300 round lot holders before trading on the New York Stock Exchange (NYSE) or National Association of Securities

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1. 15 U.S.C. § 77k (2012). See *infra* Section IV.A (providing a more detailed description of the scope of section 11 liability).

2. 15 U.S.C. § 77k(b). See also *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 684–703 (S.D.N.Y. 1968) (analyzing the potential liability of non-issuer defendants with great attention to the specific circumstances of their roles in the offering and at the company, and effectively creating a sliding scale of liability); THOMAS LEE HAZEN, 2 TREATISE ON THE LAW OF SECURITIES REGULATION § 7.4[2] (2014) (discussing the due diligence defense and the *BarChris* decision).

3. See CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS, 2014 REVIEW AND ANALYSIS fig.12 (2015) (stating that the median settlement value for cases involving both section 10b-5 claims and section 11 or section 12(a)(2) claims is \$13.8 million, whereas the median settlement value for cases alleging section 10b-5 claims only is \$8 million); see also SHEARMAN & STERLING LLP, THE WORLDCOM AND ENRON DIRECTORS' SETTLEMENTS (Jan. 2005), [http://www.shearman.com/files/Publication/f2f2aa3c-5427-4cb3-88ad-4b10b5452794/Presentation/PublicationAttachment/8a1a25d2-a83a-4b77-b149-7b4511325b9e/LIT\\_012005.pdf](http://www.shearman.com/files/Publication/f2f2aa3c-5427-4cb3-88ad-4b10b5452794/Presentation/PublicationAttachment/8a1a25d2-a83a-4b77-b149-7b4511325b9e/LIT_012005.pdf) (discussing the \$54 million WorldCom settlement and the \$168 million Enron settlement; both cases alleged section 11 violations).

4. See, e.g., Marc I. Steinberg & Brent A. Kirby, *The Assault on Section 11 of the Securities Act: A Study in Judicial Activism*, 63 RUTGERS L. REV. 1, 3–4 (2010) (classifying section 11 as “perhaps the most consumer-friendly remedy under the federal securities laws”); see also *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983) (“Section 11 places a relatively minimal burden on a plaintiff.”); HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, 2 SECURITIES LAW HANDBOOK § 31.21 (2014) (“Section 11 accordingly is appropriately viewed as a plaintiff-friendly action.”).

5. See *infra* Part IV (discussing the section 11 private right of action).

6. *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247 (2010).

7. As of the date of this Article, there appears to be no other law review article or statement by the SEC or any other regulator addressing the implication of *Morrison* for section 11 liability. Only one judicial opinion addresses the question, *In re SMART Techs., Inc. S'holder Litig.*, 295 F.R.D. 50, 55–57 (S.D.N.Y. 2013). There the court concluded, consistent with this Article's analysis, that “non-U.S. purchasers of SMART stock may not be included in the class.” *Id.* at 55. Professor Grundfest was a consultant to defendants in the *SMART Technologies* litigation. See *infra* notes 147, 203, 223 & 280 (discussing the *SMART Technologies* opinion in greater detail).

Dealers Automated Quotations system (NASDAQ) can commence.<sup>8</sup> This initial distribution is an off-exchange transaction<sup>9</sup> and can involve sales that occur through foreign brokers regulated by foreign authorities, in transactions that are governed by foreign law and that are subject to foreign forum selection provisions, and in which title transfers offshore in a transaction that is not domestic for purposes of *Morrison*.<sup>10</sup>

The first on-exchange transaction of publicly distributed shares occurs only after the initial distribution is complete and operates through an automated computerized algorithm known as the “opening cross.” That algorithm seeks to balance aftermarket supply and demand to determine a price at which to initiate aftermarket trading. The price determined in the opening cross need not equal the IPO price and, in some circumstances, diverges significantly from the price at which the initial distribution occurs. Indeed, the fact that the initial distribution and the subsequent on-exchange trading of the initially distributed shares are two distinct transactions governed by distinct legal regimes and market procedures is only emphasized by the potential for disparity between (1) the IPO price, which, by law, must be the price at which the initial, off-exchange, distribution occurs with all investors participating in the distribution, and (2) the opening on-exchange price, which is determined by the opening cross, and need not equal the IPO price at which the shares are initially distributed.<sup>11</sup>

*Morrison* holds that liability under the Securities and Exchange Act of 1934<sup>12</sup> (Exchange Act) attaches only to purchases or sales of securities that are “listed on domestic exchanges and domestic transactions in other securities.”<sup>13</sup> *Morrison* thus establishes a “two-prong” test: for U.S. securities laws to apply, the transaction must either take place on a U.S. exchange or be a domestic transaction.<sup>14</sup> Lower courts have uniformly extended *Morrison*’s holding to the Securities Act and have applied *Morrison*’s presumption against extraterritoriality to a wide range of other statutes.<sup>15</sup> There is, at present, no substantive reason to question *Morrison*’s application to the Securities Act.

Because the initial distribution of IPO shares does not occur on a domestic exchange, *Morrison*’s first prong is not satisfied.<sup>16</sup> Moreover, an initial distribution of IPO shares to offshore purchasers through offshore accounts governed by foreign regulators and subject to foreign choice of law and venue provisions where title also passes offshore is also not a “domestic transaction,” and therefore fails *Morrison*’s second prong.<sup>17</sup> *Morrison* thus compels the conclusion that, in a class action alleging a violation of section 11, non-domestic purchasers in the initial distribution have no section 11 claims and must be excluded from the plaintiff class.

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8. See *infra* Section II.A (discussing the distribution process).

9. *Id.*

10. *Id.*

11. See *infra* Section II.B (discussing the opening cross).

12. Securities and Exchange Act of 1934, Pub. L. 73-291, 48 Stat. 88115 (codified at 15 U.S.C. § 78a (2012)).

13. *Morrison v. Nat’l Austl. Bank Ltd.*, 561 U.S. 247, 266–67 (2010).

14. See, e.g., *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 66–67 (2d Cir. 2012) (discussing the two “prongs” of the *Morrison* test); *United States v. Martoma*, No. S1 12 Cr. 973, 2013 WL 6632676, at \*3 (S.D.N.Y. Dec. 17, 2013) (“*Morrison* requires courts to apply a two-prong test in determining the applicability of [s]ection 10(b).”).

15. See *infra* Section III.C (discussing *Morrison*’s application to the Securities Act).

16. See *infra* Section III.D (discussing the first prong of the *Morrison* test).

17. See *infra* Section III.E (discussing the second prong of the *Morrison* test).

This conclusion has significant potential implications for the ability of secondary market purchasers on domestic exchanges to successfully assert section 11 claims. Although domestic purchasers in an initial distribution can clearly pursue section 11 claims, a dispute exists as to whether aftermarket purchasers also have such rights. The Supreme Court has yet to address this question. A minority of lower courts has, however, ruled that aftermarket purchasers have no section 11 claims regardless of the locus of the transaction.<sup>18</sup> If that interpretation is correct, then further analysis of *Morrison*'s implications for aftermarket purchasers is unnecessary because aftermarket purchasers have no section 11 rights regardless of *Morrison*'s holding. The majority view, however, is that aftermarket purchasers have section 11 rights, provided that they can bear the burden of affirmatively tracing their shares to securities that were issued pursuant to the allegedly defective registration statement.<sup>19</sup> Plaintiffs must demonstrate their ability to trace deterministically and cannot rely on probabilistic arguments.<sup>20</sup>

In every reported instance of successful tracing, plaintiffs have been able to trace their shares to an initial transaction that gave rise to a section 11 claim in the hands of the purchaser in the initial distribution.<sup>21</sup> Accordingly, every example of successful tracing to date can be described as an instance in which the initial purchaser in the distribution has a valid section 11 claim and then sells the security, together with the associated right to bring a section 11 claim, to an aftermarket purchaser. Put another way, until *Morrison*, the requirement that an aftermarket purchaser be able to trace her shares to an initial transaction in which the initial purchaser in the pre-public trading IPO could assert a section 11 claim was synonymous with the requirement that the aftermarket purchaser trace her shares to securities issued pursuant to the allegedly defective registration statements. The two concepts were simply two different ways of describing precisely the same categories of persons and shares. Therefore, pre-*Morrison*, there was no rational reason for any court to distinguish between these two locutions of the tracing requirement. It follows that there is no precedent addressing the question of whether, for purposes of section 11 tracing, a plaintiff must trace to shares initially distributed within section 11's domestic reach, or whether it is sufficient to trace to shares that were issued pursuant to the allegedly defective registration statement, even if the initial transaction was non-domestic and thus outside of section 11's reach. It also follows that there is no support in the current case law or academic literature for the existence of a "springing" section 11 claim that would allow aftermarket purchasers to assert section 11 rights that initial purchasers of those shares could not legally assert, post-*Morrison*.

But given the operation of the Committee on Uniform Security Identification Procedures (CUSIP) identification system, as well as the netting and commingling of shares that occurs through the modern aftermarket clearance and settlement processes, if even a single share of an offshore IPO distribution is resold in the opening cross, it then becomes impossible as a practical matter for any aftermarket purchaser to successfully trace to shares that were initially purchased in domestic transactions.<sup>22</sup> Thus, the significant post-*Morrison* question of first impression is whether the courts should interpret the tracing doctrine to allow aftermarket purchasers the right to pursue section 11 claims that did not

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18. See *infra* note 237 (listing district court cases).

19. *Id.*

20. See *infra* note 273 (discussing several courts' rejection of statistical tracing to prove standing).

21. See *infra* Part V (discussing the implications of *Morrison* on section 11 tracing).

22. *Id.*

exist in the hands of the securities' initial purchasers, because those initial purchasers acquired shares in non-domestic transactions that Congress never intended to protect with Securities Act liability. To extend section 11 liability to cover these aftermarket purchasers, courts would have to invent a "springing right of action" allowing aftermarket purchasers to pursue section 11 claims that are unavailable to initial holders.

While no precedent squarely addresses this question and credible positions can be asserted on both sides, the better interpretation of the law is that aftermarket purchasers must demonstrate an ability to trace their shares to initial domestic transactions, to which Congress intended that section 11 liability extend. The argument against the invention of a springing section 11 right of action is rooted in *Morrison*'s strong presumption against extraterritorial application, the rule of narrow construction of implied private rights of action—which applies here because, although the direct purchaser's section 11 claim is undoubtedly an express private right of action, the aftermarket section 11 right of action is implied, not express—and the statute's structure, text, and legislative history.<sup>23</sup> To be sure, resolution of this dispute can raise significant public policy concerns, but these concerns are better addressed by the SEC through the administrative process than by the courts through rulings that are legislative in nature and create tension with *Morrison*'s plain language and the statute's structure, text, and legislative history.

In particular, the section 11 right of action in favor of aftermarket purchasers is implied, not express,<sup>24</sup> and the Supreme Court has frequently observed that implied rights are to be narrowly construed.<sup>25</sup> A narrow construction of the implied section 11 aftermarket right of action would permit section 11 claims to be brought only by aftermarket purchasers who can trace to initial purchasers who themselves engaged in transactions within section 11's territorial reach. Any other interpretation would violate the principle of narrow construction because it would require the judicial invention of a "springing" section 11 right of action that has heretofore never been recognized and would give section 11 an extraterritorial effect inconsistent with the Court's holding in *Morrison*.

The text and legislative history of the Securities Act were also clearly not crafted in anticipation of the complexities generated by the interaction of *Morrison* with the tracing doctrine in a modern, certificate-less, CUSIP-mediated, massively commingled clearance and settlement process. However, when the structure of the Securities Act and Exchange Act, as well as the precise text of section 11 are considered in light of the rationales applied by the courts in crafting section 11's tracing requirement, the better interpretation of the statutory text would also reject the invention of a springing section 11 right.<sup>26</sup> The statute's legislative history is essentially silent as to this question and neither adds to nor detracts from this conclusion.<sup>27</sup>

The implications of this analysis are potentially significant. Non-domestic purchasers in the initial distribution are not within section 11's reach. If aftermarket purchasers must trace to initial holders who acquired shares in domestic transactions that satisfy *Morrison*'s requirements, then, given the realities of tracing in modern securities markets, no aftermarket purchaser in an IPO with an offshore component in its initial distribution will be able to satisfy the tracing requirement if even one offshore holder sells in the opening

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23. *Id.*

24. *See infra* Section V.B (discussing the Supreme Court's narrow construction of implied rights of action).

25. *Id.*

26. *See infra* Sections V.C–D (discussing *Morrison*'s implications for section 11 tracing).

27. *Infra* Section V.E.

cross. The class of plaintiffs with valid section 11 claims is then limited to domestic purchasers in the initial distribution. The recoverable damages for this narrowed class could be a small fraction of the damages recoverable by a class that includes all aftermarket purchasers and all offshore purchasers in the initial distribution. Because the damages flowing from a defective registration statement could then be materially diminished, the incentive to engage in careful due diligence as part of the registration process could arguably be diluted.

The SEC, however, has three broad strategies available in its administrative arsenal that could be deployed to address these post-*Morrison* concerns, as well as other concerns that have long troubled commentators critical of the evolution of the tracing doctrine. First, utilizing its authority to assure that the acceleration process operates in the “public interest and [for] protection of investors,”<sup>28</sup> the Commission could require that all initial placements in registered offerings be conducted through transactions that qualify as “domestic” under *Morrison*. Sales to foreign purchasers would, of course, be permitted, provided that they occur through transactions that have a sufficient nexus with the United States to qualify as being domestic post-*Morrison*. Second, and again relying on its acceleration authority, the Commission could require that registrants, and all other persons enumerated as potential section 11 defendants, consent to the application of section 11 liability and waive any defense that could be raised because of the application of *Morrison*. Third, the Commission could, through its authority over the Depository Trust Company (DTC) as a registered clearing corporation, require that distinct CUSIP numbers be allotted to securities issued pursuant to distinct registration statements, as well as to securities placed through domestic and non-domestic transactions. This approach would address tracing challenges that arise in *Morrison* and a broad range of other circumstances. A new CUSIP numbering regime would also allow for tracing in many situations in which it is currently impossible, such as the distribution of newly registered shares into a market that is already populated by securities of the same class.

The consequences of these three regulatory approaches differ in ways both subtle and significant, and the Commission might consider various combinations or modifications of these three approaches. Careful fact-finding by the Commission will be important to determine: which approach, if any, is preferable; how each might be fine-tuned; and whether some combination of these approaches might be optimal. The administrative resolution of these issues thus presents an opportunity for precision in the evolution of section 11 liability that cannot be achieved through the litigation process. The question can also be presented to Congress for a legislative solution, but recent history suggests that the probability of a legislative resolution is not high.<sup>29</sup>

Part II of this Article describes the microstructure of the modern, internationally distributed, U.S. exchange-listed IPO, as well as the opening cross and the aftermarket trading process. Part III analyzes the Supreme Court’s decision in *Morrison*, and explains why purchasers who transact offshore in internationally distributed IPOs do not acquire shares that Congress intended to protect with section 11 liability, even if those shares are qualified for subsequent listing and trading on a U.S. exchange. Part IV describes the operation of section 11 liability, including its tracing requirement. Part V explains that no precedent holds that an aftermarket purchaser can successfully trace to shares initially purchased in a transaction not subject to section 11 liability. Part V also explains that, given

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28. 15 U.S.C. § 77h(a) (2015).

29. See *infra* Section VI.B.2 (discussing congressional hesitance to enact tracing legislation).

the text and legislative history of the relevant statutes, the holding in *Morrison*, the Supreme Court's rule favoring narrow construction of implied private rights of action, and the SEC's ability to resolve the policy issues raised by the lack of aftermarket standing, the federal courts should not invent a "springing" section 11 right that would be without precedent in the law. Part VI describes administrative measures the SEC can adopt to address policy concerns resulting from the potential reduction in deterrence that would accompany a decline in the scope of aftermarket section 11 liability. Part VII concludes.

## II. THE MICRO-STRUCTURE OF INITIAL PUBLIC OFFERINGS AND THE AFTERMARKET TRADING PROCESS

*Morrison's* implications for section 11 liability hinge on a nuanced understanding of the complexities of the initial offering process. The initial offering process includes the formalities of applying for and receiving approval to list and trade on an exchange; the mechanisms governing the opening cross (which is the initial trade on the exchange); and the aftermarket trading, clearance, and settlement processes, which involve the CUSIP securities identification system (the electronic book-entry system through which exchange-traded securities are denominated), and the commingled and netted nature of the positions reflected through the Depository Trust and Clearing Corporation (DTCC) through which exchange-traded transactions are cleared. This Part describes the details of each of these mechanisms, from a perspective relevant to the understanding of *Morrison's* implications for the operation of section 11 liability.

### A. The Initial Distribution

The initial public offering process in firm commitment underwritings,<sup>30</sup> the most common form of underwriting in the United States,<sup>31</sup> follows a highly regimented and predictable sequence.<sup>32</sup> Prior to the filing of the registration statement, the issuer negotiates with and selects underwriters.<sup>33</sup> With the assistance of underwriters and auditors, the issuer also drafts its registration statement in preparation for filing with the SEC.<sup>34</sup> During this "pre-filing" period, issuers and underwriters are prohibited from offering or selling securities in the United States.<sup>35</sup>

Once the registration statement is on file, issuers and underwriters are permitted to engage in well-defined marketing activities but continue to be prohibited from selling

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30. Under a firm commitment agreement, the issuer sells the entire allotment of securities to the underwriter. The underwriter resells these securities to the public and is responsible for any unsold securities. HAZEN, *supra* note 2, § 2:1[1–2].

31. *Id.*

32. See DAVID A. WESTENBERG, INITIAL PUBLIC OFFERINGS: A PRACTICAL GUIDE TO GOING PUBLIC §§ 10, 11, 13, 15, 17, 18, 19, 20 (Paul Matsumoto 2d ed., 2013) (providing an overview to this sequence).

33. See HAZEN, *supra* note 2, § 3:2[1] (discussing the selection of underwriters).

34. *Id.*; WESTENBERG, *supra* note 32, §§ 10, 13, 19.

35. See 15 U.S.C. § 77e(a) (2012) ("Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale."); HAZEN, *supra* note 2, § 2.3[1]; WESTENBERG, *supra* note 32, § 11:2.



securities.<sup>36</sup> During the pre-filing or waiting period, the issuer typically receives several rounds of comments from the staff of the SEC regarding the draft registration statement, and the issuer generally responds by amending the registration statement to address the staff's comments.<sup>37</sup> During this waiting period, the issuer often also selects the exchange on which its securities will be listed after the initial distribution is complete, typically either the NYSE or the NASDAQ market.<sup>38</sup> The issuer applies for listing on the selected exchange, and once it has demonstrated to the selected exchange that the issuer satisfies the exchange's issuer-status conditions necessary for listing,<sup>39</sup> the issuer's preliminary prospectus describes its shares as "approved for listing" on the designated exchange.<sup>40</sup> The preliminary prospectus does not describe the initial distribution as taking place on the designated exchange.<sup>41</sup> Indeed, in order to become listed, the underwriters must, among other conditions, notify the exchange that the initial distribution of the issuer's shares has been completed to a minimum of at least 300 or more round lot holders, where the precise number of holders depends on the market on which the issuer's aftermarket trading is to occur.<sup>42</sup>

Once the staff concludes that no further comments to the registration statement are necessary, and once the marketing effort is completed, the issuer and underwriter request that the SEC's staff exercise its discretionary acceleration authority<sup>43</sup> to declare the registration statement effective as of a specified date and time.<sup>44</sup> The staff typically responds with a notice declaring the registration statement effective as of 4:00 PM on the

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36. 15 U.S.C. § 77e (2010); HAZEN, *supra* note 2, § 2.4[1]; WESTENBERG, *supra* note 32, § 11.

37. HAZEN, *supra* note 2, §§ 3.2[1], 3.6[1]; WESTENBERG, *supra* note 32, § 17.

38. See WESTENBERG, *supra* note 32, § 15:2.2 ("Nearly all IPO companies list their common stock on one of the [NASDAQ] or NYSE market segments.>").

39. *Id.* § 15:4–5, app. 15A. Both the NYSE and the NASDAQ markets require, as a condition of listing, that securities be eligible for electronic transfer through a central depository. See Securities Exchange Commission Release No. 34-54288, 88 S.E.C. Docket 2066 (Aug. 8, 2006) (outlining the proposed rule change requiring securities in NASDAQ to be eligible to participate in a direct registration); Self-Regulatory Organizations, Exchange Act Release No. 34-54289, 88 S.E.C. Docket 2684 (Aug. 8, 2006) (outlining a proposed rule change in the NYSE). Issuers must also satisfy a number of financial, liquidity, and corporate governance requirements before listing on an exchange. THE NASDAQ OMX GROUP, INC., INITIAL LISTING GUIDE (Jan. 2015), <https://listingcenter.nasdaqomx.com/assets/initialguide.pdf>.

40. See, e.g., Twitter, Inc., Preliminary Prospectus cover page (Amendment No. 4 to Form S-1) (Nov. 4, 2013) ("Our common stock has been approved for listing on the [NYSE] under the symbol of 'TWTR.'"); see also 17 C.F.R. § 229.202 (2015) ("If the securities being described have been accepted for listing on an exchange, the exchange may be identified. The document should not however, convey the impression that the registrant may apply successfully for listing of the securities on an exchange or that, in the case of an underwritten offering, the underwriters may request the registrant to apply for such listing, unless there is reasonable assurance that the securities to be offered will be acceptable to a securities exchange for listing.>").

41. See, e.g., Twitter, Inc., Preliminary Prospectus, *supra* note 40, at 170–71.

42. See WESTENBERG, *supra* note 32, at app. 15A (discussing how the NASDAQ Global Select Market requires (1) either 450 round lot stockholders or 2200 total stockholders, (2) 400 round lot stockholders, and (3) 300 round lot stockholders; the NYSE requires (1) 400 round lot stockholders, and (2) 800 stockholders holding 500,000 shares or 400 stockholders holding 1 million shares).

43. For further discussion of the Commission's acceleration authority, see *infra* Section VI.A.

44. 17 C.F.R. § 230.461 (2012); see also HAZEN, *supra* note 2, § 2.5[1]; WESTENBERG, *supra* note 32, § 20:3.2 (describing how the request for acceleration of effectiveness must be made within two business days of desired date of effectiveness if, as is common, it is as of "a particular time of the day").

date following the request, or as soon as practicable thereafter.<sup>45</sup> The actual sale of securities can take place only after the offering is declared effective.<sup>46</sup>

Shortly after the date and time of effectiveness, representatives of the underwriter and issuer hold a pricing meeting at which they agree on the number of shares to be offered and the price at which those shares are to be offered.<sup>47</sup> Assuming that the number of shares and price set at this meeting do not diverge too significantly from the values noted on the most recent version of the preliminary prospectus,<sup>48</sup> the underwriters then proceed to purchase the shares from the issuer. Those shares are then quickly sold to a minimum of 300 or more round lot holders who acquire in this initial distribution.<sup>49</sup> All sales to purchasers in this initial distribution must take place at the price agreed upon by the issuer and underwriter in the pricing meeting. This “IPO price” is also the price designated on the final form of the registration statement that is declared effective by the Commission’s staff.<sup>50</sup>

Significantly, and without regard to the locus of any individual transaction, this initial distribution to a minimum of 300 or more round lot holders does not occur on any United States exchange. These are off-exchange transactions and, as a precondition to actual listing and trading on the NYSE or NASDAQ markets, representatives of the underwriter telephonically confirm to the listing exchange that the initial distribution has been completed.<sup>51</sup>

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45. See, e.g., TWITTER, INC., NOTICE OF EFFECTIVENESS (Nov. 6, 2013), [http://www.sec.gov/Archives/edgar/data/1418091/999999999513003200/xsIEFFECTX01/primary\\_doc.xml](http://www.sec.gov/Archives/edgar/data/1418091/999999999513003200/xsIEFFECTX01/primary_doc.xml) (setting the effectiveness date at Nov. 6, 2013).

46. 15 U.S.C. § 77(e) (2015); HAZEN, *supra* note 2, § 2.5[1].

47. WESTENBERG, *supra* note 32, § 20:5.

48. If the final price or number of shares differs materially from the information provided on the prospectus, the issuer will need to provide updated information to investors. The SEC allows an issuer to price its offering 20% higher than the upper end of the price range listed in the registration statement without filing an amendment. An amendment is also not required if the issuer decreases the price or number of shares, and the total proceeds to the issuer declines by no more than 20% (using the low end of the pricing range). See 17 C.F.R. § 230.430A(a) (2015) (“[A]ny increase or decrease in volume (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the range may be reflected in the form of prospectus filed with the Commission . . . if, in the aggregate, the changes in volume and price represent no more than a 20% change in the maximum aggregate offering price set forth in the ‘Calculation of Registration Fee’ table in the effective registration statement.”); ElizabethAnn R. Eisen, *Rules 430A and 424(b) Pricing Mechanics and Changes in Transaction Size*, in SECURITIES OFFERINGS 2014: A PUBLIC OFFERING: HOW IT IS DONE 113, 117–18 (2014).

49. WESTENBERG, *supra* note 32, § 19:2.2A (discussing how in an IPO, the underwriters purchase shares from the company and re-sell those shares to investors as part of the initial distribution); *id.* § 19:3.4 (“In a successful offering, the distribution is completed in a matter of hours.”); *id.* at app. 15A (identifying the number of round lot holders required by the different exchanges).

50. See WESTENBERG, *supra* note 32, § 20:5 & 8.1. Rule 430A permits an issuer to omit the final price from the registration statement as declared effective, as pricing does not occur until the day of effectiveness. If the issuer relies upon Rule 430A, the issuer must amend the registration statement to supply the omitted pricing and underwriting information within two business days of pricing. The price and related underwriting information are deemed to have been part of the registration statement as declared effective for purposes of section 11. Eisen, *supra* note 48, at 116.

51. See WESTENBERG, *supra* note 32, § 19:9.1 (“The common stock will begin to trade the morning after pricing . . . once the following routine steps have occurred . . . the lead managers have released the shares for sale to the public.”). In the case of the NYSE, the exchange requires “a letter from the lead managing underwriter of the IPO or the company representing that the company will be in compliance with the applicable round-lot holder . . . requirements upon completion of the IPO.” *Id.* § 15:5.2[F]. Exchange Act Rule 12d1-3 requires that the

The initial distribution to a minimum of 300 or more round lot holders can occur either inside or outside the United States, and the jurisdictions in which those sales occur are unrelated to the fact that the sole listed market for subsequent secondary trading is in the United States.<sup>52</sup> Put another way, even though all aftermarket trading will occur on a U.S. exchange, the initial distribution of those shares can occur anywhere in the world. The offshore component of the initial distribution will often occur through a foreign registered affiliate of a U.S.-based underwriter, and is generally governed by an account agreement containing a choice of law provision stating that foreign law governs all matters related to the account, as well as a forum selection provision designating a foreign venue as the locus for the resolution of any disputes.<sup>53</sup>

### B. The Opening Cross

The issuer's shares actually become listed for trading on the U.S. exchange only after the initial distribution is complete. The first on-exchange, listed transaction typically occurs

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exchange certify to the Commission that a security has been approved for listing, together with "any conditions imposed on such certification." Requirements as to Certification, 17 C.F.R. § 240.12d1-3(b) (2015). When the NASDAQ Market certifies an IPO, its certification to the Commission states that the approval is subject to a "notice of issuance," which "occurs after the securities are issued in the initial distribution." The documentation is phrased in this manner because "in most cases, an IPO company does not satisfy certain listing criteria before the initial distribution, including the requirement to have 300 (NASDAQ Capital Market) or 400 (NASDAQ Global Market) shareholders. In addition, the offering is needed to establish the price of the security for purposes of demonstrating compliance with the \$4 initial listing price and the required value of its public float." E-mail from Arnold P. Golub, Vice President, Office of General Counsel, NASDAQ OMX to Joseph Grundfest, William A. Franke Professor of Law and Business at Stanford Law School (May 9, 2014) (on file with author). Thus, "when NASDAQ lists an IPO, it does so following the initial distribution by the company through its underwriters." *Id.*

52. It is not rare for IPO prospectuses to include information suggesting that the underwriters are contemplating initial distributions of shares in foreign markets. *See, e.g.,* Alibaba Group Holding Limited, Prospectus at 314–16 (Amendment No. 6 to Form S-1) (Sept. 5, 2014) (describing potential initial distributions in the Cayman Islands, the European Economic Area, Hong Kong, Japan, Kuwait, People's Republic of China, Qatar, Saudi Arabia, Singapore, the United Arab Emirates, and the United Kingdom); Twitter, Inc., Preliminary Prospectus at 171–73 (Amendment No. 3 to Form S-1) (Oct. 24, 2013) (describing potential initial distributions in the European Economic Area, United Kingdom, Hong Kong, Singapore, and Japan); Facebook, Inc., Prospectus at 170–71 (Amendment No. 8 to Form S-1) (May 16, 2012) (describing potential initial distributions in the European Economic Area, the United Kingdom, and Hong Kong).

53. *See, e.g.,* GOLDMAN SACHS AUSTRALIA PTY. LTD., INTERMEDIARY CLIENT ACCOUNT AGREEMENT 10, 15 (Feb. 17, 2013), <http://www.jbwere.com.au/jbwere/assets/File/Intermediary%20Client%20Account%20Agreement.pdf> (defining "Applicable Law" as "the Corporations Act, *Australian Securities and Investments Commission Act 2001*, applicable regulations and the rules, regulations, policies, Procedures, guides, guidance and similar requirements of any Approved Securities Exchange, clearing house or self-regulating organization [sic], and ASIC"; defining "[g]overning [l]aw" as an "[a]greement [ ] governed by and interpreted in accordance with the law in the State of Victoria and each of the parties submit to the non-exclusive jurisdiction of the courts of the State of Victoria and courts competent to hear appeals from those courts"; and requiring that notice be provided to Goldman Sachs Australia in Australia). Goldman Sachs Australia is subject to the oversight of the Australian Securities and Investments Commission (ASIC). *See, e.g.,* *Goldman Sachs Australia Pty Ltd Pays \$35,000 Infringement Notice Penalty*, AUSTRALIAN SEC. & INV. COMMISSION (Sept. 1, 2014), <http://www.asic.gov.au/about-asic/media-centre/find-a-media-release/2014-releases/14-216mr-goldman-sachs-australia-pty-ltd-pays-35-000-infringement-notice-penalty/> (noting that Goldman Sachs Australia self-reported the violation to Australian authorities, and cooperated with ASIC throughout the investigation).

between 11:00 AM and noon of the day following the date of effectiveness<sup>54</sup> and relies on a computerized process known as the opening cross.<sup>55</sup> This computerized process is designed to find a stable opening price at which continuous secondary market trading can commence and reflects the forces of aftermarket supply and demand, as indicated by orders submitted to the listing exchange.<sup>56</sup> In some circumstances, the price determined by the opening cross can be significantly higher or lower than the IPO price determined by the issuer and underwriter in the pricing meeting, and that appears in the final form of the prospectus filed with the Commission.<sup>57</sup> The fact that the opening cross price can diverge significantly from the IPO price underscores the fact that the initial distribution (which occurs off the exchange) and the opening cross (the first time that transactions actually occur on an exchange) are two different transactions. Alibaba, Inc.'s recent IPO illustrates this point quite clearly. The IPO price at which the company's shares were sold in the initial

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54. See WESTENBERG, *supra* note 32, at ch. 20, § 29:90.1 ("Trading on the first day often does not begin until a few hours after the market opens, as the initial purchase and sale orders are matched by the lead managers."); see also Julianna Pepitone, *Why Facebook Won't Start Trading at the Opening Bell*, CNNMONEY (May 17, 2012, 7:03 PM EST), <http://money.cnn.com/2012/05/17/technology/facebook-ipo-trading-start-time/> (describing how Facebook, with the help of NASDAQ, decided when its stocks would start to trade).

55. See, e.g., *In re Nasdaq Stock Market LLC and NASDAQ Execution Services, LLC*, Exchange Act Release No. 696555, Admin. Proc. 3-15339 (May 29, 2013), <https://www.sec.gov/litigation/admin/2013/34-69655.pdf> ("In a typical IPO on NASDAQ, shares of the issuer are sold by the IPO's underwriters to participating purchasers at approximately midnight and secondary market trading begins later that morning. Secondary trading begins after a designated period – called the 'Display Only Period' or 'DOP' – during which members can specify the price and quantity of shares that they are willing to buy or sell (along with various other order characteristics), and can also cancel and/or replace previous orders. The DOP usually lasts 15 minutes, although NASDAQ's rules permit the DOP to be extended by up to 30 minutes (in 5 minute intervals) if certain conditions related to the balance of buy and sell orders are met. At the end of the DOP, NASDAQ's 'IPO Cross Application' analyzes all of the buy and sell orders to determine the price at which the largest number of shares will trade and then NASDAQ's matching engine matches buy and sell orders at that price. (The matching of the buy and sell orders is referred to as the 'cross.') The electronic calculation by the IPO Cross Application usually takes approximately one to two milliseconds to complete.")

56. See, e.g., NASDAQ OMX, THE NASDAQ IPO CROSS (2013), [www.nasdaqtrader.com/content/productsservices/trading/IPOCross\\_fs.pdf](http://www.nasdaqtrader.com/content/productsservices/trading/IPOCross_fs.pdf) (stating that the goal of the process is to "[p]rovide fair executions at a single price that maximizes volume and is reflective of supply and demand in the market").

57. See HAZEN, *supra* note 2, § 6.3[1] (noting that trading in the aftermarket can commence at a price that is different than the initial offering price); see also Matt Andrejczak, *Tesla Motors Shares Soar 41% in Market Debut*, MARKETWATCH (June 29, 2010, 4:58 PM EST), <http://www.marketwatch.com/story/tesla-motors-ipo-opens-12-above-offer-price-2010-06-29> ("The stock opened at \$19 a share, 12% above the \$17 offer price."); Michael J. De La Merced, *Facebook Closes at \$38.23, Nearly Flat on Day*, N.Y. TIMES (May 18, 2012, 4:16 PM), [http://dealbook.nytimes.com/2012/05/18/facebook-opens-at-42-05-in-debut-but-falls-quickly/?\\_php=true&\\_type=blogs&\\_r=0](http://dealbook.nytimes.com/2012/05/18/facebook-opens-at-42-05-in-debut-but-falls-quickly/?_php=true&_type=blogs&_r=0) (noting that Facebook's IPO price was around \$38 and that shares started trading on NASDAQ at \$42.05); Telis Demos et al., *Twitter IPO: Relief, Riches and a \$25 Billion Finish*, WALL STREET J. (Nov. 7, 2013, 10:22 PM EST), <http://online.wsj.com/news/articles/SB10001424052702303309504579182403432312182> ("Shares opened at \$45.10 on the [NYSE], up 73% from the \$26 IPO price set Wednesday evening."); Renée Schultes, *King's IPO Leaves Sour Taste*, WALL STREET J. (Mar. 26, 2014, 4:34 PM EST), <http://online.wsj.com/news/articles/SB10001424052702304688104579463523232433780?mg=reno64wsj&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB10001424052702304688104579463523232433780.html> ("[S]hares slid 16% from their initial public offering price of \$22.50 Wednesday, which valued the games developer at \$7.1 billion."); Stu Woo et al., *LinkedIn IPO Soars Feeding Web Boom*, WALL STREET J. (May 20, 2011, 12:01 AM EST), <http://online.wsj.com/news/articles/SB10001424052748704816604576333132239509622> ("Shares of LinkedIn . . . opened at \$83 on the [NYSE], up 84% from its initial public offering price of \$45.")

distribution was \$68,<sup>58</sup> but the opening trade on the NYSE, the first on exchange aftermarket transaction, was at \$92.70.<sup>59</sup> These were obviously two distinct transactions at different prices involving very different populations of buyers and sellers.

Some purchasers in the initial distribution sell all or a portion of their initial allocation in the opening cross, thereby helping establish aftermarket liquidity for the issuer's shares.<sup>60</sup> For ease of exposition, and without any loss of generality, this Article assumes that the underwriters have sold shares in the initial distribution to purchasers whose accounts are located outside the United States, through broker-dealers regulated by foreign authorities, where the purchasers' accounts are governed by choice of law provisions designating foreign law as controlling and requiring that all disputes be resolved in a foreign forum, and where irrevocable liability also attaches offshore.<sup>61</sup> This Article also assumes that at least one share of the initial distribution that was purchased in such a non-domestic transaction is then re-sold in the opening cross.<sup>62</sup>

### C. Aftermarket Trading

The vast majority of securities transactions in the United States occur in certificateless, electronic book-entry form.<sup>63</sup> The transfers are represented exclusively through entries on electronic ledgers and not through the issuance or transfer of any paper-based documents.<sup>64</sup> In this electronic ledger system, the beneficial owners of the securities are described as holding a "security entitlement"<sup>65</sup> that reflects a fractional claim to a larger, aggregated, and undifferentiated mass of securities of the same class held by securities intermediaries, such as brokers or banks.<sup>66</sup>

In this electronic book-entry system, the shares sold in the initial distribution—whether in the United States or abroad—that are then resold in the opening cross and in

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58. Jeffery Cane, *Midday Retreat*, N.Y. TIMES (Sept. 19, 2014, 1:04 PM), <http://dealbook.nytimes.com/2014/09/19/live-blog-tracking-the-giant-alibaba-i-p-o/>.

59. William Alden, *Alibaba's Shares Close Up 38% on First Day of Trading*, N.Y. TIMES (Sept. 19, 2014, 6:32 AM), <http://dealbook.nytimes.com/2014/09/19/live-blog-tracking-the-giant-alibaba-i-p-o/>.

60. See HAZEN, *supra* note 2, § 6.0 n.7 ("Flipping" is the practice of buying a 'hot issue' and then selling it within a short period of time into a rising market, earning a quick profit on the transactions." (quoting *In Re Account Management Corp.*, Exchange Act Release No. 34-36314, 1995 WL 579449, at \*2 n.3 (Sept. 29, 1995)); see also WESTENBERG, *supra* note 32, at ch.19, § 19:3.5 (noting the practice of "flipping," whereby purchasers in the initial distribution immediately sell their shares in the aftermarket); see also SEC, Release No. 34-63010, 2010 WL8609513 (Sept. 29, 2010), <http://www.sec.gov/rules/sro/nasd/2010/34-63010.pdf> (proposing a rule that would "prohibit members or persons associated with a member from directly or indirectly recouping, or attempting to recoup, any portion of a commission or credit paid or awarded to an associated person for selling shares of a new issue that are subsequently flipped by a customer").

61. See *supra* note 53 (referencing a Goldman Sachs Australia Pty Ltd client agreement that is governed by Australian corporation law).

62. This assumption facilitates the analysis by supporting the conclusion that, absent the creation of a "springing" section 11 right of action, no aftermarket purchaser has standing.

63. See *infra* note 95 (describing the prevalence of book-entry transactions).

64. "Settlement of securities trading occurs not by delivery of certificates or by registration of transfer on the records of the issuers or their transfer agents, but by computer entries in the records of clearing corporations and securities intermediaries." U.C.C. art. 8 pref. note at I.B (AM. LAW INST. & UNIF. LAW COMM'N 1994) [hereinafter Prefatory Note].

65. *Id.* § 802(a)(7).

66. *Id.*

subsequent on-exchange aftermarket trading are entirely indistinguishable from each other for four distinct reasons. First, all shares of the same class (regardless of the venue in which they are initially distributed) are identified by a common CUSIP number<sup>67</sup> that is referenced in the trading, clearance, and settlement process.<sup>68</sup> A CUSIP number consists of nine characters, including letters and numbers that uniquely identify a company and its corresponding security. The first six characters identify the issuer, while the seventh and eighth characters identify the particular issue.<sup>69</sup> The ninth character is an automatically generated check on the previous characters.<sup>70</sup> It is therefore impossible as a practical matter to distinguish any one share of stock from any other share of the same class of security because all shares of the same class are identified by precisely the same code: they are a fungible, indistinguishable, electronic book-entry mass.<sup>71</sup>

Second, approximately 70–80% of all U.S. public company stock is held in “street name,”<sup>72</sup> meaning that the issuers, as well as the participants in the clearance and settlement process, never know the names of the individual beneficial holders of the shares being held or transacted.<sup>73</sup> The participants in the process only know the name of the

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67. See *CUSIP Number*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/answers/cusip.htm> (last visited Oct. 23, 2015) (explaining the concept of a CUSIP number); see also CUSIP GLOBAL SERVICES, INSIDE THE CGS IDENTIFICATION SYSTEM 4–5 (Aug. 2010), [https://www.cusip.com/pdf/CUSIP%20Intro\\_%2008.09.10.pdf](https://www.cusip.com/pdf/CUSIP%20Intro_%2008.09.10.pdf) (illustrating the assignment of CUSIP identifiers). Subsequent issues of the same type and class of securities, if offered under the same terms, will generally be assigned the same CUSIP number as the original issue. *Id.* Issuers outside the United States and Canada do not use CUSIPs; they typically use a nine-character CUSIP International Numbering System (CINS) or a 12-character International Securities Identification Number (ISIN). *CUSIP*, INVESTING ANSWERS, <http://www.investinganswers.com/financial-dictionary/investing/cusip-1045> (last visited Oct. 23, 2015). Seventy percent of securities worldwide are labeled by either CUSIPs or ISINs. *Id.*

68. See WESTENBERG, *supra* note 32, at ch. 15, § 15:6.5 (“A CUSIP number—a nine-character alphanumeric identifier that facilitates the clearing and settlement of all securities trades—must be assigned by the CUSIP Service Bureau to the company’s common stock before trading can commence.”); see *id.* at ch.16, § 16:8.3 (“A CUSIP number must be assigned to the company’s common stock before it can be listed on an exchange and commence trading.”); DEPOSITORY TRUST COMPANY, OPERATIONAL ARRANGEMENTS II.A, at 14 (Jan. 2012) (explaining that as a precondition to accessing the custody, clearing and settlement services offered by the DTC, issuers “must obtain a CUSIP number from Standards & Poor’s CUSIP Service Bureau for each of its issues”); *About CGS Identifiers*, CUSIP GLOBAL SERVICES, <https://www.cusip.com/cusip/about-cgs-identifiers.htm> (last visited Oct. 23, 2015) (noting that CUSIP identifiers enable “[a]ccurate and efficient clearance and settlement of securities transaction”); see also SEC, Processing Requirements for Cancelled Security Certificates, Release No. 34-48931 at III.D.3 (Dec. 23, 2003), <https://www.sec.gov/rules/final/34-48931.htm> (observing “that the use of CUSIP numbers, which is currently the most widely-used securities issue identification system, provides for uniformity and that it substantially aids the Commission, [Lost and Stolen Securities Program], and law enforcement programs”).

69. *About CGS Identifiers*, *supra* note 68; *CUSIP Number*, *supra* note 67.

70. *CUSIP Number*, *supra* note 67.

71. See *In re Puda Coal Sec. Litig.*, No 11 Civ. 2598, 2013 WL 5493007, at \*7 (S.D.N.Y. Oct. 1, 2013) (noting that “[a]ll shares in a [participant’s DTC] account were undifferentiated and fungible”).

72. See SEC, Order Approving Proposed Rule Change, Exchange Act Release No. 60215, at 3 (July 1, 2009), <https://www.sec.gov/rules/sro.nyse.2009/34-60215.pdf> (discussing street name registration).

73. See *In re Fleetboston Fin. Corp. Sec. Litig.*, 253 F.R.D. 315, 344 (D.N.J. 2008) (discussing street name registration, “where investors hold securities indirectly, e.g., by utilizing securities depositories, the actual stock certificates are immobilized in the depositories, and the depositories are designated as ‘nominal’ owner of the securities on the books of the issuer,” and recognizing that street name registration “mask[s] the beneficial owner of each particular security”); John C. Wilcox et al., “*Street Name*” Registration & The Proxy Solicitation Process, in A PRACTICAL GUIDE TO SEC PROXY AND COMPENSATION RULES § 12-6 (2006) (“Shares deposited at DTC . . .

broker, bank, or other “street” entity at which the account is being held. Only the broker, bank, or other street entity knows the name of the beneficial owner who actually owns the shares represented by the street name account. This challenge to the identification of individual account holders is not new, and existed well before the introduction of modern certificateless clearance and settlement processes.<sup>74</sup>

Third, the clearance, custody, and settlement process for securities traded in the United States operates largely through two subsidiaries of the DTCC<sup>75</sup>—the DTC,<sup>76</sup> which is the largest securities depository in the world,<sup>77</sup> and the National Securities Clearing Corporation (NSCC), which provides clearing and settlement services to broker-dealers and other participants.<sup>78</sup> DTC is owned by its “participants,” the brokerage firms, banks, and other member organizations of the various national stock exchanges.<sup>79</sup> DTC holds shares on behalf of the participating banks and brokers, which in turn hold shares on behalf of their clients, who are the beneficial owners.<sup>80</sup>

Most large U.S. broker-dealers and banks are DTC participants.<sup>81</sup> DTC, through its subsidiary, Cede & Co.,<sup>82</sup> appears in an issuer’s stock records as the sole registered owner of securities deposited at DTC, making DTC the shareholder of record for a large portion

. are said to be registered in ‘street name’”); *see also* Mariya Deryugina, *Standardization of Securities Regulation: Rehypothecation and Securities Commingling in the United States and the United Kingdom*, 29 REV. BANKING & FIN. L. 253, 259 (2009–2010) (stating that shares could be registered under the name of the broker-dealer); *Street Name*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/answers/street.htm> (last visited Oct. 23, 2015) (“When you buy securities through a brokerage firm, most firms will automatically put your securities into ‘street name.’ This means your brokerage firm will hold your securities in its name or another nominee and not in your name, but your firm will keep records showing you as the real or ‘beneficial owner.’”).

74. *See, e.g.*, *Barnes v. Osofsky*, 373 F.2d 269, 272 (2d Cir. 1967) (“[W]hen stock is held in margin accounts in street names . . . 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.”).

75. *See* Prefatory Note, *supra* note 64, at I.C (discussing the role of DTC and NSCC); LARRY THOMPSON, DTCC: AN OVERVIEW 2 (Aug. 2013), <http://www.dtcc.com/~media/Files/Downloads/About/government-relations/LThompson-DTCC-Overview-Aug2013.pdf> (“Through its subsidiaries, DTCC provides clearance, settlement and information services for equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments and over-the-counter derivatives.”). Each of DTC’s subsidiaries serves a specific segment and risk profile within the securities industry. *Id.* at 4–6.

76. THOMPSON, *supra* note 75, at 4; *The Depository Trust Company*, DTCC, <http://www.dtcc.com/about/businesses-and-subsiadiaries/dtc.aspx> (last visited Oct. 23, 2015).

77. *See* SEC OFFICE OF INVESTOR EDUCATION & ADVOCACY, INVESTOR BULLETIN: DTC CHILLS AND FREEZES 1 (May 2012), <http://www.sec.gov/investor/alerts/dtcfreezes.pdf> [hereinafter DTC CHILLS AND FREEZES] (explaining the DTC); *see also* Larry T. Garvin, *The Changed (And Changing?) Uniform Commercial Code*, 26 FLA. ST. U. L. REV. 285, 315 (1999) (“The [DTC], a New York company, holds about three-quarters of shares in publicly traded companies.”).

78. THOMPSON, *supra* note 75, at 4; *National Securities Clearing Corporation*, DTCC, <http://www.dtcc.com/about/businesses-and-subsiadiaries/nscc.aspx> (last visited Oct. 23, 2015).

79. *Wilcox et al.*, *supra* note 73, at 11.02[B].

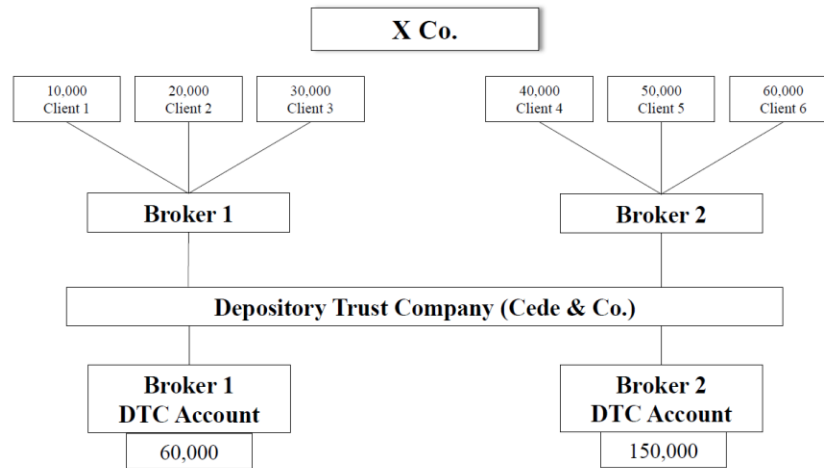
80. *Id.*

81. DTC CHILLS AND FREEZES, *supra* note 77, at 1; *see also* Prefatory Note, *supra* note 64, at I.C (observing that “some 600 or so broker-dealers and banks” are DTC participants,” and that “[e]ssentially all of the trading in publicly held companies is executed through the broker-dealers who are participants in the DTC”).

82. For a detailed discussion of Cede & Co.’s role in the modern stock ownership process, *see Kurz v. Holbrook*, 989 A.2d 140, 147 (Del. Ch. 2010) (discussing street name registration), *rev’d in part & remanded sub. nom.*, *Crown Emak Partners, LLC v. Kurz*, 992 A.2d 377, 382 (Del. 2010) (same).

of the outstanding shares of all publicly traded companies.<sup>83</sup> Accounts at DTC are typically in the name of participating financial institutions and not in the name of the investors who are the beneficial holders of the shares represented in these institutional accounts.<sup>84</sup> Again, only the records of the brokers and banks show the identities of the individual customers.<sup>85</sup>

The following figure<sup>86</sup> illustrates the chain of ownership of a fictitious company, X Co., whose shares are held at DTC.



83. See DEPOSITORY TRUST COMPANY, OPERATIONAL ARRANGEMENTS, *supra* note 68, at I.B.1.c. 5 (requiring that underwriters or issuers “deposit[] with DTC one or more security certificates registered in the name of DTC’s nominee, Cede & Co., for each [stated maturity] of the Securities, the total of which represents 100% of the principal amount of that issuance”); see also Prefatory Note, *supra* note 64, at I.B (“The certificates representing the largest portion of the shares of publicly traded companies, however, are not held by the beneficial owners, but by clearing corporations.”); DEPOSITORY TRUST COMPANY, ASSESSMENT OF COMPLIANCE WITH THE CPSS/IOSCO RECOMMENDATIONS FOR SECURITIES SETTLEMENT SYSTEMS 15 (Dec. 12, 2012) (“We estimate that in excess of 90% of the corporate and municipal securities issued to the public in the U.S. are distributed through DTC and are represented by one or more physical certificates that are immobilized at the depository.”); see also Wilcox et al., *supra* note 79, § 11.02[B] (DTC is the “largest ‘legal’ owner of most public companies’ shares”; “DTC registers its shares on companies’ share registers under the name ‘Cede & Co.’”).

84. See Prefatory Note, *supra* note 64, at I.D (“The depository’s records in turn show the identity of the banks or brokers who are its members, and the records of those securities intermediaries show the identity of their customers.”); *id.* at I.C (“Essentially all of the trading in publicly held companies is executed through the broker-dealers who are participants in DTC, and the great bulk of public securities . . . are held by these broker dealers and banks on behalf of their customers.”); DTC CHILLS AND FREEZES, *supra* note 77, at 1 (“Most large U.S. broker-dealers and banks are DTC participants, meaning that they deposit and hold securities at DTC . . . DTC holds the deposited securities in ‘fungible bulk,’ meaning that there are no specifically identifiable shares directly owned by DTC participants.”); *Street Name*, *supra* note 73 (“When you buy securities through a brokerage firm, most firms will automatically put your securities into ‘street name.’ This means your brokerage firm will hold your securities in its name or another nominee and not in your name, but your firm will keep records showing you as the real or ‘beneficial owner.’”).

85. Prefatory Note, *supra* note 64, at I.D.

86. This figure is adapted from Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1238 (2008).



When participating brokers deposit securities into their DTC account, DTC holds the securities in “fungible bulk,” meaning that there are no specifically identifiable shares directly owned by DTC participants.<sup>87</sup> “Rather, each participant owns a pro rata interest in the aggregate number of shares of a particular issuer held at DTC.<sup>88</sup> Correspondingly, each customer of a DTC participant, such as an individual investor, owns a pro rata interest in the shares in which the DTC participant has an interest.”<sup>89</sup> An investor holding securities in a depository, therefore, does not “own” any actual physical securities, even if the physical securities existed, which is typically not the case.<sup>90</sup> Instead, the investor owns a “securities entitlement” in the aggregate number of shares of a particular stock, or fungible bulk, controlled by his broker-dealer and held in the depository.<sup>91</sup> As a result of this

87. See *In re Puda Coal Sec. Litig.*, No 11 Civ. 2598, 2013 WL 5493007, at \*7 (S.D.N.Y. Oct. 1, 2013) (noting that all shares in a participant’s DTC account are “undifferentiated and fungible”); DTC CHILLS AND FREEZES, *supra* note 77, at 1.

88. DTC CHILLS AND FREEZES, *supra* note 77, at 1.

89. *Id.*

90. Prior to 1970, possession and delivery of physical stock certificates were considered to be key factors in a well-organized securities system. *In re Fleetboston Fin. Corp. Sec. Litig.*, 253 F.R.D. 315, 344 (D.N.J. 2008). “Transfer of securities in the traditional certificate-based system was, however, a complicated, labor-intensive process. Each time securities were traded, the physical certificates had to be delivered from the seller to the buyer, and in the case of registered securities, the certificates had to be surrendered to the issuer or its transfer agent for registration of transfer.” See *Kurz v. Holbrook*, 989 A.2d 140, 168 (Del. Ch. 2010) (citing Prefatory Note, *supra* note 64), *rev’d on other grounds by* *Crown EMAK Partners, LLC v. Kurz*, 992 A.2d 377 (Del. 2010); *Fleetboston*, 253 F.R.D. at 344 (citing U.C.C. §§ 8-102(1)(d), 8-407(2) (1977)). Issuers had to print new stock certificates to represent the transferred securities, and broker-dealers and clearing corporations had to process the necessary transfer documents resulting from this physical exchange. See *id.* (citing Martin J. Aronstein et al., *Article 8 Is Ready*, 93 HARV. L. REV. 889, 890 (1980)).

In the late 1960s, a tremendous increase in trading led to an industry-wide paper crisis. *Id.* The high trading volume made it difficult for many broker-dealers to keep up with the necessary recordkeeping. *Kurz*, 989 A.2d at 168. “Congress responded by passing the Securities Investor Protection Act of 1970, which required the SEC to study the practices leading to the growing crisis in securities transfer.” See *id.* (citing 15 U.S.C. § 78kkk(g) (2006)). “The SEC recommended discontinuing the physical movement of certificates and adopting a depository system.” See *id.* (citing Suellen M. Wolfe, *Escheat and the Challenge of Apportionment: A Bright Line Test to Slice a Shadow*, 27 ARIZ. ST. L.J. 173, 182 n.58 (1995)). “Congress then passed the Securities Acts Amendments of 1975 which, among other things, directed the SEC to ‘use its authority under this chapter to end the physical movement of securities certificates in connection with the settlement among brokers and dealers of transactions in securities consummated by means of the mails or any means or instrumentalities of interstate commerce.’” *Id.* (quoting 15 U.S.C. § 78q-1(e) (2006)); *Fleetboston*, 253 F.R.D. at 344 (citing Securities Act Amendments of 1975, Pub.L. No. 94-29, 89 Stat. 97 (1975); 15 U.S.C. §§ 78q-1(e), 78w(b)(4)(C)).

The key to this new system was the use of a central securities depository where paper certificates could be immobilized. In 1973, banks, brokerage firms, and other members of the NYSE created the DTC to allow them to deposit certificates centrally and leave them at rest. Garvin, *supra* note 77, at 315. By immobilizing certificates under the control of a securities depository, which became the nominal owner of the shares, transfers and pledges could be effected by entries on the depository’s books, without delivering any physical stock certificates. *Id.*; *Fleetboston*, 253 F.R.D. at 344 (citing Charles W. Mooney, Jr., *Property, Credit, and Regulation Meet Information Technology: Clearance and Settlement in the Securities Markets*, 55 L. & CONTEMP. PROBS. 131, 136 (1992)); DEPOSITORY TRUST COMPANY, ASSESSMENT OF COMPLIANCE, *supra* note 83, at 15.

91. *Fleetboston*, 253 F.R.D. at 344 (citing 17 C.F.R. § 240.13d-3 (1995)). Drafters of the Uniform Commercial Code adopted the concept of a “securities entitlement” when they revised the Code in 1994 to “adequately deal with the system of securities holdings through securities intermediaries” such as banks, brokers, and clearing agencies. See Prefatory Note, *supra* note 64 (discussing Article 8 revisions); Revised Article 8, which governs the mechanism by which interests in securities are transferred, see *id.* at II.B., defines a “security entitlement” to mean “the rights and property interest of a person who holds securities or other financial assets

commingling, “it is often impossible to determine whether previously traded shares are old or new, and that tracing is further complicated when stock is held in margin accounts in street names since many brokerage houses do not identify specific shares with particular accounts but instead treat the account as having an unallocated interest in the house’s position.”<sup>92</sup> In most circumstances, neither the investors, nor the broker-dealers, nor the depositories, will have any means of identifying which specific shares belong to which individual investors.<sup>93</sup>

Indeed, brokerage firms that buy or sell publicly traded securities typically have client account agreements that permit shares to be deposited with DTC and held in fungible bulk. A typical brokerage agreement provides that when securities are held in a broker’s participant account, the broker does not need to deliver the same securities as those deposited with or received by it for an account. The broker can instead deliver securities of an equivalent amount and of the same nature and kind.<sup>94</sup>

Finally, the modern process for settling and transferring securities makes it virtually impossible to trace the origins or flows of any “particular share” once the share enters the marketplace—assuming that it even makes sense to speak of a differentiated share given the structure of modern market mechanisms. Most securities that are bought and sold today are distributed through DTC in electronic “book-entry” form,<sup>95</sup> and not through the transfer of paper certificates that can be physically traced.<sup>96</sup> The book-entry system accounts for share transfers by electronically debiting the selling broker’s account and simultaneously

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through a securities intermediary.” U.C.C. § 8-102, Official Comment ¶ 17 (AM. LAW INST. & UNIF. LAW COMM’N 2001). The drafters recognized, however, that “[a] security entitlement is not . . . a specific property interest in any financial asset held by the securities intermediary or by the clearing corporation through which the securities intermediary holds the financial asset.” *Id.*

92. *Barnes v. Osofsky*, 373 F.2d 269, 272 (2d Cir. 1967).

93. *See* U.C.C. § 8-503, Official Comment ¶ 1 (2001) (recognizing that “securities intermediaries generally do not segregate securities in such fashion that one could identify particular securities as the ones held for customers”); *id.* § 8-504, Official Comment ¶ 1 (“This section recognizes the reality that as the securities business is conducted today, it is not possible to identify particular securities as belonging to customers as distinguished from other particular securities that are the firm’s own property. Securities firms typically keep all securities in fungible form, and may maintain their inventory of a particular security in various locations and forms, including physical securities held in vaults or in transit to transfer agents, and book entry positions at one or more clearing corporations.”); *see also In re Puda Coal Sec. Litig.*, No 11 Civ. 2598, 2013 WL 5493007, at \*8 (S.D.N.Y. Oct. 1, 2013) (recognizing that when shares are commingled with other securities at the DTC, “they lose any specific identity”).

94. *See, e.g., Levitin v. Paine Webber, Inc.*, 159 F.3d 698, 703–06 (2d Cir. 1998) (describing federal regulations that expressly permit broker commingling of customer funds and securities, and observing that any state law that would require segregation of customer collateral “would be in direct conflict with Rules 15c2-1 and 15c3-2, each of which permit the commingling of customer assets subject to certain consent and notice requirements”; also observing that brokerage contracts commonly permit the broker to “hypothecate property, including . . . securities, in her account and to commingle her property with its own or that held for others, all without notice to” the customer).

95. *See* WESTENBERG, *supra* note 32, § 15:6.3 (noting that one of the conditions for listing securities on the NYSE or NASDAQ is that “[t]he common stock must be eligible for deposit at DTC to enable shares to be held in street name and to qualify for direct registration”); *see also* DEPOSITORY TRUST COMPANY, ASSESSMENT OF COMPLIANCE, *supra* note 83, at 15 (stating that over 99% of municipal and corporate debt by par value distributed through DTC was in book-entry-only form).

96. For securities distributed through DTC in book-entry form, DTC holds one or more “global” certificates representing the entire outstanding quantity of securities in the issue. DEPOSITORY TRUST COMPANY, ASSESSMENT OF COMPLIANCE, *supra* note 83, at 15; Wilcox et al., *supra* note 73, at 11.02B.

crediting the purchasing broker's account in the same amount.<sup>97</sup> Because there is no paper trail to follow, securities within the book-entry system are no longer linked to the individual investors who actually purchased or sold the shares.<sup>98</sup>

The book-entry system has also been streamlined through a process of netting that renders the ability to trace the flow of individual shares through the trading process all the more impractical. At the end of each trading day, the brokerage firms and the NSCC net their internal transactions before reporting their positions to the DTC.<sup>99</sup> Thus, if a brokerage firm begins a trading day with 10,000 shares of X Co. in its DTC account, and if the brokerage firm's Client 1 buys 100 shares of X Co. while Client 2 of the same brokerage sells 100 shares of X Co., then the brokerage still has 10,000 shares of X Co. in its DTC account and reports no new net activity to DTC.<sup>100</sup> DTC thus records no transfers on its books for that broker for that particular day, and the only transfer of shares observable in the system occurs at the individual customer account level at the brokerage firm.

If, on the other hand, Client 1 buys 10,000 shares of X Co., but all other clients of the brokerage sell an aggregate of 100,000 shares, then the brokerage will report net sales of 90,000 shares to DTC. In that case, there will be no inflow of shares to the broker's DTC account because the broker's net position at DTC was actually diminished by the day's trading. The transfer of shares to Client 1's account will exist only as an internal entry on the broker's books and will not be apparent to anyone other than to the broker and the client. Put another way, there is no way to trace Client 1's purchases through DTC because the internal netting process at the broker eliminates any evidence of those purchases. The net sales of 90,000 shares reported to DTC could also be the result of 1 million sales and 910,000 purchases, 90,000 sales and no purchases, or 100 million sales and 99,910,000 purchases. DTC's records are therefore useless in determining the ultimate flow of securities interests in any individual customer's account. Thus, because securities trades are typically settled on a net basis by book-entry movements, it is de facto impossible to

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97. DEPOSITORY TRUST COMPANY, ASSESSMENT OF COMPLIANCE, *supra* note 83, at 11; *see also* J. Robert Brown, Jr., *The Shareholder Communication Rules and the Securities and Exchange Commission*, 13 J. CORP. L. 683, 688 (1988) ("Each time a change in beneficial ownership occurs, the transfer is reflected through book entries, without the need for a new certificate.").

98. *See Puda Coal*, 2013 WL 5493007, at \*4 (noting that when shares are transferred by book-entry, "the shares are not specifically identifiable" and hence are "not distinguishable" from any other shares of the same issuer held at DTC).

99. *See* Prefatory Note, *supra* note 64, at I.C ("Significant processing efficiency has been achieved by netting all of the transactions among the participants that occur each day, so that entries need be made on the depository's books only for the net changes in the positions of each participant . . . at the end of each day.").

100. *See id.* ("The broker-dealers and banks who are participants in the DTC-NSCC system in turn provide analogous clearance and settlement functions to their own customers. If Customer A buys 100 shares of XYZ Co. through Broker, and Customer B sells 100 shares of XYZ Co. through the same Broker, the trade can be settled by entries on Broker's books. Neither DTC's books showing Broker's total position in XYZ Co., nor XYZ Co.'s books showing DTC's total position in XYZ Co., need to be changed to reflect the settlement of this trade. One can readily appreciate the significance of the settlement function performed at this level if one considers that a single major bank may be acting as securities custodian for hundreds or thousands of mutual funds, pension funds, and other institutional investors. On a given day, the customers of that bank may have entered into an enormous number of trades, yet it is possible that relatively little of this trading activity will result in any net change in the custodian bank's positions on the books of DTC. Settlement of market trading in most of the major U.S. securities markets is now effected primarily through some form of netted clearance and depository system. Virtually all publicly traded corporate equity securities, corporate debt securities, and municipal debt securities are now eligible for deposit in the DTC system.").

trace the path of any particular security once it enters the marketplace.<sup>101</sup>

### III. *MORRISON* AND THE INTERNATIONALLY DISTRIBUTED, U.S.-LISTED IPO

In *Morrison v. National Australia Bank Ltd.*<sup>102</sup> the Supreme Court revolutionized the application of U.S. securities laws to international transactions. For decades, lower courts had applied the conduct,<sup>103</sup> effects,<sup>104</sup> and admixture tests<sup>105</sup> to determine when anti-fraud

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101. Section 8-502 of the Uniform Commercial Code provides the following example, which illustrates this point: “Suppose, for example, that S has a 1000 share position in XYZ common stock through an account with a broker, Able & Co. S’s identical twin impersonates S and directs Able to sell the securities. That same day, B places an order with Baker & Co., to buy 1000 shares of XYZ common stock. Later, S discovers the wrongful act and seeks to recover ‘her shares.’ Even if S can show that, at the stage of the trade, her sell order was matched with B’s buy order, that would not suffice to show that ‘her shares’ went to B. Settlement between Able and Baker occurs on a net basis for all trades in XYZ that day; indeed Able’s net position may have been such that it received rather than delivered shares in XYZ through the settlement system.” U.C.C. § 8-502, Official Comment ¶ 2 (AM. LAW INST. & UNIF. LAW COMM’N 2000); *see also Puda Coal*, 2013 WL 5493007, at \*7–9 (granting summary judgment based on plaintiff’s inability to assert a valid section 11 claim and noting that plaintiff’s shares were transferred by book-entry from one DTCC account to another, and that “[o]nce a part of the DTCC group of Puda Coal shares, they lose any specific identity . . . . This fungibility of shares is fatal to Rosenberg’s attempt to trace particular shares to the December 2010 Offering.”); *In re Fleetboston Fin. Corp. Sec. Litig.*, 253 F.R.D. 315, 345 (D.N.J. 2008) (“While this practice of registering securities in ‘nominee’ or ‘street name’ made it notably easier for transactions to be cleared in securities markets, this practice of masking the beneficial owner of each particular security allowed for a peculiar side effect: beneficial owners (that is, the owners of ‘securities entitlements’ in the aggregate bulk of shares of a particular stock) became unable to satisfy the tracing requirement of [s]ection 77k . . . in the event their aggregate bulks consist of identically denominated and, thus, wholly fungible, shares generated by the issuer as a result of more than one offering.”); *In re Initial Pub. Offering Sec. Litig.*, 227 F.R.D. 65, 118 (S.D.N.Y. 2004) (“The modern practice of electronic delivery and clearing of securities trades, in which all deposited shares of the same issue are held together in fungible bulk, makes it virtually impossible to trace shares to a registration statement once additional unregistered shares have entered the market.”); *see also Abbey v. Comput. Memories, Inc.*, 634 F. Supp. 870, 873–76 (N.D. Cal. 1986) (granting summary judgment of plaintiff’s section 11 claim where plaintiff’s shares were commingled at the depository and plaintiff could not trace his shares to the relevant offering); *Klein v. Comput. Devices, Inc.*, 591 F. Supp. 270, 273 n.7 (S.D.N.Y. 1984) (“The open-market purchaser . . . must be able to trace his particular securities to the registration statement when it covered additional securities of an outstanding class . . . . If the purchaser bought identical securities already being traded on the open market, he must look elsewhere for relief.”) (citations omitted); *Lorber v. Beebe*, 407 F. Supp. 279, 287 (S.D.N.Y. 1975) (dismissing section 11 claim where plaintiff could not distinguish between old and new stock).

102. *Morrison v. Nat’l Austl. Bank Ltd.*, 561 U.S. 247 (2010).

103. *See Morrison v. Nat’l Austl. Bank Ltd.*, 547 F.3d 167, 171 (2d Cir. 2008) (discussing the three tests); *Psimenos v. E.F. Hutton & Co.*, 722 F.2d 1041, 1045–46 (2d Cir. 1983) (applying the conduct test); *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1333–35 (2d Cir. 1972).

104. *See Morrison*, 547 F.3d at 171 (discussing the three tests); *Schoenbaum v. Firstbrook*, 405 F.2d 200, 206–08 (2d Cir. 1968), *rev’d with respect to holding on merits*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied sub nom.*; *see also Manley v. Schoenbaum*, 395 U.S. 906 (1969) (applying the effects test and concluding “that the district court has subject matter jurisdiction over violations of the Securities Exchange Act although the transactions which are alleged to violate the Act take place outside the United States, at least when the transactions involve stock registered and listed on a national securities exchange, and are detrimental to the interests of American investors”).

105. *Morrison*, 547 F.3d at 171 (discussing the three tests); *Itoba Ltd. v. Lep Group PLC*, 54 F.3d 118, 122 (2d Cir. 1995) (“There is no requirement that [the conduct and effects] tests be applied separately and distinctly from each other. Indeed, an admixture or combination of the two often gives a better picture of whether there is sufficient United States involvement to justify the exercise of jurisdiction by an American court.”).

liability under U.S. securities law governed transactions with foreign components. *Morrison* replaced those venerable standards with a two-part transactional test that recognizes Exchange Act liability “only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States.”<sup>106</sup>

*Morrison* immediately presented the lower courts with a range of difficult interpretive questions,<sup>107</sup> many of which have yet to be resolved. It also quickly generated a copious body of commentary and analysis.<sup>108</sup> This rich literature has yet, however, to address *Morrison*’s implications for the scope of liability under section 11 of the Securities Act when a portion of the initial distribution of an IPO occurs in non-domestic transactions. As already explained, the initial distribution of IPO shares does not occur on any stock exchange, even if the shares are authorized for listing and subsequent trading on a U.S. exchange. Further, the initial distribution of IPO shares does not constitute “a purchase or sale in the United States” when purchasers acquire title to the securities offshore, such as through foreign accounts held at foreign broker dealers that are regulated by foreign authorities, and where the clients’ account agreements contain choice of law clauses stating that foreign law governs all disputes related to the account as well as forum selection provisions establishing that all disputes are to be resolved in foreign fora.<sup>109</sup> It follows that, if *Morrison* applies to the Securities Act, these “Offshore Purchasers” fail both parts of *Morrison*’s transactional test: they do not transact on a U.S. exchange and do not purchase or sell any security in the United States. These Offshore Purchasers therefore are not among the category of investors that Congress intended to protect with the Securities Act and cannot assert a valid claim under section 11, even if their shares are qualified for subsequent

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106. *Morrison*, 561 U.S. at 273.

107. For example, lower courts have considered whether *Morrison* applies to Securities Act claims and other statutes, see *infra* Section III.C; whether listing a security on a domestic exchange satisfies *Morrison*’s domestic transaction requirement, see *infra* Section III.D; and whether off-exchange transactions are domestic within the meaning of *Morrison*, see *infra* Section III.E.

108. See, e.g., Katherine Florey, *Bridging the Divide: The Case for Harmonizing State and Federal Extraterritoriality Principles after Morrison and Kiobel*, 27 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 197 (2014) (exploring the extraterritorial reach of state law in the wake of *Morrison* and *Kiobel v. Royal Dutch Petroleum Co.*); Kelley Morris White, *Is Extraterritorial Jurisdiction Still Alive? Determining the Scope of U.S. Extraterritorial Jurisdiction in Securities Cases in the Aftermath of Morrison v. National Australia Bank*, 37 N.C. J. INT’L L. & COM. REG. 1187, 1190 (2012) (discussing the “jurisdictional issues raised by *Morrison* and the extent to which the Dodd–Frank Act resolves them”); Richard D. Bernstein et al., *Closing Time: You Don’t Have to Go Home, But You Can’t Stay Here*, 67 BUS. LAW. 957, 959–65 (Aug. 2012) (addressing the impact of *Morrison* on exchange transactions, off-exchange transactions, and other federal statutes); John D. Roesser & Louis A. Russo, *How ‘Morrison’ Inadvertently Broadens Extraterritorial Actions*, 248 N.Y.L.J. 1, 1 (2012), (discussing “various conflicting applications of the transactional test” by lower federal courts); Thomas Allan Dubbs, *Textualism and Transnational Securities Law: A Reappraisal of Justice Scalia’s Analysis in Morrison v. National Australia Bank* (June 17, 2014) (unpublished manuscript), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2398597](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2398597) (reappraising the textual analysis of *Morrison* in light of Justice Scalia’s later work).

109. This analysis is not to suggest that, in order to avoid the reach of U.S. securities law under *Morrison*, a purchaser in an initial distribution must acquire a foreign account held at a foreign broker dealer that is regulated by a foreign authority and that the account agreement must contain a choice of law provision designating a foreign nation’s law as controlling, as well as a forum selection provision requiring that the dispute be resolved in a foreign forum. These conditions are sufficient for purposes of this Article’s analysis. Precedent interpreting *Morrison* suggests that not all of these conditions would likely be viewed as necessary in order to support the conclusion that a transaction is not domestic for purposes of *Morrison*. See *infra* Section III.E (discussing when off-exchange transactions are domestic within the meaning of *Morrison*).

listing on a U.S. exchange.

*A. Morrison's Holding and the Supreme Court's Rationale*

In *Morrison*, the Court for the first time addressed the extraterritorial reach of section 10(b) of the Exchange Act. *Morrison* was a “foreign-cubed action,” in which “(1) *foreign* plaintiffs [were] suing (2) a *foreign* issuer in an American court for violations of American securities laws based on securities transactions in (3) *foreign* countries.”<sup>110</sup> Lead plaintiffs were foreign investors who purchased ordinary shares issued by the National Australia Bank (NAB) on the Australian Stock Exchange. Plaintiffs sued in the Southern District of New York under section 10(b), alleging that defendants made fraudulent statements concerning the financial performance of one of NAB’s U.S. subsidiaries.<sup>111</sup> NAB had filed separate, but materially identical, financial statements in Australia and in the United States.<sup>112</sup>

The district court dismissed the foreign plaintiffs’ claims for lack of subject matter jurisdiction.<sup>113</sup> The Second Circuit affirmed,<sup>114</sup> and applying its longstanding “conduct” and “effects” tests, considered “(1) whether the wrongful *conduct* occurred in the United States, and (2) whether the wrongful conduct had a substantial *effect* in the United States or upon United States citizens.”<sup>115</sup> The court found that neither test was satisfied because (1) the acts and omissions by the defendants undertaken in Australia were “significantly more central to the fraud and more directly responsible for the harm to investors” than the allegedly wrongful conduct that occurred in the United States; and (2) the plaintiffs had failed to assert that the alleged fraud “had any meaningful effect on America’s investors or its capital markets.”<sup>116</sup>

On a grant of certiorari, the Supreme Court noted that the extraterritorial application of section 10(b) is not a question of subject-matter jurisdiction, but instead presents a “merits question” regarding “what conduct [section] 10(b) prohibits.”<sup>117</sup> The Court relied

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110. *Morrison*, 561 U.S. at 283 n.11 (Breyer, J., concurring in part and concurring in the judgment) (quoting *Morrison v. Nat’l Austl. Bank Ltd.*, 547 F.3d 167, 172 (2d Cir. 2008)).

111. *In re Nat’l Austl. Bank Sec. Litig.*, No. 03 Civ. 6537(BSJ), 2006 WL 3844465, at \*1–2 (S.D.N.Y. Oct. 25, 2006). While none of NAB’s ordinary shares were traded on any U.S. exchange, instruments called American Depositary Receipts (ADRs), which represented quantities of NAB ordinary shares, were traded on the NYSE. *Id.* at \*1. One of the original lead plaintiffs—Robert Morrison—was a U.S. resident who purchased NAB’s ADRs on the NYSE, but Morrison’s claims were dismissed for failure to allege damages. *Morrison*, 561 U.S. at 252 n.1.

112. *Nat’l Austl. Bank Sec. Litig.*, 2006 WL 3844465, at \*8 n.9.

113. *Id.* at \*8.

114. *See Morrison*, 547 F.3d at 177 (“This particular mix of factors—the fact that the fraudulent statements at issue emanated from NAB’s corporate headquarters in Australia, the complete lack of any effect on America or Americans, and the lengthy chain of causation between HomeSide’s actions and the statements that reached investors—add up to a determination that we lack subject matter jurisdiction.”).

115. *Id.* at 171 (emphasis added).

116. *Id.* at 176.

117. *Morrison v. Nat’l Austl. Bank Ltd.*, 561 U.S. 247, 254 (2010). Lower courts have consistently interpreted *Morrison* as a matter of the plaintiff’s entitlement to relief under a particular cause of action (a merits question), and not as a question of whether the court possesses subject matter jurisdiction to hear the claim (a jurisdictional question). *Norex Petroleum Ltd. v. Access Indus., Inc.*, 631 F.3d 29, 31 (2d Cir. 2010) (posing the issue as a merits question); *In re UBS Sec. Litig.*, No. 07 Civ. 11225, 2011 WL 4059356, at \*2 (S.D.N.Y. Sept. 13, 2011) (interpreting *Morrison*’s transition test as a merits question); *In re Banco Santander Sec.-Optimal Litig.*, 732 F. Supp. 2d 1305, 1318 n.6 (S.D. Fla. 2010) (noting that *Morrison* held the issue of extraterritoriality as a

on the “longstanding principle of American law” that, unless a statute gives a “clear indication of an extraterritorial application,” the statute “is meant to apply only within the territorial jurisdiction of the United States.”<sup>118</sup> “This ‘canon of [statutory] construction,’ which the Court had previously labeled ‘the presumption against extraterritoriality’ . . . is based on the assumption that ‘Congress ordinarily legislates with respect to domestic, not foreign matters.’”<sup>119</sup> It follows that “[u]nder this presumption, ‘[w]hen a statute gives no clear indication of an extraterritorial application, it has none.’”<sup>120</sup> “The Court observed that ‘[o]n its face, [section] 10(b) contains nothing to suggest that it applies abroad.’”<sup>121</sup> “Nor did the statute’s ‘general reference to foreign commerce in the definition of “interstate commerce” . . . defeat the presumption against extraterritoriality.’”<sup>122</sup> “Thus, finding ‘no affirmative indication in the Exchange Act that [section] 10(b) applies extraterritoriality,’ the Court ‘concluded that it does not.’”<sup>123</sup>

*Morrison* also addressed “what it referred to as the ‘focus of congressional concern’ expressed by the statute”:<sup>124</sup>

[T]he focus of the Exchange Act is not upon the place where the deception originated, but upon purchases and sales of securities in the United States. Section 10(b) does not punish deceptive conduct, but only deceptive conduct “in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered.” Those purchase-and-sale transactions are the objects of the statute’s solicitude . . . . [I]t is in our view only transactions in securities listed on domestic exchanges, and domestic transactions in other securities, to which [section] 10(b) applies.<sup>125</sup>

Accordingly, “[n]ot deception alone, but deception with respect to certain purchases or sales is necessary for a violation of the statute.”<sup>126</sup> The majority rejected the “conduct” and “effects” tests because those tests lacked textual basis, were difficult to administer, yielded inconsistent and unpredictable results, and conflicted with the presumption against

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merits question). Practitioners and commentators are in accord. *See, e.g.*, Alex Reed, *But I’m an American! A Text-Based Rationale for Dismissing F-Squared Securities Fraud Claims after Morrison v. National Australia Bank*, 14 U. PA. J. BUS. L. 515, 523 n.73 (2012) (suggesting that in *Morrison*, “the extraterritorial application of [s]ection 10(b) was found to constitute a merits question properly reviewed under Rule 12(b)(6).”); SULLIVAN & CROMWELL, *THE TERRITORIAL REACH OF U.S. SECURITIES LAWS AFTER MORRISON V. NATIONAL AUSTRALIA BANK* 5 (2011), [http://www.sullcrom.com/siteFiles/Publications/SC\\_Publication\\_The\\_Territorial\\_Reach\\_of\\_US\\_Securities\\_Laws.pdf](http://www.sullcrom.com/siteFiles/Publications/SC_Publication_The_Territorial_Reach_of_US_Securities_Laws.pdf) (noting that in *Morrison*, “the Supreme Court held that whether foreign-cubed claims may proceed in a U.S. court is not an issue of jurisdiction, but rather a question of whether there is a cause of action for foreign-cubed claims under [s]ection 10(b).”); PAUL VIZCARRONDO, JR. ET AL., *LIABILITIES UNDER THE FEDERAL SECURITIES LAWS* 7 (2012), <http://www.wlrk.com/files/2012/FederalSecuritiesLaws2012.pdf> (“*Morrison* addressed the substantive reach of section 10(b), not the federal courts’ jurisdiction.”).

118. *Morrison*, 561 U.S. at 248–55 (internal quotation marks omitted).

119. *Parkcentral Global Hub Ltd. v. Porsche Auto. Holdings SE*, 763 F.3d 198, 210 (2d Cir. 2014) (quoting *Morrison*, 561 U.S. at 255).

120. *Id.* (quoting *Morrison*, 561 U.S. at 255).

121. *Id.* (quoting *Morrison*, 561 U.S. at 262).

122. *Id.* (quoting *Morrison*, 561 U.S. at 263).

123. *Id.* (quoting *Morrison*, 561 U.S. at 265).

124. *Parkcentral*, 763 F.3d at 210 (quoting *Morrison*, 561 U.S. at 266).

125. *Id.* (quoting *Morrison*, 561 U.S. at 266–67) (emphasis added) (citation omitted).

126. *Id.* at 211 (quoting *Morrison*, 561 U.S. at 272).

extraterritorial application of U.S. law.<sup>127</sup>

The Court explained that its new “transactional” test properly emphasized that “the focus of the Exchange Act is not upon the place where the deception originated, but upon purchases and sales of securities in the United States.”<sup>128</sup> Under this test, section 10(b) applies only to “securities listed on domestic exchanges[] and domestic transactions in other securities.”<sup>129</sup> Stated differently, under this two-prong test, “[s]ection 10(b) reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States.”<sup>130</sup>

The majority observed that in addition to bringing certainty to the application of U.S. securities law, the transactional test would avoid conflict with foreign law. The transactional test was thus intended to avoid the problem of “interference with foreign securities regulation that application of [section] 10(b) abroad would produce” and to respect the authority of “foreign countries [to] regulate their domestic securities exchanges and securities transactions occurring within their territorial jurisdiction.”<sup>131</sup> The majority stressed that it “know[s] of no one who thought that the [Exchange] Act was intended to ‘regulat[e]’ foreign securities exchanges—or indeed who even believed that under established principles of international law Congress had the power to do so.”<sup>132</sup>

Applying this rule to the case before it, the Court held that plaintiffs failed to state a claim upon which relief could be granted because the purchase or sale of NAB ordinary shares in Australia “involve[d] no securities listed on a domestic exchange, and all aspects of the purchases complained of by those petitioners who still have live claims occurred outside the United States.”<sup>133</sup> The majority rejected plaintiffs’ suggestion that defendants’ deceptive conduct within the state of Florida constituted “domestic” activity that brought their claims within the scope of section 10(b).<sup>134</sup> Rather, the majority noted that “it is a rare case of prohibited extraterritorial application that lacks *all* contact with the territory of the United States,” and that “the presumption against extraterritorial application would be a craven watchdog indeed if it retreated to its kennel whenever *some* domestic activity is involved in the case.”<sup>135</sup> The majority was thus keenly aware that its new test would preclude extraterritorial application of section 10(b) to foreign securities transactions involving alleged wrongful conduct that occurs in the United States, and that could cause harm to American investors in the United States.

The Second Circuit is the jurisdiction most actively involved in the interpretation of *Morrison*.<sup>136</sup> That court has emphasized that it reads “*Morrison* to ‘wholeheartedly

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127. *Morrison*, 561 U.S. at 258–61.

128. *Id.* at 266.

129. *Id.* at 267.

130. *Id.* at 273.

131. *Id.* at 269.

132. *Morrison*, 561 U.S. at 267.

133. *Id.* at 273.

134. *Id.* at 266.

135. *Id.*

136. As of September 14, 2015, of the 59 appellate decisions interpreting *Morrison*, 19 (32%) have been issued by the Second Circuit. Of the 197 district court decisions interpreting *Morrison*, 107 (54%) have been issued by courts in the Southern District of New York. These numbers were generated by searching Westlaw’s federal cases database for the phrase (morrison /3 national /3 australia), and then limiting search results to particular courts.



embrace[] application of the presumption against extraterritoriality, finding that ‘unless there is the affirmative intention of the Congress clearly expressed to give extraterritorial effect, we must presume it is primarily concerned with domestic conditions.’”<sup>137</sup> The Second Circuit thus looks for “a ‘clear’ and ‘affirmative indication’ that a statute applies to conduct occurring outside the territorial jurisdiction of the United States before concluding that the presumption has been overcome.”<sup>138</sup>

### B. The Congressional Response

Approximately one month after *Morrison* was decided, President Obama signed into law the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act). Section 929P(b) of that act, entitled “Extraterritorial Jurisdiction of the Antifraud Provisions of the Federal Securities Laws,” amends the Securities Act,<sup>139</sup> the Exchange Act,<sup>140</sup> and the Investment Advisers Act,<sup>141</sup> and adds the following language:

The district courts of the United States and the United States courts of any Territory shall have jurisdiction of an action or proceeding brought or instituted by the Commission or the United States alleging a violation of the antifraud provisions of this title involving—(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.<sup>142</sup>

Congress was evidently aware of *Morrison*’s consequences for private securities fraud litigation under both the Securities Act and Exchange Act and decided not to disturb *Morrison*’s holding with respect to private party litigation under either statute. Section 929P(b) was instead limited to an effort to restore a version of the pre-existing “conduct” and “effects” tests for the exclusive benefit of the SEC and the Department of Justice (DOJ).<sup>143</sup>

137. *Liu v. Siemens A.G.*, 763 F.3d 175, 178 (2d Cir. 2014) (quoting *Norex Petroleum Ltd. v. Access Indus., Inc.*, 631 F.3d 29, 32 (2d Cir. 2010)).

138. *Id.* (quoting *United States v. Weingarten*, 632 F.3d 60, 65 (2d Cir. 2011)).

139. 15 U.S.C. § 77v(c) (2012).

140. 15 U.S.C. § 78aa(b).

141. 15 U.S.C. § 80b-14(b).

142. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P(b), 124 Stat. 1376, 1864–65 (2010).

143. The text of section 929P(b) is framed in terms of a grant of “jurisdiction.” *Morrison*, however, expressly rejects the notion that its interpretation of the Exchange Act is based on jurisdictional considerations and instead emphasizes that the presumption against extraterritorial application animates its analysis. Thus, an open question remains as to whether section 929P(b) restores the SEC or DOJ’s right to rely on the “conduct” and “effects” tests in transnational litigation. *See, e.g.*, Andrew Rocks, *Whoops! The Imminent Reconciliation of U.S. Securities Laws with International Comity after Morrison v. National Australia Bank and the Drafting Error in the Dodd-Frank Act*, 56 VILL. L. REV. 163, 166, 188 (2011) (suggesting that “the Act fails to expand the geographic enforcement capabilities of the SEC or the [DOJ] under U.S. securities laws”); GEORGE T. CONWAY III, WACHTELL, LIPTON, ROSEN & KATZ, EXTRATERRITORIALITY OF THE FEDERAL SECURITIES LAWS AFTER DODD-FRANK: PARTLY BECAUSE OF A DRAFTING ERROR, THE STATUS QUO SHOULD REMAIN UNCHANGED (July 21, 2010), <http://www.wlrk.com/webdocs/wlrknew/wlrkmemos/wlrk/wlrk.17763.10.pdf> (concluding that Dodd–Frank Act provisions 929P(b) and 929Y concerning antifraud provisions of federal securities laws do not “overturn[]

The Dodd–Frank Act also ordered the SEC to conduct a study to determine the extent to which the antifraud provisions of the Exchange Act should be extended extraterritorially in the context of private rights of action.<sup>144</sup> In the resulting study, the Commission took no position as to whether Congress should take further legislative action in response to *Morrison*. The agency instead presented several options for Congressional consideration, including: (1) legislative enactment of the “conduct and effects” tests; (2) narrowing the conduct test’s scope to require the plaintiff to demonstrate that injury resulted directly from conduct within the United States; (3) enacting the conduct and effects tests only for U.S. resident investors; (4) clarifying the transactional test by permitting investors to pursue a section 10(b) claim for the purchase or sale of any security of the “same class of securities registered in the United States, irrespective of the actual location of the transaction;” (5) “authorizing [s]ection 10(b) private actions against intermediaries such as broker-dealers and investment advisers that engage in securities fraud while purchasing or selling securities overseas for U.S. investors or providing other services related to overseas securities transactions to U.S. investors;” (6) permitting investors to “pursue a [s]ection 10(b) private action if they can demonstrate that they were fraudulently induced while in the United States to engage in the transaction”, irrespective of the actual focus of the transaction; and (7) clarifying that “an off-exchange transaction takes place in the United States if either party [makes] the offer to sell or purchase, or accept[s] the offer to sell or purchase, while in the United States.”<sup>145</sup>

### C. *Morrison and the Securities Act*

*Morrison*’s holding is technically limited to the scope of private section 10(b) civil liability under the Exchange Act. Precedent and logic, however, suggest that *Morrison*’s presumption against extraterritoriality applies with equal force to the Securities Act. “Indeed, *Morrison* itself expressly states that the Exchange Act and the Securities Act share “[t]he same focus on domestic transactions.”<sup>146</sup> Consistent with this observation, every court to have considered the question has concluded that *Morrison* applies to Securities

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[*Morrison*], and neither should extend the substantive reach of the securities laws extraterritorially at all”); see also SEC v. A Chi. Convention Ctr., LLC, 961 F. Supp. 2d 905, 910–16 (N.D. Ill. 2013) (analyzing the effect of section 929P(b) on *Morrison*, but declining to “resolve this complex interpretation issue”); Asadi v. GE Energy (USA), LLC, No. 4:12–345, 2012 WL 2522599, at \*4 (S.D. Tex. June 28, 2012) (suggesting that “[s]ection 929P(b) gives the district courts extraterritorial jurisdiction, but only over certain enforcement actions brought by the SEC or the United States”).

144. See Pub. L. No. 111-203 § 929Y, 124 Stat. at 1871 (requiring a study on the extraterritorial scope of Exchange Act private rights of action). On April 11, 2012, the SEC released its “Study on the Cross-Border Scope of the Private Right of Action Under Section 10(b) of the Securities Exchange Act of 1934.” STAFF OF THE U.S. SEC. AND EXCHANGE COMMISSION, STUDY ON THE CROSS-BORDER SCOPE OF THE PRIVATE RIGHT OF ACTION UNDER SECTION 10(B) OF THE SECURITIES EXCHANGE ACT OF 1934 iv–v (2012), <http://www.sec.gov/news/studies/2012/929y-study-cross-border-private-rights.pdf> [hereinafter SEC STUDY]. Several foreign governmental authorities submitted comment letters supporting *Morrison*’s transactional test, including: HM Treasury, U.K. Government; Government of the Federal Republic of Germany; Government of France; Australian Government; European Commission; Government of Switzerland; and Autorité des Marchés Financiers (the French securities regulator). *Id.* at 40 n.145.

145. SEC STUDY, *supra* note 144, at vi–vii.

146. SEC v. Goldman Sachs & Co., 790 F. Supp. 2d 147, 164 (S.D.N.Y. 2011) (quoting *Morrison v. Nat’l Austl. Bank Ltd.*, 561 U.S. 247, 268 (2010)); see also *In re Royal Bank of Scot. Grp.*, 765 F. Supp. 2d 327, 338 n.11 (S.D.N.Y. 2011) (“[T]he *Morrison* Court clearly expressed that the territorial reach of the Exchange Act and Securities Act involves the ‘same focus on domestic transactions.’”) (quoting *Morrison*, 561 U.S. at 268).

Act claims, with no precedent suggesting a cogent argument to the contrary.<sup>147</sup>

*Morrison*'s presumption against extraterritoriality has also been applied to a wide range of statutes other than the Exchange Act, some of which are quite far removed from the Exchange Act's subject matter.<sup>148</sup> For example, in *Kiobel v. Royal Dutch Petroleum*,<sup>149</sup> a unanimous Supreme Court followed *Morrison* and ruled that the Alien Tort Claims Act, adopted in 1789, would not allow corporations to be held liable for aiding and abetting international human rights abuses or other violations of international law. There was no indication that Congress in 1789 intended that the United States would become "a uniquely hospitable forum for the enforcement of international norms."<sup>150</sup> Lower courts have also applied *Morrison* to the anti-retaliation provision of the Dodd–Frank Act,<sup>151</sup> the Commodity Exchange Act,<sup>152</sup> the Bankruptcy Act,<sup>153</sup> the Robinson–Patman Act,<sup>154</sup> the Family and Medical Leave Act,<sup>155</sup> the Longshore and Harbor Workers' Compensation Act,<sup>156</sup> federal bribery and wire fraud statutes,<sup>157</sup> and to the Racketeer Influenced and

147. See, e.g., *SEC v. Levine*, 462 F. App. 717, 719 (9th Cir. 2011) (applying *Morrison* to Securities Act liability); *In re SMART Techs., Inc.*, 295 F.R.D. 50, 55–57 (S.D.N.Y. 2013) (applying *Morrison* to section 11 and 12(a)(2) claims, and excluding from a class action all initial purchasers who acquired shares in Canada and subsequent aftermarket purchasers who transacted on a Canadian exchange); *SEC v. Tourre*, No. 10 Civ. 3229, 2013 WL 2407172, at \*4, \*6–9 (S.D.N.Y. June 4, 2013) (applying *Morrison* to section 17 claim); *In re Vivendi Universal*, 842 F. Supp. 2d 522 (S.D.N.Y. 2012) ("*Morrison*'s underlying logic counsels extending its holding to cover the Securities Act"; dismissing section 11 and section 12(a)(2) claims); *SEC v. ICP Asset Mgmt., LLC*, No. 10 Civ. 4791, 2012 WL 2359830, at \*2 (S.D.N.Y. June 21, 2012) ("I join this nascent consensus and conclude that the *Morrison* analysis for the Securities Act claim is identical [to] that applicable to claims under the Exchange Act"; noting that "[t]he elements of a claim under [s]ection 17(a) of the Securities Act are essentially the same as those under [s]ection 10(b) of the Exchange Act."); *Royal Bank*, 765 F. Supp. 2d at 338 & n.11 ("Under *Morrison*, the Securities Act, like the Exchange Act, does not have extraterritorial reach"; dismissing section 11, 12(a)(2) and 15 claims); *Goldman Sachs*, 790 F. Supp. 2d at 164 ("[T]he Court agrees that *Morrison* applies to [s]ection 17(a) of the Securities Act."); *In re Petrobras Sec. Litig.*, No. 14-cv-9662, 2015 WL 4557364, at \*15 (S.D.N.Y. July 30, 2015) ("The Securities Act applies only to securities listed on a domestic stock exchange or purchased or sold in the United States.").

However, at least one commentator has questioned *Morrison*'s application to Securities Act claims in light of the "meaningful differences" between the Exchange Act and the Securities Act. Richard A. Grossmann, *Morrison v. National Australia Bank and the Securities Act of 1933* 85 (Aug. 5, 2013) (unpublished manuscript), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2307710](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2307710) (arguing that *Morrison*'s transactional test "does not translate tidily to Securities Act claims").

148. On the other hand, courts have resisted applying *Morrison* to the Investment Advisers Act. See *SEC v. Gruss*, 859 F. Supp. 2d 653, 660–65 (S.D.N.Y. 2012) (distinguishing the Investment Advisers Act from the Exchange Act, which was the focus of *Morrison*).

149. *Kiobel v. Royal Dutch Petroleum Co.*, 133 S. Ct. 1659, 1667 (2013).

150. *Id.* at 1661–62.

151. *Liu v. Siemens A.G.*, 763 F.3d 175, 176 (2d Cir. 2014) (interpreting 15 U.S.C. § 78u-6(h)(1)(A) (2012)).

152. *Loginovskaya v. Batratchenko*, No. 13-1624-cv, slip op. at 19 (2d Cir. Sept. 4, 2014) (holding that *Morrison* applies to the Commodity Exchange Act); *In re Libor-Based Fin. Instruments Antitrust Litig.*, 935 F. Supp. 2d 666, 695–96 (Bankr. S.D.N.Y. 2013) (explaining *Morrison*'s extraterritoriality test).

153. See *Sec. Inv'n Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 513 B.R. 222, 226–33 (S.D.N.Y. 2014) (interpreting section 550(a)(2) of the Bankruptcy Code).

154. *NewMarket Corp. v. Innospec, Inc.*, No. 3:10CV503-HEH, 2011 WL 1988073, at \*3–4 (E.D. Va. May 20, 2011).

155. *Souryal v. Torres Advanced Enter. Solutions, LLC*, 847 F. Supp. 2d 835, 841–43 (E.D. Va. 2012).

156. *Keller Found./Case Found. v. Tracy*, 696 F.3d 835, 844–47 (9th Cir. 2012).

157. *United States v. Sidorenko*, No. 3:14-cr-00341-CRB, 2015 WL 1814356, at \*3 (N.D. Cal. Apr. 21, 2015).

Corrupt Organizations Act.<sup>158</sup> In each of these instances, courts found no evidence to overcome the presumption against extraterritoriality. Courts have also made clear that *Morrison* applies “regardless of whether liability is sought criminally or civilly.”<sup>159</sup>

The conclusion that *Morrison* applies to the Securities Act is further buttressed by Dodd–Frank section 929P(b), which expressly applies to the Securities Act as well as to the Exchange Act. Had Congress thought that *Morrison* applied narrowly to the Exchange Act, it would have perceived no reason also to amend the Securities Act to preserve the government’s civil and criminal enforcement authority. The fact that the Dodd–Frank Act amends the Securities Act along with the Exchange Act indicates that Congress understood that *Morrison*’s logic would also apply to the Securities Act, and that the transactional test applied there as well.<sup>160</sup>

#### *D. Morrison’s First Prong: The Domestic Exchange Test*

To determine whether *Morrison*’s first prong, the U.S. exchange trading requirement, applies to the offshore placement of the initial distribution of shares authorized for listing on a U.S. exchange, four points of fact warrant emphasis. First, the shares sold in the initial distribution, whether sold in U.S. or offshore transactions, are not yet listed on any U.S. exchange.<sup>161</sup> These shares are sold in off-exchange transactions. Second, as a condition of listing, the issuer and underwriter must confirm to the exchange that the initial distribution is complete.<sup>162</sup> Listing and on-exchange trading does not occur until after that condition is satisfied, and until that point, the issuer is only conditionally approved for listing.<sup>163</sup> Third,

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158. See *Norex Petroleum v. Access Indus.*, 631 F.3d 29, 32–33 (2d Cir. 2010) (describing how in the context of a private lawsuit brought pursuant to 18 U.S.C. § 1964(c), “[t]he slim contacts with the United States alleged by Norex are insufficient to support extraterritorial application of the RICO statute”); *European Cmty. v. RJR Nabisco Inc.*, 764 F.3d 129, 136 (2d Cir. 2014) (clarifying *Norex* and holding that *Morrison* does not always bar RICO from having extraterritorial reach. Instead, “RICO applies extraterritorially if, and only if, liability or guilt could attach to extraterritorial conduct under the relevant RICO predicate [offense]. Thus, when a RICO claim depends on violations of a predicate statute that manifests an unmistakable congressional intent to apply extraterritorially, RICO will apply to extraterritorial conduct, too, but only to the extent the predicate would”).

159. *United States v. Vilar*, 729 F.3d 62, 66 (2d Cir. 2013). However, the Dodd–Frank Act purports to authorize extraterritorial jurisdiction for all actions brought by the Commission or the U.S. Department of Justice. Dodd–Frank Wall Street Reform and Consumer Protection Act, *supra* note 142. Whether it actually does so is a matter of debate. See *supra* note 143 (discussing the debate around the extraterritorial reach of the federal securities laws in the wake of Dodd–Frank).

160. See 156 CONG. REC. H5233 (daily ed. June 30, 2010) (statement of Rep. Kanjorski) (“This bill’s provisions concerning extraterritoriality, however, are intended to rebut th[e] presumption [against extraterritoriality established by *Morrison*] by clearly indicating that Congress intends extraterritorial application in cases brought by the SEC or the Justice Department. Thus, the purpose of the language of section 929P(b) of the bill is to make clear that in actions and proceedings brought by the SEC or the Justice Department, the specified provisions of the Securities Act, the Exchange Act and the Investment Advisers Act may have extraterritorial application. . . .”); see also Application of “Security-Based Swap Dealer” and “Major Security-Based Swap Participant” Definitions to Cross-Border Security-Based Swap Activities, Exchange Act Release No. 34-72472, 79 FR 47278-01, 47360 (2014) (“Congress enacted section 929P(b) in the wake of the Supreme Court’s decision in *Morrison v. National Australia Bank*, which created uncertainty about the Commission’s cross-border enforcement authority under the antifraud provisions of the federal securities laws.”).

161. See *supra* Section II.A (discussing the initial distribution).

162. *Id.*

163. *Id.*

the initial on-exchange transaction occurs as part of the opening cross.<sup>164</sup> The price set in that transaction can differ, sometimes significantly, from the price set for the IPO, which is the price at which the initial distribution must occur.<sup>165</sup> Fourth, the preliminary prospectus describes the shares as “approved for listing.” It does not characterize the initial distribution as occurring on any exchange, in the United States or elsewhere.<sup>166</sup>

The simplest response to the question of whether the initial IPO distribution satisfies *Morrison*’s U.S. exchange trading requirement thus looks to the language of *Morrison* itself. *Morrison* applies to securities already listed on a U.S. exchange. The exchange listing requirement is not satisfied by transactions in securities that are *yet to be listed* on a U.S. exchange. Indeed, any reading of *Morrison* that attaches U.S. securities liability to an offshore transaction simply because it is a precursor to a subsequent U.S. exchange transaction would be inconsistent with the plain text of the Court’s opinion, and would run roughshod over the presumption against extraterritoriality. It would also effectively reintroduce the conduct test that was so resoundingly rejected in *Morrison* by attaching liability to offshore, foreign conduct that is preparatory to a U.S. exchange listing. Further, because foreign law expressly governs these offshore transactions, applying U.S. security law would create the very potential for conflict that *Morrison* expressly sought to avoid.

Lower court precedent strongly supports this conclusion. Most significantly, in *City of Pontiac*<sup>167</sup> (*Pontiac*) the Second Circuit held that *Morrison*’s ban on extraterritorial application of U.S. securities laws applies to securities that are cross-listed on U.S. and foreign exchanges, and not just to situations in which securities are listed exclusively on foreign exchanges. In reaching this conclusion, the court rejected the plaintiffs’ “listing theory” in a manner that buttresses the conclusion that initial distributions are not transactions on a U.S. exchange subject to *Morrison*’s first prong. Under the “listing theory,” the foreign locus of a plaintiff’s purchase would be irrelevant if the very same class of shares is cross listed on a U.S. exchange. The plaintiffs in *Pontiac* argued that the defendants had voluntarily listed their shares on the NYSE, and that *Morrison*’s plain text calls for nothing more than a U.S. listing in order to trigger liability under the Exchange Act.<sup>168</sup>

The Second Circuit conceded that language in *Morrison* “taken in isolation, supports plaintiffs view,”<sup>169</sup> but refused to follow that language to the plaintiffs’ desired conclusion because the plaintiffs’ listing theory was “irreconcilable with *Morrison* read as a whole.”<sup>170</sup> *Morrison* emphasized “the location of the securities *transaction* and not the

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164. See *supra* Section II.B (discussing the opening cross).

165. *Id.*

166. See *supra* Section II.A (discussing the initial distribution).

167. *City of Pontiac Policemen’s and Firemen’s Ret. Sys. v. UBS AG*, 752 F.3d 173, 188 (2d Cir. 2014).

168. *Id.* at 179–80.

169. *Id.* at 180.

170. *Id.* For other decisions rejecting the listing theory, see, e.g., *In re Satyam Comput. Servs. Ltd. Sec. Litig.*, 915 F. Supp. 2d 450, 475 (S.D.N.Y. 2013) (rejecting plaintiff’s “interpretation of *Morrison* under which every purchase of a Satyam ADS is covered under section 10(b), regardless of where the transaction itself occurs, simply because Satyam ADSs are listed on the NYSE,” and observing that “[t]his argument has been rejected by several courts in this District as incongruous with *Morrison*’s transactional test”); *Pope Inv. II, LLC v. Deheng Law Firm*, No. 10 Civ. 6608(LLS), 2012 WL 3526621, at \*5 (S.D.N.Y. Aug. 15, 2012) (“[A]lleging merely that a company’s shares are listed on a domestic exchange does not sufficiently plead that plaintiffs engaged in a domestic securities transaction and thus does not bring the alleged fraud within section 10(b)’s coverage.”); *In re Vivendi Universal, S.A. Sec. Litig.*, 765 F. Supp. 2d 512, 531 (S.D.N.Y. 2011) (“There is no indication that the *Morrison* majority

location of an exchange where the security may be dually listed.”<sup>171</sup> The fact of a domestic listing thus acts “as a proxy for a domestic transaction,”<sup>172</sup> and is not, in and of itself, outcome determinative. Indeed, the defendant in *Morrison* had American Depository Receipts (ADRs) listed on the NYSE, thereby satisfying plaintiffs’ listing theory, but the Supreme Court nevertheless ruled that Exchange Act liability would not attach.<sup>173</sup> Plaintiffs therefore could not overcome *Morrison*’s strictures “simply because [their] shares are also listed on a domestic exchange.”<sup>174</sup> Even the SEC recognizes that in the wake of *Morrison*, “an investor in a cross-listed security cannot maintain a section 10(b) cause of action if he or she purchased or sold the security on the foreign exchange.”<sup>175</sup> It follows, *a fortiori*, that if the listing theory fails then an initial off-exchange distribution of shares that are not yet even listed on an exchange must also fail to satisfy *Morrison*’s exchange-trading requirement.

Further support for this conclusion arises from the distinction between shares that are “registered” with the SEC and shares that are “listed” for trading on an American exchange. In *In re Vivendi Universal, S.A. Securities Litigation*, Vivendi, a French company, issued ordinary shares that traded primarily on the Paris Bourse and did not trade on any U.S.

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read [s]ection 10(b) as applying to securities that may be cross-listed on domestic and foreign exchanges, but where the purchase and sale does not arise from the domestic listing, particularly where (as here) the domestic listing is not even for trading purposes.”); *In re BP P.L.C. Sec. Litig.*, 843 F. Supp. 2d 712, 794–95 (S.D. Tex. 2012) (“In applying *Morrison*, a majority of district courts have found the citizenship of the investors involved or mere ‘listing’ on the NYSE insufficient reasons to extend section 10(b) liability.”); *In re UBS Sec. Litig.*, No. 07 Civ. 11225(RJS), 2011 WL 4059356, at \*5 (S.D.N.Y. Sept. 13, 2011) (noting that the *Morrison* Court’s “concern was with respect to the location of the securities transaction and not the location of an exchange where the security may be dually listed[.]”; “[F]oreign-cubed claims asserted against issuers whose securities are cross-listed on an American exchange are outside of the scope of [section] 10(b).”); *In re Royal Bank of Scot. Grp. PLC Sec. Litig.*, 765 F. Supp. 2d 327, 336 (S.D.N.Y. 2011) (“The idea that a foreign company is subject to U.S. Securities laws everywhere it conducts foreign transactions merely because it has ‘listed’ some securities in the United States is simply contrary to the spirit of *Morrison*.”); *In re Infineon Tech. Sec. Litig.*, No. C 04-04156 JW, 2011 WL 7121006, at \*3 (N.D. Cal. Mar. 17, 2011) (granting motion to dismiss claims of shareholders who purchased securities on the Frankfurt Stock Exchange and noting that “Plaintiffs’ reliance on the fact that Infineon shares were ‘listed and registered’ on the [NYSE] to overcome *Morrison* is misplaced”); *In re Societe Generale Sec. Litig.*, No. 08 Civ. 2495, 2010 WL 3910286, at \*5–6 (S.D.N.Y. Sept. 29, 2010) (rejecting listing theory); *In re Alstom SA Sec. Litig.*, 741 F. Supp. 2d 469, 472–73 (S.D.N.Y. 2010) (rejecting listing theory and holding that the “most natural and elementary reading of *Morrison*” is “[t]hat the transactions themselves must occur on a domestic exchange to trigger application of [section] 10(b)”; *Sgalambo v. McKenzie*, 739 F. Supp. 2d 453, 464 (S.D.N.Y. 2010) (holding that *Morrison* warranted dismissal of claims of any potential class members who purchased Canadian Superior common stock on a foreign exchange, even though Canadian Superior’s shares were also sold on the American Stock Exchange at all times during the class period). This argument is also undermined by the fact that the issuer in *Morrison* listed ADRs on an American stock exchange. *In re Nat’l Austl. Bank Sec. Litig.*, No. 03 Civ. 6537(BSJ), 2006 WL 3844465, at \*1 (S.N.Y.D 2006). Thus, if the listing theory is correct, *Morrison v. Nat’l Bank Ltd.*, 561 U.S. 247, 250 (2010) itself was wrongly decided.

171. *City of Pontiac*, 752 F.3d at 180.

172. *Id.*

173. *Id.* (citing *Morrison*, 561 U.S. at 250).

174. *Id.* at 181.

175. SEC STUDY, *supra* note 144, at 29.

exchange.<sup>176</sup> Vivendi also issued ADRs<sup>177</sup> that were listed and traded on the NYSE.<sup>178</sup> Both the ordinary shares and the ADRs were registered with the SEC.<sup>179</sup> The court acknowledged that while *all* of Vivendi's ordinary shares were registered,<sup>180</sup> only some—those intended to back up the domestically traded ADRs—were actually listed on the NYSE.<sup>181</sup> Shares that were registered but not listed would automatically “fall outside plaintiffs’ literalist reading of the *Morrison* bright-line test as well as the underlying language of [s]ection 10(b).”<sup>182</sup>

Stated differently, the court found that registering securities with the SEC was not the same as “listing” those securities on a domestic exchange, and that registration was not determinative of whether the securities were purchased in a “domestic” transaction within the meaning of *Morrison*.<sup>183</sup> It follows that *Morrison*'s first prong is not triggered by the mere registration of shares with the SEC when those shares are not listed or traded on any exchange until after the distribution is complete and until after the opening cross takes place.

The courts have also narrowly construed the term “exchange” and have, for purposes of *Morrison*, limited its meaning to “the eighteen registered national security exchanges”

176. *In re Vivendi Universal, S.A. Sec. Litig.*, 765 F. Supp. 2d 512, 521 (S.D.N.Y. 2011).

177. ADRs are negotiable certificates which represent an interest in securities of a foreign issuer. *In re Infineon Techs. AG Sec. Litig.*, No. C 04-04156JW, 2011 WL 7121006, at \*3 n.11 (N.D. Cal. March 17, 2011) (citing 1 EDWARD F. GREENE ET AL., U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS 2–19 (9th ed. 2009)); *see also In re Societe Generale Sec. Litig.*, No. 08 Civ. 2495, 2010 WL 3910286, at \*4 n.5 (S.D.N.Y. Sept. 29, 2010) (holding that ADRs “represent[] one or more shares of a foreign stock or a fraction of a share” (quoting *Copeland v. Fortis*, 685 F. Supp. 2d 498, 506 (S.D.N.Y. 2010))). ADRs are usually issued by a U.S. commercial bank with whose foreign correspondent the underlying shares have been deposited. *Id.* An ADR holder generally can exchange ADRs for the underlying shares at any time, and similarly, additional shares generally can be deposited against issuance of additional ADRs. *Id.*

178. *Vivendi*, 765 F. Supp. 2d at 521.

179. *Id.* at 528.

180. Plaintiffs argued, and the court seemed to accept, that Vivendi's registration of the ordinary shares underlying its ADR issuance caused the entire class of Vivendi's ordinary shares (including those shares that did not underlie any ADRs) to be registered with the SEC. *Id.* at 528–29.

181. *Id.*

182. *Id.* at 529.

183. The fact that a security is registered with the SEC is insufficient to satisfy either prong of *Morrison*'s tests. *See In re Vivendi Universal, S.A. Sec. Litig.*, 284 F.R.D. 144, 150–51 (S.D.N.Y. 2012) (rejecting plaintiffs' argument that “the parties . . . passed title in the United States by virtue of the terms of the merger and the registration and delivery of the shares in the U.S.” (internal quotation marks omitted)); *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 68–69 (2d Cir. 2012) (“[W]e cannot conclude that the identity of the security [including whether the securities were issued by United States companies and registered with the SEC] necessarily has any bearing on whether a purchase or sale is domestic within the meaning of *Morrison*.”); *In re UBS Sec. Litig.*, No. 07 Civ. 11225, 2011 WL 4059356, at \*5–6 (S.D.N.Y. Sept. 13, 2011) (rejecting the argument that U.S. securities laws should apply “when the security is registered with a U.S. exchange, regardless of whether the purchase or sale occurred in the United States or abroad”). Indeed, courts held to this proposition even prior to *Morrison*. *See Parks v. Fairfax Fin. Holding Ltd.*, No. 06 CV 2820(GBD), 2010 WL 1372537, at \*6 n.7 (S.D.N.Y. Mar. 29, 2010) (“[W]hether NYSE traded in Fairfax stock may be relevant, but it is not a determinative factor [under the effects test]. The relevant inquiry is whether, and to what extent, United States investors are harmed.”); *In re Novagold Res. Inc. Sec. Litig.*, 629 F. Supp. 2d 272, 306 (S.D.N.Y. 2009) (“While SEC filings constitute U.S. conduct, [citation omitted], filing documents with the SEC alone is insufficient to confer subject matter jurisdiction” under the conduct test); *Euro Trade & Forfaiting, Inc. v. Vowell*, No. 00 CIV. 8431(LAP), 2002 WL 500672, at \*9 (S.D.N.Y. March 29, 2002) (finding no jurisdiction in case where stock was traded on an American market but no specific harm to American investors' interests was specified).

listed on the SEC's website.<sup>184</sup> Securities listed on the Pink Sheets<sup>185</sup> and on the Over the Counter Bulletin Board (OTCBB)<sup>186</sup> are not within the category of U.S. exchange listed securities; the Pink Sheets and the OTCBB are not listed as among the eighteen registered national securities exchanges even though these securities trade in organized secondary markets in the United States.<sup>187</sup> It follows, *a fortiori*, that the initial distribution of IPOs, which does not even occur on the Pink Sheets or OTCBB, also does not satisfy *Morrison*'s exchange trading requirement.

*E. Morrison's Second Prong: The Domestic Transaction Test*

*Morrison*'s second prong hinges on the "purchase or sale of [a] security in the United States."<sup>188</sup> *Morrison*'s text, however, "provides little guidance as to what constitutes a domestic purchase or sale,"<sup>189</sup> and fails to recognize the real world complexity of situations in which the test will have to be applied.<sup>190</sup> It falls to the lower courts to flesh out *Morrison*'s cryptic second prong.<sup>191</sup>

The Second Circuit's decision in *Absolute Activist*,<sup>192</sup> as elaborated upon in *Pontiac*<sup>193</sup> and *Parkcentral*,<sup>194</sup> is the dominant precedent interpreting *Morrison*'s second

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184. United States v. Giorgioui, 777 F.3d 125, 133–34 (3d Cir. 2015) (citing *Exchanges*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/divisions/marketreg/mrexchanges.shtml> (last visited Oct. 23, 2015)).

185. *Id.* at 134.

186. The Pink Sheets, now known as OTC Market Group Inc., is "an electronic inter-dealer quotation system that displays quotes from broker-dealers for many over-the-counter (OTC) securities." *Id.* at 130 n.2 (quoting *OTC Link LLC*, U.S. SEC. & EXCHANGE COMMISSION, <http://sec.gov/answers/pink.htm> (last visited Aug. 31, 2015)).

187. "The OTCBB is '[a]n interdealer quotation system for unlisted, over-the-counter securities. The OTC Bulletin 'Board or 'OTCBB' allows Market Makers to display firm prices for domestic securities, foreign securities, and [American Depository Receipts] that can be updated on a real-time basis.'" *OTCBB Glossary*, FIN. INDUSTRY REG. AUTHORITY, <http://www.finra.org/industry/otcbb/otcbb-glossary> (last visited Oct. 23, 2015).

188. *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247, 273 (2010).

189. *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 63 (2d Cir. 2012).

190. See, e.g., Hannah L. Buxbaum, *Remedies for Foreign Investors Under U.S. Federal Securities Law*, 75 L. & CONTEMP. PROBS. 161, 167–68 (2011) ("Determining the location of non-exchange-based transactions has proved quite complicated. Not surprisingly, many investment transactions involve touches with multiple countries or are executed by electronic or other means to which it is difficult to assign a location."); see also *id.* at 173 (explaining that "in extending a bright-line test to all forms of investment transactions, the [Supreme Court in *Morrison*] ignored the substantial variability of such transactions").

191. The significance of this task is magnified by the fact that lower court decisions appear to strongly reject a formalistic application of the first prong's listing requirement and instead emphasize the "location of the securities transaction" over the locus of the issuer's listing as the dispositive test under *Morrison*. See, e.g., *City of Pontiac Policemen's and Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173, 176 (2d Cir. 2014) (holding that "*Morrison* precludes claims brought pursuant to the Securities Exchange Act of 1934 ('Exchange Act') by purchasers of shares of a foreign issuer on a foreign exchange, even if those shares were cross-listed on a United States exchange."); see also *supra* note 170 (discussing decisions rejecting the listing theory). The effect of this emerging emphasis is, in practice, to insert the analysis necessary for the application of *Morrison*'s second prong into the operation of *Morrison*'s first prong. It follows that *Morrison*'s second prong is likely to emerge as the dominant mode of analysis governing the application of U.S. securities law to transactions with foreign components.

192. *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60 (2d Cir. 2012).

193. *City of Pontiac*, 752 F.3d at 173.

194. *Parkcentral Global Hub Ltd. v. Porsche Auto. Holdings SE*, 763 F.3d 198 (2d Cir. 2014).



prong. *Absolute Activist* held that a transaction is domestic for purposes of *Morrison* when “the purchaser incurred irrevocable liability within the United States to take and pay for a security, or . . . the seller incurred irrevocable liability within the United States to deliver a security.”<sup>195</sup> “Put another way . . . the ‘purchase’ and ‘sale’ take place when the parties become bound to effectuate the transaction,”<sup>196</sup> which is where the parties reach a “meeting of the minds.”<sup>197</sup> Alternatively, “a sale of securities can be understood to take place at the location in which title is transferred.”<sup>198</sup> The result is the two-part *Absolute Activist* test, which explains that “to sufficiently allege a domestic transaction in securities not listed on a domestic exchange . . . a plaintiff must allege facts suggesting that irrevocable liability was incurred or title was transferred within the United States.”<sup>199</sup>

In reaching this result, the Second Circuit rejected suggestions that the location of the broker was determinative “because the location of the broker alone does not necessarily demonstrate where a contract was executed.”<sup>200</sup> It also rejected suggestions that transactions are domestic within the meaning of *Morrison* if “the securities are issued by United States companies and are registered with the SEC.”<sup>201</sup> That approach is “belied by the wording of the [transactional] test announced in *Morrison*.”<sup>202</sup> This conclusion is also

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195. See *Absolute Activist*, 677 F.3d at 68 (observing that “this test has already been adopted and applied by district courts [in the Second Circuit]”). *SEC v. Goldman Sachs & Co.*, 790 F. Supp. 2d 147, 159 (S.D.N.Y. 2011); *Plumbers’ Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*, 753 F. Supp. 2d 166, 177 (S.D.N.Y. 2010).

196. *Absolute Activist*, 677 F.3d at 67.

197. *Id.* at 68.

198. *Id.* at 67 (citing *Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada*, 645 F.3d 1307, 1310–11 (11th Cir. 2011)).

199. See *id.* at 68 (concurring with the Second Circuit and holding that “territoriality under *Morrison* turns on ‘where, physically, the purchaser or seller committed him or herself’ to pay for or deliver a security”); *United States v. Giorgiou*, 77 F.3d 1, 6 (1st Cir. 1996) (quoting *United States v. Vilar*, 729 F.3d 62, 77 n.11 (2d Cir. 2012)). “[I]rrevocable liability can be used to determine the locus of a securities purchase or sale.” *Id.* at 6. Other Circuits are also in accord. See *Quail Cruises*, 645 F.3d at 1310–11 (alleging in the complaint the fact that closing occurred and that the transaction was consummated in Florida was sufficient to satisfy *Morrison* at motion to dismiss, where the purchase and sale agreement confirmed that it was not until this domestic closing that title to the shares was transferred); *SEC v. Levine*, 462 F. App’x 717, 719 (9th Cir. 2011) (“The Securities Act governs the . . . sales because the actual sales closed in Nevada when [the seller] received completed stock purchase agreements and payments.”); *United States v. Isaacson*, 752 F.3d 1291, 1299 (11th Cir. 2014) (explaining that the fund at issue was “run out of New York City and . . . [defendant’s] office was located in Florida, which supports the inference that the [] fund purchased the securities in the United States”).

While the parties to a contract will often incur irrevocable liability at the time of closing, courts will not automatically assume this to be true. In *SEC v. Goldman Sachs*, the Commission alleged that the securities transaction at issue closed in New York. *Goldman Sachs*, 790 F. Supp. 2d at 153. The court, however, found no facts alleging that any party incurred irrevocable liability in the United States and dismissed the underlying claims. *Id.* at 158–60. According to the court “the closing, absent a purchase or sale . . . made in the United States, is not determinative” of where the parties incurred irrevocable liability under *Morrison*. *Id.* at 158–59. Stated differently, the closing, by itself, is not sufficient to make a purchase or sale a domestic transaction for purposes of *Morrison*’s transactional test. See *Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada*, 732 F. Supp. 2d 1345, 1350 (S.D. Fla. 2010) (holding that even if the transaction closed in Miami, “the relevant conduct . . . the purchase or sale of foreign securities . . . occurred abroad and therefore is not governed by federal law”), *vacated*, 645 F.3d 1307 (11th Cir. 2011), *remanded to* (S.D. Fla. 2011).

200. *Absolute Activist*, 677 F.3d at 68.

201. *Id.*

202. *Id.*

consistent with the opinions of several courts holding that the act of registering securities in the United States does not satisfy *Morrison*'s transactional test because the act of registration is not, in and of itself, a transaction. Registration, rather, is conduct in preparation for a transaction that might or might not occur in the United States.<sup>203</sup> The court also rejected tests based on the citizenship or residency of parties to the transaction, observing that “[a] purchaser’s citizenship or residency does not affect where a securities transaction occurs; a foreign resident can make a purchase within the United States, and a United States resident can make a purchase outside the United States.”<sup>204</sup> Existing precedent thus precludes both United States and foreign residents who purchase shares on a foreign exchange from raising a section 11 claim after *Morrison*.<sup>205</sup>

*Pontiac* expands on *Absolute Activist*, explaining that “the fact that a U.S. entity places a buy order in the United States for the purchase of foreign securities on a foreign exchange is insufficient to incur irrevocable liability, as set forth in *Absolute Activist*, in the United States.”<sup>206</sup> The entry of a buy order from the United States that is executed abroad is insufficient “standing alone”<sup>207</sup> to demonstrate that the purchaser incurred irrevocable liability in the United States. “There is nothing in the text of *Morrison* to suggest that the Court intended the location of an investor placing a buy order to be determinative of

203. See *In re SMART Techs., Inc. S’holder Litig.*, 295 F.R.D. 50, 56–57 (S.D.N.Y. 2013) (rejecting plaintiffs’ theory that “the filing of a defective registration statement or prospectus on its own constitutes sufficient ‘domestic conduct’” to satisfy the *Morrison* test, and excluding from class any putative class members who incurred irrevocable liability or obtained title to securities in Canada, notwithstanding the fact that the shares were registered in the United States).

204. *Absolute Activist*, 677 F.3d at 69.

205. Even after *Morrison*, foreign investors who purchase or sell securities on a United States exchange or pursuant to a “domestic transaction” can properly raise a claim under the federal securities laws in United States courts. See, e.g., *In re Elan Corp. Sec. Litig.*, No. 08 Civ. 8761, 2011 WL 1442328, at \*1 (S.D.N.Y. March 18, 2011) (“As to purchases of American Depositary Receipts (‘ADRs’) or call options on such ADRS, I hold that *Morrison* does not compel dismissal at the pleadings stage”); *Foley v. Transocean Ltd.*, 272 F.R.D. 126, 133–34 (S.D.N.Y. 2011) (stating *Morrison* provides no support for the “notion that foreign investors are not adequate plaintiffs in the United States courts when the securities at issue were purchased on a United States exchange”); *Hufnagle v. Rino Int’l Corp.*, No. 10-8695, 2011 WL 710704, at \*8 (C.D. Cal. Feb. 14, 2011) (holding *Morrison* did not preclude claims of foreign purchasers who purchased on an American exchange); *In re Vivendi Universal S.A. Sec. Litig.*, 765 F. Supp. 2d 512, 527 (S.D.N.Y. 2011) (“The parties agree that *Morrison* has no impact on the claims of ADR purchasers since Vivendi’s ADRs were listed and traded on the NYSE.”); *Sgalambo v. McKenzie*, F. Supp. 2d 453, 480 (S.D.N.Y. 2010) (appointing a Belgian citizen who purchased shares on an American exchange as lead plaintiff in a class action alleging violations of United States securities laws); *Stackhouse v. Toyota Motor Co.*, No. 10 Civ. 0922, 2010 WL 3377409, at \*2 (C.D. Cal. July 16, 2010) (appointing in class action under section 10(b) of the Exchange Act “the proposed lead plaintiff with the largest alleged American Depositary Share (‘ADS’) loss”); *In re Alstom SA Sec. Litig.*, 741 F. Supp. 2d 469, 471–73 (S.D.N.Y. 2010) (dismissing the claims of plaintiffs who purchased ordinary shares on a foreign exchange but allowing the claims of ADR purchasers to proceed); SEC STUDY, *supra* note 144, at 28 (“At the outset, it should be observed that there appears to be no dispute that *foreign investors* who purchase securities either through a U.S. exchange or otherwise in the United States fall within the transactional test.”); *but cf. In re Societe Generale Sec. Litig.*, No. 08 Civ. 2495, 2010 WL 3910286, at \*6–7 (S.D.N.Y. Sept. 29, 2010) (precluding investors who purchased ADRs in the over-the-counter market in the United States from raising Exchange Act claims in the wake of *Morrison*; the ADRs “were not traded on an official American securities exchange; instead, ADRs were traded in a less formal market with lower exposure to U.S.-resident buyers,” hence “[t]rade in SocGen ADRs is a ‘predominantly foreign securities transaction’” (quoting *Copeland v. Fortis*, 685 F. Supp. 2d 498, 506 (S.D.N.Y. 2010))).

206. *City of Pontiac Policemen’s and Firemen’s Ret. Sys. v. UBS AG*, 752 F.3d 173, 188–89 (2d Cir. 2014).

207. *Id.* at 181.

whether such a transaction is ‘domestic’ for purposes of [section] 10(b).”<sup>208</sup>

Courts, likewise, have declined to label a transaction “domestic” when the defendant prepared and/or reviewed allegedly misleading marketing material in the United States which was later sent to the purchaser, or when a defendant in the United States solicited purchases.<sup>209</sup> Similarly, an investor’s transfer of money for the purchase of securities to a U.S. bank is insufficient to satisfy the transactional test where the payment of the funds was “one step” in a sales process in which the seller, by the terms of the parties’ subscription agreement, still retained the right to accept or reject the transaction.<sup>210</sup> “[T]he transaction was not completed until [defendant] finally accepted an application [for investment]—presumably in its Cayman Islands offices.”<sup>211</sup>

Any contrary holdings would again reinstate the “conduct” and “effects” tests that *Morrison* expressly rejected.<sup>212</sup> Focusing on the individual steps in the execution of a

208. *In re UBS Sec. Litig.*, No. 07 Civ. 11225, 2011 WL 4059356, at \*7–8 (S.D.N.Y. Sept. 13, 2011); *see also Morrison v. Nat’l Austl. Bank Ltd.*, 561 U.S. 247, 266 (2010) (“[T]he presumption against extraterritoriality would be a craven watchdog indeed if it retreated to its kennel whenever some domestic activity is involved in the case”); *Satyam Comput. Servs. Ltd. v. Venture Glob. Eng’g*, 323 F. App’x 474 (holding that “Lead Plaintiffs have failed to establish that MPERS’ off-exchange purchases of foreign stock constitutes a domestic transaction subject to section 10(b) liability,” despite the fact that MPERS’ buy orders were placed from the United States). *In re Royal Bank of Scotland Group PLC Sec. Litig.*, 765 F. Supp. 2d 327, 337 (S.D.N.Y. 2011) (finding that post-*Morrison*, a U.S. resident who purchased on a foreign exchange did not have a claim under U.S. securities laws); *Plumbers’ Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*, 753 F. Supp. 2d 166, 178 (S.D.N.Y. 2010) (dismissing section 10(b) claim and stating that “as a general matter, a purchase order in the United States for a security that is sold on a foreign exchange is insufficient to subject the purchase to the coverage of section 10(b) of the Exchange Act”); *Societe Generale*, 2010 WL 3910286, at \*6 (“By asking the Court to look to the location of ‘the act of placing a buy order,’ and to the ‘the place of the wrong,’ Plaintiffs are asking the Court to apply the conduct test specifically rejected in *Morrison*.”); *Cornwell v. Credit Suisse Grp.*, 729 F. Supp. 2d 620, 624–26 (S.D.N.Y. 2010) (“[R]ead as a whole, the *Morrison* opinions indicate that the Court considered that under its new test [section] 10(b) would not extend to foreign securities trades executed on foreign exchanges even if purchased or sold by American investors, and even if some aspects of the transaction occurred in the United States.” “[T]o carve out of the new rule [Plaintiffs’] purchase . . . of securities on a foreign exchange because some acts that ultimately result in the execution of the transaction abroad take place in the United States amounts to nothing more than the reinstatement of the conduct test.”); *Stackhouse v. Toyota Motor Co.*, No. CV-10-0922, 2010 WL 3377409, at \*2 (C.D. Cal. July 16, 2010) (explaining that the “position . . . better supported by *Morrison*” is that a United States resident purchasing stock on a foreign exchange “has figuratively traveled to that foreign exchange—presumably via a foreign broker—to complete the transaction”); SEC STUDY, *supra* note 144, at 32–33 (noting that “[c]ourts have thus far held that the purchase or sale of a security by a U.S. investor on a foreign exchange is not within the reach of [s]ection 10(b)” and collecting cases at notes 114–20).

209. *SEC v. Goldman Sachs & Co.*, 790 F. Supp. 2d 147, 158 (S.D.N.Y. 2011); *Cascade Fund LLP v. Absolute Capital Mgmt. Holdings Ltd.*, No. 08-cv-01381, 2011 WL 1211511, at \*6 (D. Colo. Mar. 31, 2011) (noting that the Supreme Court in *Morrison* placed no significance on the place of solicitation in reaching its holding); *but cf. Stackhouse*, 2010 WL 3377409, at \*1 (“[D]omestic transactions’ or ‘purchase[s] or sale[s] . . . in the United States’ means purchases and sales of securities explicitly solicited by the issuer within the United States.”).

210. *Cascade Fund LLP v. Absolute Capital Mgmt. Holdings Ltd.*, No. 08-cv-01381, 2011 WL 1211511, at \*7 (D. Colo. Mar. 31, 2011).

211. *Id.*

212. *See, e.g., Cornwell*, 729 F. Supp. 2d at 624 (“Plaintiffs would exclude from operation of the new test transactions in securities traded only on exchanges abroad if the purchase or sale involves American parties, or if some aspects or contacts of such foreign transactions occur in the United States. But insofar as this proposition superimposes an exclusion based strictly on the American connection of the purchaser or seller, it simply amounts to a restoration of the core element of the effect test. Similarly, to carve out of the new rule a purchase or sale of

transaction:

[W]ould invite extensive analysis required to parse foreign securities trades so as to assess quantitatively how many and which parts or events of the transactions occurred within United States territory, and then to apply value judgments to determine whether the cluster of those activities sufficed to cross over the threshold of enough domestic contacts to justify extraterritorial application of [section] 10(b). The complexity inherent in such far-reaching inquiries and fine-line judgments in practice formed a central element of the *Morrison* Court's 'damning indictment' of the conduct and effect tests.<sup>213</sup>

Indeed, such a test would also allow courts to apply U.S. securities laws to many transactions that are governed by the foreign law of the jurisdictions in which the securities were actually transacted, in violation of *Morrison* and principles of international comity.<sup>214</sup>

In *Parkcentral*, the Second Circuit had occasion to consider the application of *Morrison* to a set of total returns swaps. The plaintiffs in that case, more than thirty international hedge funds, had purchased swap contracts that referenced the price of German-listed shares, and alleged that the German issuer had engaged in fraud. The German issuer was a stranger to the swap contracts. It had no reason to be aware of the contracts, had no control over the contract's terms and conditions, and could do nothing to control the magnitude of exposure the contracts created. The plaintiffs alleged, to varying degrees, that they entered into the swap agreements referencing the German-listed shares in the United States.<sup>215</sup>

The Second Circuit applied *Morrison* and *Absolute Activist* to conclude that "while a domestic transaction or listing is *necessary* to state a claim under [section] 10(b), a finding that . . . [swap] transactions were domestic would not *suffice* to compel the conclusion that the plaintiffs' invocation of [section] 10(b) was appropriately domestic."<sup>216</sup> Application of U.S. securities law to the German entity under the facts of that case "would so obviously implicate the incompatibility of U.S. and foreign laws that Congress could not have intended it *sub silentio*."<sup>217</sup> The court recognized that the "false statements may have been intended to deceive investors worldwide" but found "the relevant actions . . . are so predominantly German as to compel the conclusion that the complaints fail to invoke [section] 10(b) in a manner consistent with the presumption against extraterritoriality."<sup>218</sup> The *Parkcentral* court was, however, cautious in expressing its functionalist interpretation of *Morrison*, emphasizing that its decision did not seek to define "a rule that will properly

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securities on a foreign exchange because some acts that ultimately result in the execution of the transaction abroad take place in the United States amounts to nothing more than the reinstatement of the conduct test.").

213. *Id.* at 624 (citing *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247, 258–59 (2010)).

214. *See supra* notes 131 & 132 and accompanying text (discussing the *Morrison* majority's objective of avoiding conflicts with foreign law).

215. *Parkcentral Global Hub Ltd. v. Porsche Auto. Holdings SE*, No. 11-397-cv, 2014 WL 3973877, at \*6 (2d Cir. Aug. 15, 2014).

216. *Id.* at \*15. The court dismissed plaintiffs' claims with leave to amend, observing that the court's decisions in *Parkcentral* and *Absolute Activist* "elaborated on the standards set forth in *Morrison* in such a way that the plaintiffs might conceivably be able to draft amended complaints" that could satisfy the Court's new standards. *Id.* at \*17.

217. *Id.* at \*15 (citing *Morrison*, 561 U.S. at 269).

218. *Id.*

apply the principles of *Morrison* to every future [section] 10(b) action involving the regulation of securities-based swap agreements . . . or of more conventional securities generally.”<sup>219</sup> *Parkcentral* thus teaches that, when interpreting *Morrison* and *Absolute Activist*, courts are sensitive to the prospect of conflict with foreign law in a manner that can override the formalist, bright-line tests otherwise articulated by specific decisions—even those of the Supreme Court.

Applying *Morrison*’s second prong thus leads to the conclusion that the offshore initial distribution of SEC-registered IPO shares is insufficient to support the application of federal securities laws to those shares when the sales occur pursuant to account agreements that are governed by foreign law, specify that disputes will be resolved in foreign forums, and are conducted through offshore broker-dealers who are regulated by foreign governmental authorities. In this circumstance, neither the underwriter-seller nor the initial purchaser of the securities can enforce any purchase or sales agreement without applying foreign law and litigating in a foreign forum under the oversight of a foreign regulator.<sup>220</sup> Irrevocable liability therefore cannot arise in the United States. Further, applying *Parkcentral*’s functionalist approach, because the transactions at issue are clearly regulated by foreign authorities and are clearly subject to foreign choice of law and forum selection provisions, any decision to apply U.S. securities law would create the very conflict with foreign law that *Morrison* is designed to avoid.

Nor is title to the shares transferred in the United States under those circumstances. The shares held by an initial purchaser taking in street name will be listed on the corporation’s books as part of the undifferentiated mass represented by Cede & Co, and not in the name of the beneficial owner. Similarly, at DTC, there is no entry identifying the individual purchaser. Instead, the customer’s security entitlement is reflected only in the net DTC account held by the broker or bank.

Only the offshore broker or bank at which the client has its offshore account has the information necessary and the legal capacity required to cause the transfer of the security interest to or from the ultimate purchaser or seller. Thus, title can be said to pass only in the relationship between the broker or bank and the beneficial holder of the security. That step in the transaction is, however, governed by the customer’s account agreement. And, when that account agreement is offshore, with a broker or bank that is regulated by a foreign authority, and subject to a foreign choice of law provision as well as a foreign forum selection provision, the transfer of title cannot be said to occur in the United States. Indeed, under these circumstances, any assertion of U.S. jurisdiction would create precisely the sort of conflict with foreign law that *Morrison* was clearly designed to avoid.

To be sure, intermediate steps in the transaction process do occur in the United States. The transfer on the corporation’s books to Cede & Co. and the transfer on the books of the DTC all occur as part of a larger process by which securities flow through the system. But that flow of undifferentiated interests in larger fungible pools of undifferentiated securities interests is different from the transfer of title associated with a specific transaction that represents a purchase or sale of a security entitlement. Indeed, the commingled and netted

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219. *Parkcentral*, 2014 WL 3973877, at \*6.

220. *See M/S Bremen v. Zapata Offshore Co.*, 407 U.S. 1, 10 (1972) (holding that forum selection clauses are “prima facie valid and should be enforced unless enforcement is shown by the resisting party to be ‘unreasonable’ under the circumstances”); *see also Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 593–94 (1991) (extending *Bremen*’s presumption of validity to encompass forum selection provisions embedded in cruise line tickets and other standardized form contracts that are commonly viewed as contracts of adhesion).

nature of the transfer, clearance, and settlement process make it impossible to correlate any of these intermediate transactions to any specific purchase or sale by any ultimate transactor. Moreover, these intermediate steps, just like the entry of a purchase order in the United States,<sup>221</sup> or the transfer of money to a United States bank,<sup>222</sup> are clearly insufficient to cause title to transfer in the United States, or for a purchase or sale to occur in the United States.

It follows that non-domestic purchasers in the initial distribution of shares that are authorized to be listed, but that are not yet actually listed on a United States exchange have not engaged in transactions that satisfy *Morrison*'s two-part test. Because these transactions are not domestic, purchasers in the offshore distribution are not within the category of investors that Congress intended to protect through the Securities Act or through section 11.<sup>223</sup> Those non-domestic purchasers in the initial distribution therefore cannot assert valid section 11 claims.

#### IV. THE SECTION 11 TRACING REQUIREMENT

Having addressed *Morrison*'s implications for the placement of initially distributed shares, and having established that non-domestic purchasers in the initial distribution cannot bring a section 11 claim, the next question is whether and how *Morrison* implicates the section 11 rights of shares traded in the aftermarket on a U.S. exchange, subsequent to completion of the initial distribution. This deceptively simple question requires a complex analysis because section 11 is unique among all the liability provisions of federal securities law in that it requires proof of "tracing" as a pre-condition to any aftermarket purchaser's ability to assert a section 11 claim. It is the definition of the tracing requirement that raises the possibility that no aftermarket purchasers can assert a valid section 11 claim—even if they transacted on a U.S. exchange—as long as a single share of the initial distribution was sold in a non-domestic transaction and then re-sold in the opening cross.

More precisely, the law of section 11 tracing has evolved in a manner that creates a significant ambiguity with regard to the analysis of the implications of the Court's decision in *Morrison*, because pre-*Morrison* precedent fails to distinguish between a requirement that plaintiffs (1) trace to shares simply issued pursuant to a defective registration statement, as opposed to a requirement that they (2) trace to shares that were initially acquired in a domestic distribution that Congress intended to protect with section 11 rights. The absence of this distinction in the literature is entirely unsurprising because, in a pre-*Morrison* world, the two conditions were synonymous. Under the now-rejected conduct and effects tests, shares issued pursuant to a defective registration statement and listed for trading on a U.S. exchange typically gave rise to a valid section 11 claim in the hands of the original purchaser, without regard to the locus of the transaction. Identically, every initial purchaser with a valid section 11 claim acquired shares issued pursuant to a defective registration statement. Again, the purchaser would achieve this status without regard to the

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221. See *supra* notes 206–08. "Actions needed to carry out the transactions, and not the transactions themselves . . . [are] insufficient to demonstrate a domestic transaction." *Loginovskaya v. Batratchenko et al.*, 764 F.3d 266, 275 (2d Cir. 2014).

222. See *supra* note 210 (citing a case in which money from the plaintiff was wired to a New York bank).

223. The single decision that addresses this question, *In re SMART Technologies, Inc. Shareholder Litigation*, 295 F.R.D. 50, 55 (S.D.N.Y. 2013), concurs with this Article's analysis that purchasers who acquired IPO shares in an initial distribution outside the United States may not be included in a class asserting section 11 claims.

locus of the transaction. The courts therefore had no cause to analyze a circumstance in which an initial purchaser acquires securities issued pursuant to a defective registration statement but has no valid section 11 claim because, pre-*Morrison*, such situations did not exist.

*Morrison*, however, disrupts this status quo and, for the first time, creates situations in which purchasers in the initial distribution of registered securities do not have valid section 11 claims even if the shares they purchased were issued pursuant to the allegedly defective registration statement because the transaction was offshore. What then does section 11's tracing requirement mandate? Is it sufficient to demonstrate that the shares purchased in the aftermarket were issued pursuant to the allegedly defective registration statement, even if the original purchaser has no section 11 rights because they purchased in a non-domestic transaction that Congress never intended section 11 liability to reach? Or, must the plaintiff demonstrate that the shares purchased in the aftermarket were both issued pursuant to the allegedly defective registration statement and that the initial holder acquired the shares in a transaction subject to section 11's territorial reach?

To address this question of first impression, this Part IV begins with a summary of section 11 liability and a description of the evolution and logic of the section 11 tracing requirement. The analysis then describes the practical challenges to satisfying the section 11 tracing requirement, as the law existed prior to *Morrison*. This analysis is a prologue to the more complex consideration of *Morrison*'s implication for the ability of aftermarket purchasers to assert section 11 claims, which is presented in Part V.

#### A. Section 11

Section 11 of the Securities Act, subject to significant conditions, creates an express private right of action for damages in the event a registration statement declared effective by the SEC contains a material misrepresentation or omission.<sup>224</sup> For an issuer, subject to various defenses, section 11 liability can be "virtually absolute."<sup>225</sup> Other enumerated defendants, including underwriters, directors, auditors, experts, and any other person signing the registration statement, bear the burden of demonstrating that they can satisfy a sliding scale "due diligence" defense in order to avoid liability.<sup>226</sup> Plaintiffs need not establish scienter.<sup>227</sup> Purchasers who knew of the alleged untruth or omission as of the time of the acquisition cannot bring suit under section 11.<sup>228</sup> Lower courts are inconsistent in their description of section 11 as containing a reliance requirement. Some suggest that

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224. See, e.g., *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381–82 (1983); HAZEN, *supra* note 2, § 7.3.

225. *Herman & MacLean*, 459 U.S. at 382.

226. HAZEN, *supra* note 2, § 7.3[10]; see also *Herman & MacLean*, 459 U.S. at 382 (noting that defendants other than the issuer "bear the burden of demonstrating due diligence"); *Escott v. BarChris Construction Co.*, 283 F. Supp. 643, 684–703 (S.D.N.Y. 1968) (creating a sliding scale of liability for non-issuer defendants based on their role in the offering and at the company). See generally William K. Sjoström, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L.J. 549 (2006) (exploring how non-issuing parties can escape liability by establishing a due diligence defense).

227. HAZEN, *supra* note 2, § 7.3[7] ("Neither fraud nor scienter are elements of the claim."); see also *In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d 347, 359 (2d Cir. 2010) ("[P]laintiffs bringing claims under sections 11 and 12(a)(2) need not allege scienter, reliance, or loss causation.").

228. See 15 U.S.C. § 77k(a) (2012) (stating that a party cannot recover under section 11 if "it is proved that at the time of such acquisition he knew of such untruth or omission").

reliance is not an element of plaintiffs' cause of action.<sup>229</sup> Others have concluded that plaintiffs benefit from a presumption of reliance that can be rebutted, for example, by proof that the plaintiff had entered into a legally binding commitment to purchase the securities at issue before the allegedly fraudulent registration statement was on file.<sup>230</sup>

Damages under section 11 are calculated as the difference between the purchase price and either the value of the shares at the time the lawsuit was commenced, the price at which the plaintiff previously sold the security, or the price at which the security was sold after suit but before judgment.<sup>231</sup> Damages cannot, however, exceed the offering price.<sup>232</sup> The statutory reference to "value" as distinct from price can raise complexities in the calculation of damages.<sup>233</sup> Defendants can also reduce their exposure by bearing the burden of establishing "negative causation," through a demonstration that the decline in price or value subsequent to the offering was attributable to factors other than the alleged fraud.<sup>234</sup>

Causes of action under the federal securities laws are cumulative.<sup>235</sup> Plaintiffs who are unable to assert section 11 claims because, for example, they are unable to satisfy section 11's tracing requirement, are not foreclosed from all available avenues for relief. They can still pursue claims under section 10(b) of the Exchange Act, or any other provision of state or federal law.

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229. See, e.g., *Morgan Stanley*, 592 F.3d at 359 (stating that reliance may not be a cause of action); *Rombach v. Chang*, 355 F.3d 164, 169 n.4 (2d Cir. 2004).

230. See, e.g., *APA Excelsior III, L.P. v. Premiere Techs., Inc.*, 476 F.3d 1261, 1277 (5th Cir. 2007), *cert. denied*, 544 U.S. 1032 (2005) ("Section 11 presumption of reliance does not apply in the limited and narrow situation where sophisticated investors participating in an arms-length corporate merger make a legally binding investment commitment months before the filing of a defective registration statement."); *In re HealthSouth Corp. Sec. Litig.*, 261 F.R.D. 616, 647 (N.D. Ala. 2009) (citing *APA Excelsior III* for the broad proposition that "a registration statement cannot be the basis for an investment decision where an investor made its investment decision before the registration statement has been filed").

231. 15 U.S.C. § 77b(e).

232. *Id.* § 77(g).

233. See, e.g., *McMahan & Co. v. Warehouse Entm't, Inc.*, 65 F.3d 1044, 1048–49 (2d Cir. 1995) (providing guidance on the meaning of "value" in section 11(e), and noting that "the value of a security may not be equivalent to its market price"); *Beecher v. Able*, 435 F. Supp. 397, 412–15 (S.D.N.Y. 1975) (discussing the parties' competing approaches to calculating value, and adjusting the market price to account for panic selling in the market that was unrelated to the misrepresentations in the registration statements); Allan Horwich, *Section 11 of the Securities Act: The Cornerstone Needs Some Tuckpointing*, 58 BUS. LAW. 1, 12 n.77 (2002) ("The use of the term 'value' rather than 'price' in the first alternative may be deliberate" and suggesting that market price on the date of suit does not necessarily govern).

234. The damage formula under section 11 is "complex" and "is designed to award the difference between the purchase price and the true value of the securities, thereby reflecting the extent to which the purchase price was inflated by the material misstatements or omissions. This figure is then reduced by that portion of the loss that defendant can show was attributable to factors other than the misstatements in question." HAZEN, *supra* note 2, § 7.5[1].

235. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 383–87 (1983) (discussing the "cumulative construction of the remedies under the 1933 and 1934 Acts" and "hold[ing] that the availability of an express remedy under [section] 11 of the 1933 Act does not preclude defrauded purchasers of registered securities from maintaining an action under [section] 10(b) of the 1934 Act"). However, "[b]ecause a violation of [section] 11 is nearly identical to a violation of [section] 12 [of the Exchange Act], a purchaser of securities allegedly defrauded by statements in a Registration Statement and Prospectus will usually allege a cause of action for violation of both [section] 11 and [section] 12(2) . . . . However, even if the plaintiff can establish liability under both sections, the remedies of [section] 11 and section 12(2) are not cumulative, and at judgment the plaintiff must elect whether to seek damages under [section] 11 or [section] 12(2)." *In re Intel Sec. Litig.*, 89 F.R.D. 104, 115 (N.D. Cal. 1981).



### B. The Law and Logic of Tracing

One of the most significant constraints on a plaintiffs' ability to file a section 11 claim arises from the law's tracing requirement. Early decisions made clear that suit could be maintained by "those who purchase securities that are the direct subject of the prospectus and registration statement,"<sup>236</sup> i.e., participants in the initial distribution of an IPO or other registered shares. The lower courts are split, however, as to whether section 11's coverage is limited to purchasers who acquire their shares directly from issuers or underwriters (initial purchasers), or whether section 11 claims can also be brought by plaintiffs who purchase securities in the aftermarket, for example, on a national exchange (aftermarket purchasers).<sup>237</sup> Every court that has recognized aftermarket standing has, however,

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236. *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 786 (2d Cir. 1951); *see Franklin Life Ins. Co. v. Commonwealth Edison Co.*, 451 F. Supp. 602, 607 n.1 (S.D. Ill. 1978), *aff'd*, 598 F.2d 1109 (7th Cir. 1979) (discussing how section 11 has been "limited to damages for purchasers at the original offering"); *see also Wolfson v. Solomon*, 54 F.R.D. 584, 588 (S.D.N.Y. 1971) (holding that "persons who purchased securities that are the direct subject of the prospectus and registration statement may sue under [s]ection 11").

237. District courts are split on this question. *Compare In re Global Crossing, Ltd. Sec. Litig.*, 313 F. Supp. 2d 189, 206 (S.D.N.Y. 2003) (finding that to have standing to assert a section 11 claim, "plaintiffs must be able to 'trace their shares to an allegedly misleading registration statement'" (quoting *DeMaria v. Andersen*, 318 F.3d 170, 176 (2d Cir. 2003))), and *Dorchester Investors v. Peak Trends Trust*, No. 99 Civ. 4696(LMM), 2002 WL 272404, at \*6 (S.D.N.Y. Feb. 26, 2002) ("[S]econdary market purchasers who fall within the class may pursue a Section 11 claim."), and *Milman v. Box Hill Sys. Corp.*, 192 F.R.D. 105, 109 (S.D.N.Y. 2000) ("[S]econdary market purchasers who can trace their shares to a registered offering have standing to assert claims under [section] 11"), and *In re Number Nine Visual Tech. Corp. Sec. Litig.*, 51 F. Supp. 2d 1, 11–12 (D. Mass. 1999) ("[P]laintiff may satisfy [s]ection 11 standing requirements by purchasing securities 'traceable to' an initial public offering."), *with In re Summit Med. Sys., Inc. Sec. Litig.*, 10 F. Supp. 2d 1068, 1070 (D. Minn. 1998) (holding that aftermarket purchasers lacked standing under section 11), and *In re WRT Energy Sec. Litig.*, Nos. 96 Civ. 3610, 3611(JFK), 1997 WL 576023, at \*6 (S.D.N.Y. Sept. 15, 1997), *vacated*, 75 F. App'x 839 (2d Cir. 2003) ("[S]ection 11 standing is limited to those who purchase their securities in a public offering"), and *Gannon v. Cont'l Ins. Co.*, 920 F. Supp. 566, 575 (D.N.J. 1996) (same), and *Murphy v. Hollywood Entm't Corp.*, No. 95-1926-MA, 1996 WL 393662, at \*3 (D. Or. May 9, 1996) (same).

The circuit courts have also split on the question. *See VIZCARRONDO, JR. ET AL., LIABILITIES UNDER THE FEDERAL SECURITIES LAWS*, *supra* note 117, § II.B.6, 29–30 (discussing split). The majority of circuit courts, including the Second, Fifth, Eighth, Ninth, and Tenth, have held that stock purchased in the aftermarket is "the direct subject of the prospectus and registration statement" if the purchaser can affirmatively "trace" his shares back to securities that were covered by the defective registration statement. *Krim v. pcOrder.com, Inc.*, 402 F.3d 489, 495, 498 (5th Cir. 2005) (stating section 11 is available to aftermarket purchasers whose "shares are traceable to the registration statement in question"); *see Demaria v. Andersen*, 318 F.3d 170, 178 (2d Cir. 2003) (holding that "aftermarket purchasers who can trace their shares to an allegedly misleading registration statement have standing to sue under [section] 11 of the 1933 Act"); *see also Lee v. Ernst & Young, LLP*, 294 F.3d 969, 978 (8th Cir. 2002) (holding that aftermarket purchasers have standing if they can trace their shares to the registration statement); *Joseph v. Wiles*, 223 F.3d 1155, 1159 (10th Cir. 2000) ("[W]e conclude that an aftermarket purchaser has standing to pursue a claim under section 11 so long as he can prove the securities he bought were those sold in an offering covered by the false registration statement."); *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076, 1082 (9th Cir. 1999) ("[P]urchasers in the aftermarket are within the group of purchasers provided a cause of action by [s]ection 11."); *Barnes v. Osofsky*, 373 F.2d 269, 273 (2d Cir. 1967) (stating that section 11 extends "liability to open-market purchasers of the registered shares"); *Steinberg & Kirby*, *supra* note 4, at 26–27 (discussing how section 11 extends to aftermarket purchasers if the stock is traceable); *Brian Murray, Aftermarket Purchase Standing Under § 11 of the Securities Act of 1933*, 73 ST. JOHN'S L. REV. 633, 636 (1999) (discussing how courts have allowed aftermarket purchasers to have standing under section 11). Decisions in the Third Circuit appear to be in conflict. *Compare In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256, 274 n.7 (3d Cir. 2006) (agreeing that plaintiffs adequately pled standing under section 11 by alleging that their stock was purchased in

conditioned plaintiffs' claim on an ability to satisfy a strict "tracing" requirement.

The Supreme Court has yet to consider whether aftermarket purchasers may assert section 11 claims and, if so, subject to which, if any, tracing conditions. If the Court determines at some point to address this question, and if it rules that aftermarket purchasers cannot assert section 11 claims, then no further analysis of *Morrison*'s implication for aftermarket standing is necessary: aftermarket purchasers will then not be able to assert section 11 claims without regard to the locus of any transaction.<sup>238</sup> If, however, courts continue to recognize aftermarket section 11 rights of action subject to a tracing requirement, then *Morrison* has significant potential implications for the evolution of the tracing requirement.

*Barnes v. Osofsky*<sup>239</sup> is the genesis case that establishes the tracing doctrine, and later courts have followed its logic closely.<sup>240</sup> In *Barnes*, Judge Friendly faced claims by objectors to a class action securities fraud settlement that limited recovery to "persons who could establish that they purchased securities issued under"<sup>241</sup> the allegedly defective

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or traceable to the challenged offering) with *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 286 (3d Cir. 1992) ("If plaintiffs' shares were purchased in the secondary market, they would not be linked to a registration statement filed during the class period, and the [section] 11 claim would fail."). The Seventh Circuit appears not to have addressed the question, and district courts within that circuit appear to be in conflict. *Compare Cent. Laborers' Pension Fund v. SIRVA, Inc.*, No. 04 C 7644, 2006 WL 2787520, at \*4 (N.D. Ill. Nov. 13, 2007) (finding plaintiff's allegation that it purchased SIRVA stock "issued pursuant or traceable to the November 25, 2003 IPO and/or June 10, 2004 SPO" was "sufficient to put plaintiff in the class of investors covered by section 11"), with *Franklin Life Ins. Co. v. Commonwealth Edison Co.*, 451 F. Supp. 602, 607 n.1 (S.D. Ill. 1978) (noting that section 11 "has been interpreted generally as being limited to damages for purchasers at the original offering, thus excluding those members of the plaintiff class who purchased in a secondary market").

238. Courts that limit standing to initial purchasers and that exclude aftermarket purchasers typically rely on *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995), where the Supreme Court held that section 12(a)(2) actions can only be brought by plaintiffs who purchase as part of a public offering and not in the secondary market. *See, e.g., WRT Energy*, 1997 WL 576023, at \*6 (finding "that the standing principles the Supreme Court announced in *Gustafson* apply equally to section 11 claims"). For a summary of the argument that aftermarket purchasers should not have section 11 standing, see Paul C. Cumin & Christine M. Ford, *The Critical Issue of Standing Under Section 11 of the Securities Act of 1933*, 6 *FORDHAM J. CORP. & FIN. L.* 155, 156 (2001) (suggesting that section 11 "should be construed to confer standing only upon purchasers who acquired securities directly in a public offering").

239. *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967).

240. In sum, "the tracing theory "recognizes aftermarket purchasers' standing to sue under [s]ection 11 as long as they can demonstrate they bought their securities pursuant to the registration statement." *Wiles*, 223 F.3d at 1160 (and cases cited therein); *see also In re Century Aluminum Co. Sec. Litig.*, 729 F.3d 1104, 1107 (9th Cir. 2013) (finding that the tracing requirement is the condition Congress has imposed for granting access to the "relaxed liability requirement [section] 11 affords"); *Krim*, 402 F.3d at 497 ("[A]ftermarket purchasers seeking standing must demonstrate the ability to 'trace' their shares to the faulty registration."); *Demaria*, 318 F.3d at 176 ("[T]he long-standing practice in this circuit [permits] suit under [section] 11 by those who can "trace" their shares to the allegedly defective registration statement."); *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 872 (5th Cir. 2003) (finding that even after *Gustafson*, aftermarket purchasers have standing to sue under section 11); *Ernst & Young*, 294 F.3d at 977-78 ("[R]equiring aftermarket purchasers to show that their securities can be traced to the allegedly defective registration statement further ensures fidelity to the statutory purpose, and we again emphasize that tracing is a requirement of aftermarket purchaser standing under [section] 11 in this circuit."); *In re Puda Coal Sec. Litig.*, No 11 Civ. 2598, 2013 WL 5493007, at \*6 (S.D.N.Y. Oct. 1, 2013) (citing *Klein v. Comput. Devices, Inc.*, 591 F. Supp. 270, 273 n.7 (S.D.N.Y. 1984)) (holding that plaintiffs bear the burden of demonstrating that their shares are traceable, and showing that "identical shares to those issued in an offering may have been acquired is not enough to demonstrate actual traceability to a specific offering").

241. *Barnes*, 373 F.2d at 271.

registration statement when the issuer had pre-existing registered shares of the same class traded on the same market.<sup>242</sup> As framed by Judge Friendly, the question presented “is whether the district court was right in ruling that [section] 11 extends only to the purchasers of the newly registered shares.”<sup>243</sup>

Judge Friendly began with an analysis of section 11’s text and observed an ambiguity in the statutory language. Section 11(a) provides that if a registration statement as declared effective contains a material misrepresentation or omission “any person acquiring *such* security . . . may, either at law or in equity, in any court of competent jurisdiction, sue.”<sup>244</sup> “[T]he difficulty, presented when as here the registration is of shares in addition to those already being traded, is that ‘such’ has no referent.”<sup>245</sup> Does “such” refer most broadly to all securities of the same class or nature as those registered by the allegedly defective filing? Or, does “such” refer more narrowly only to the specific securities registered pursuant to the allegedly defective filing?

Judge Friendly resolved the question in favor of the narrower interpretation, thereby imposing upon plaintiffs a tracing requirement. In reaching this conclusion, Judge Friendly first observed that the “broader reading would be inconsistent with the overall statutory scheme.”<sup>246</sup> The Securities Act and Exchange Act contain other provisions that clearly

242. *Id.* at 270.

243. *Id.* at 271.

244. *Id.* (emphasis added). The full text of section 11(a) provides:

Persons possessing cause of action; persons liable. 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 (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

- (1) every person who signed the registration statement;
- (2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect 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, person performing similar functions, or partner;
- (4) every accountant, engineer, or 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, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;
- (5) every underwriter with respect to such security.

If such person 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, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

15 U.S.C. § 77k(a) (2012).

245. *Barnes*, 373 F.2d at 271.

246. *Id.* at 272.

provide remedies addressing aftermarket purchases and sales.<sup>247</sup> In contrast, the “stringent penalties [of section 11] are to insure full and accurate disclosure through registration,”<sup>248</sup> and because, under section 6 of the Securities Act, “only individual shares are registered, it seems unlikely that [section 11] developed to ensure proper disclosure in the registration statement was meant to provide a remedy for other than the shares registered.”<sup>249</sup> Aftermarket purchasers are free to pursue their claims under other provisions of the securities laws that are far more clearly designed to provide them with remedies, but under terms and conditions very different from those established under section 11.

Judge Friendly also looked to the statute’s overall damages limitation, which states that in no case shall the amount recoverable under this section exceed “the price at which the security was offered to the public.”<sup>250</sup> The broader reading of section 11 would permit section 11 claims on the part of all aftermarket purchasers, even if the shares they acquired were not issued pursuant to the allegedly defective registration statement, and would thereby greatly expand defendant’s total exposure to an amount that could be far in excess of the value of the registered offering.<sup>251</sup> This inconsistency further argued for the narrower reading of section 11 that would preclude aftermarket claims unless holders could successfully trace their shares. As the Ninth Circuit noted, “[s]uch provisions ‘would be unnecessary if only a person who bought in the actual offering could recover, since, by definition, such a person would have paid ‘the price at which the security was offered to the public.’”<sup>252</sup> Indeed, aftermarket purchasers who pay more than the offering price for their securities are the only people who could have losses which exceed the price at which the securities were offered to the public.<sup>253</sup> Courts have thus held that “the damages provisions of section 11 clearly demonstrate that Congress intended its protection to extend to those who purchase securities in the aftermarket.”<sup>254</sup>

The legislative history also urges a narrower interpretation in Judge Friendly’s view.<sup>255</sup> Both the House and Senate versions of the present section 11, in identical language, established a conclusive presumption of reliance upon the registration statement by “every person acquiring any securities specified in such statements and offered to the public.”<sup>256</sup> Both bills then continued, “in case any such statements shall be false in any material respect, any persons acquiring any securities to which such statement relates, either from the original issuer or from any other person’ shall have a cause of action against

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247. These remedies include, without limitation, actions that can be brought pursuant to sections 12 and 17 of the Securities Act, and sections 9, 10(b), 14, 16, and 18 of the Exchange Act. In *Barnes*, Judge Friendly expressly addressed only sections 12 and 17 of the Securities Act. *Id.*

248. *Id.*

249. *Id.* *Accord* *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076, 1080 (9th Cir. 1999) (finding that this reference to “such security” means that “the person must have purchased a security issued under that, rather than some other, registration statement”); *Joseph v. Wiles*, 223 F.3d 1155, 1159 (10th Cir. 2000) (“[T]he material reading of ‘any person acquiring such security’ is simply that the buyer must have purchased a security issued under the registration statement at issue, rather than some other registration statement.”).

250. *Barnes*, 373 F.2d at 272 (citing 15 U.S.C. § 11(g) (2010)).

251. *Id.*

252. *Wiles*, 223 F.3d at 1159.

253. *Id.*

254. *In re Complete Mgmt. Inc. Sec. Litig.*, 153 F. Supp. 2d 314, 339 (S.D.N.Y. 2001).

255. *Barnes*, 373 F.2d at 272.

256. *Id.* (citing § 9, S. 875; § 9, H.R. REP. 4314, 73d Cong., 1st Sess. (1933)).

certain specified persons.”<sup>257</sup> The reference to “persons acquiring any securities to which such statement relates,” when the immediately preceding reference is to “securities specified in such [registration] statements and offered to the public,” supports the natural interpretation that Congress intended that the section 11 cause of action be limited to purchasers of the securities that were specified by the defective registration statement.

In reaching this conclusion, Judge Friendly recognized that he was rejecting three plaintiff arguments that had appeal. In particular, plaintiffs began “from the seemingly correct premise that an unduly optimistic prospectus will affect the price of shares already issued to almost the same extent as those of the same class about to be issued.”<sup>258</sup> Plaintiffs thus contend that it would be “unreasonable to distinguish newly registered shares from those previously traded.”<sup>259</sup> Plaintiffs also observed that to interpret section 11 “as applying only to purchasers who can trace the lineage of their shares to the new offering makes the result turn on mere accident since most trading is done through bankers who neither know nor care whether they are getting newly registered or old shares.”<sup>260</sup> Finally, plaintiffs complained that a tracing requirement would impose an insurmountable burden on aftermarket purchasers because “it is often impossible to determine whether previously traded shares are old or new.”<sup>261</sup> This practical problem is exacerbated by the fact that “when stock is held in margin accounts in street names . . . 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.”<sup>262</sup> Judge Friendly recognized that his holding “gives [section] 11 a rather accidental impact between an open-market purchase of a stock already being traded and another,” but he remained “unpersuaded that, by departing from the more natural meaning of the words, a court could come up with anything better.”<sup>263</sup> Plaintiffs’ recourse, instead, was to seek congressional reexamination of the Securities Act and Exchange Act “with a view to simplifying and coordinating their different and often overlapping remedies.”<sup>264</sup>

### *C. Practical Implications of the Tracing Requirement*

The implications of the tracing requirement, given the practical operation of the CUSIP numbering system and the commingling that occurs through the clearance and settlement process, are best demonstrated with reference to two scenarios. The first involves an initial public offering and aftermarket trading that occurs when no other shares have entered the public market. In this situation, when “all of [a] company’s shares were issued in a single offering under a single registration statement . . . [simply] alleging that the plaintiffs’ shares are directly traceable to the offering in question states a claim ‘that is plausible on its face’ . . . because, by definition all of the company’s shares will be directly traceable to the offering in question.”<sup>265</sup> This articulation of section 11’s tracing

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257. *Id.*

258. *Id.* at 271.

259. *Id.*

260. *Barnes*, 373 F.2d at 271–72.

261. *Id.* at 272.

262. *Id.*

263. *Id.* at 273.

264. *Id.* (citing Milton H. Cohen, *Truth in Securities Revisited*, 79 HARV. L. REV. 1340 (1966)).

265. *In re Century Aluminum*, 729 F.3d 1104, 1107 (9th Cir. 2013) (quoting *Bell Atl. Corp. v. Twombly*,

requirement is accurate in a pre-*Morrison* world, but as explained in Part V, this conclusion does not hold in a post-*Morrison* environment.

The second, more complex scenario, involves an issuer with an outstanding class of registered publicly traded securities who then, pursuant to an allegedly defective registration statement, sells additional securities of that same class into public markets. In this circumstance, tracing is “‘often impossible’ because ‘most trading is done through brokers who neither know nor care whether they are getting newly registered or old shares’ and ‘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.’”<sup>266</sup> Further, following *Twombly*<sup>267</sup> and *Iqbal*,<sup>268</sup> a plaintiff cannot simply assert that they can satisfy the tracing requirement. Their pleadings must instead “allege facts from which we can reasonably infer that their situation is different” from the large majority of aftermarket purchasers who will find it impossible to satisfy the tracing requirement.<sup>269</sup> A plaintiffs’ failure to adequately plead the traceability of shares “results in failure to state a claim on which relief can be granted.”<sup>270</sup> Put another way, “[t]oday, industry practice is to issue stock in ‘street name.’”<sup>271</sup> With ‘street name’ stock, direct tracing is virtually impossible in all practicality, as there is no feasible means to distinguish registered stock from non-registered stock or to determine who purchased a share of stock.”<sup>272</sup>

Plaintiffs have sought to avoid a strict application of the tracing requirement by relying on statistical arguments designed to demonstrate a high probability that their shares are traceable to those issued pursuant to an allegedly defective registration statement. These

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550 U.S. 544, 570 (2007)); *see also* *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 873 (5th Cir. 2003) (“[B]ecause there was only one offering of Azurix stock, all of the plaintiffs’ stock is traceable to the challenged registration statement.”); *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076, 1080 (9th Cir. 1999) (finding standing for aftermarket purchaser because “the only Dignity stock ever sold to the public was pursuant to the allegedly misleading registration statement at issue in this case”); *In re Initial Pub. Offering Sec. Litig.*, 227 F.R.D. 65, 119 n.402 (S.D.N.Y. 2004), *vacated on other grounds*, 471 F.3d 24 (2d Cir. 2006) (holding that “plaintiffs’ section 11 class periods are appropriately limited to the periods between each IPO and the time when unregistered shares entered the market”).

266. *Century Aluminum*, 729 F.3d at 1107 (quoting *Barnes*, 373 F.2d at 271–72).

267. *Twombly*, 550 U.S. at 544.

268. *Ashcroft v. Iqbal*, 556 U.S. 662 (2009).

269. *Century Aluminum*, 729 F.3d at 1107–08.

270. *Id.* at 1109 (quoting *Leeson v. Transamerica Disability Income Plan*, 671 F.3d 969, 977–78 (9th Cir. 2012)).

271. Steinberg & Kirby, *supra* note 4, at 33 (citing *Krim v. pcOrder.com, Inc.*, 402 F.3d 488, 498 n.42 (5th Cir. 2005)); Silber v. Mabon, 957 F.2d 697, 700 (9th Cir. 1992) (recognizing the “widespread practice of holding securities in street names”). Under “street name” registration, the security is registered in the name of a brokerage firm or depository on the issuer’s books, and the brokerage firm or depository holds the security for the purchaser. *Holding Your Securities - Get the Facts*, U.S. SEC. AND EXCHANGE COMMISSION, <http://www.sec.gov/investor/pubs/holdsec.htm> (last visited Oct. 23, 2015). This is opposed to “direct” registration, where the security is registered under the purchaser’s name on the issuer’s books. *Id.* *See also supra* Section II.C (discussing aftermarket trading).

272. Steinberg & Kirby, *supra* note 4, at 33; *see also* *Harden v. Raffensperger, Hughes & Co.*, 933 F. Supp. 763, 766–67 (S.D. Ind. 1996) (noting difficulties associated with tracing in the open market); Murray, *supra* note 237, at 636 (“If other securities of the same type at issue in a case were traded prior to the issuance of the false or misleading registration statement, tracing securities purchased in the open market back to the registration statement is very difficult.”).

efforts have been consistently rejected.<sup>273</sup> As courts have emphasized, “[t]he purpose of section 11’s tracing requirement is to limit standing to sue to those individuals who *actually* purchased shares issued pursuant to a defective registration statement;”<sup>274</sup> it is not enough that shares *might* have been so issued.<sup>275</sup>

Most notably, in *Krim v. pcOrder.com*,<sup>276</sup> the Fifth Circuit required that each plaintiff trace their individual shares directly to the challenged registration statement. When plaintiffs proved unable to do so except through use of statistical probabilities, the court dismissed all plaintiffs’ claims.<sup>277</sup> *Krim* thus re-affirms the view that once shares issued pursuant to a registration statement become commingled with identical shares from other sources (such as shares issued in previous or subsequent registration statements, or through registration-exempt sales, or through option exercises) investors who purchase in the aftermarket may lose the ability to assert a section 11 claim.<sup>278</sup> As one commentator has noted, “for secondary offerings, there is, in the real world, no ability by any open-market purchaser to trace even a purchase made seconds after the secondary offering went into effect.”<sup>279</sup>

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273. See, e.g., *Krim*, 402 F.3d at 501–02 (affirming the district court’s holding that plaintiffs lacked standing, and stating that “[t]he task before the district court was to determine, by a preponderance of the evidence, whether and in what amount a plaintiff’s shares are tainted, not whether the same number of shares drawn at random would likely include at least one tainted share. Understood in this light, statistical tracing is not up to the task at hand”); *Grand Lodge of Pa. v. Peters*, 550 F. Supp. 2d 1363, 1374 (M.D. Fla. 2008) (adopting *Krim*’s position that “[s]tanding cannot be based on statistical likelihoods that all of the securities purchased can be traced to a specific faulty registration statement”); *In re FleetBoston Fin. Corp. Sec. Litig.*, 253 F.R.D. 315, 351 n.40 (D.N.J. 2008) (thoroughly discussing *Krim*’s rejection of statistical tracing and drawing a “distinction between the uncertain ‘statistical tracing’ rejected in *Krim* and the reliable ‘mathematical tracing’” at issue in the case at bar); *Davidco Inv’rs, LLC v. Anchor Glass Container Corp.*, No. 8:04CV2561T-24EAJ, 2006 WL 547989, at \*23 (M.D. Fla. Mar. 6, 2006) (relying on *Krim* for the premise that “[s]tanding [in a section 11 claim] cannot be based on a statistical tracing theory, i.e., by showing a very high probability that shares can be traced to the allegedly defective registration statement”) (emphasis omitted); *In re Alamosa Holdings, Inc.*, 382 F. Supp. 2d 832, 864 (N.D. Tex. 2005) (applying *Krim* by stating “mere probability that a plaintiff can trace shares is clearly insufficient to establish standing”); *In re Quarterdeck Office Sys., Inc. Sec. Litig.*, No. CV 92-3970-DWW(GHKx), 1993 WL 623310, at \*2–3 (C.D. Cal. Sept. 30, 1993) (holding ninety-seven percent probability that the shares were sold in the public offering insufficient to establish tracing); *Abbey v. Comput. Memories, Inc.*, 634 F. Supp. 870, 875–76 (N.D. Cal. 1986) (rejecting use of “fungible mass” statistical tracing); *Kirkwood v. Taylor*, 590 F. Supp. 1375, 1378–81 (D. Minn. 1984) (granting summary judgment after rejecting “fungible mass” statistical tracing method); see also Steinberg & Kirby, *supra* note 4, at 29–33 and accompanying text (“[T]he weight of authority among federal district courts rejects the use of statistical evidence to prove tracing.”).

274. *Abbey*, 634 F. Supp. at 876 (emphasis added).

275. *Barnes v. Osofsky*, 373 F.2d 269, 273 n.2 (2d Cir. 1967); accord *Lorber v. Beebe*, 407 F. Supp. 279, 287 (S.D.N.Y. 1975); *Quarterdeck*, 1993 WL 623310, at \*2; *Kirkwood*, 590 F. Supp. at 1380–81.

276. *Krim*, 402 F.3d at 501–02.

277. *Id.* at 491, 500–02.

278. See Noel M. Hensley et al., *Seven on 11: Potential Paths to Early Dismissal of Section 11 Claims*, 15 SEC. LITIG. J. 2, 14 (2005); see also VIZCARRONDO, JR. ET AL., LIABILITIES UNDER THE FEDERAL SECURITIES LAWS, *supra* note 117, § II.B.6., 30 (“Once other securities not issued pursuant to the offering in question enter the market . . . persons acquiring their shares in the aftermarket will not be able to trace those shares to the offering and, therefore, will not be able to establish a [section] 11 claim.”).

279. Howard B. Sirota, *Vanished Without a Trace: The Disappearance of Section 11 Rights*, HOWARD.SIROTA BLOG (Jan. 4, 2010, 9:50 AM), <http://howardsirota.blogspot.com/2010/01/vanished-without-trace-disappearance-of.html>.

## V. MORRISON'S IMPLICATIONS FOR SECTION 11 TRACING

*Morrison* presents a fundamental challenge to the established law of tracing and poses a significant question of first impression that was not contemplated by Congress in 1933 when it adopted the Securities Act.<sup>280</sup> Section 11's tracing requirement is typically framed as calling for proof that the aftermarket-acquired securities were issued pursuant to (or "covered by") the allegedly defective registration statement.<sup>281</sup> When these initial purchasers sold their shares they effectively conveyed the right to bring a section 11 claim together with the transacted shares. Section 11's tracing requirement could therefore be expressed as requiring proof either that the initial security holder could assert a valid section 11 claim, or that the securities were issued pursuant to the challenged filing. Because the two conditions were equivalent, and because neither condition could exist without the other, pre-*Morrison* case law had no cause to dilate on the implications of the existence of an initial purchaser who acquired pursuant to the challenged filing but who could not assert a valid section 11 claim.

*Morrison* undoes this equivalence: an initial purchaser acquiring through a non-domestic transaction now cannot assert a valid section 11 claim even if the shares are registered pursuant to the allegedly defective registration statement. How then is the post-*Morrison* tracing requirement to be applied? Does tracing require that aftermarket purchasers establish a provenance that originates from distribution transactions within section 11's territorial reach? Or, does tracing require that aftermarket purchasers demonstrate that their securities were among those registered pursuant to the allegedly

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280. The opinion that comes closest to addressing this question is *In re SMART Techs, Inc. S'holder Litig.*, 295 F.R.D. 50, 55–57 (S.D.N.Y. 2013). There, the court considered a situation in which a tranche of securities that was qualified for later trading on the Toronto Stock Exchange and on the NASDAQ Market was initially placed in Canada pursuant to offering documents that complied with Canadian provincial law. Those same securities were also concurrently registered in the United States with the SEC. Defendants successfully excluded all Canadian initial purchasers from the United States action alleging a violation of section 11. *Id.* at 55. Defendants also sought to exclude from the plaintiff class all secondary market purchasers, arguing that "shares purchased after the IPO could not be "traced" back to a sale pursuant to the [r]egistration [s]tatement because: (1) all shares share[d] the same CUSIP; and (2) some shares were sold in Canada pursuant to a Canadian prospectus." *Id.* at 61. The court agreed that "certain aspects of the argument are compelling" because "[i]t is based upon an inarguably correct premise that traceability to a misleading registration statement is required prior to a showing that a putative class member was in fact damaged." *Id.* Nonetheless, the court was "unwilling to go as far as defendants suggest" at the class certification stage for three reasons. *Id.* First, the court concluded that while determining traceability could require individualized inquiries, the potential for such inquiries alone did not defeat predominance. *SMART Techs.*, 295 F.R.D. at 61. The court also found that ruling on defendants' argument would embroil the court in a merits dispute, which was improper at the class certification stage. *Id.* at 61–62. Finally, accepting "[d]efendants' argument would require the [c]ourt to assume that no aftermarket purchaser of SMART shares has 'proof' of a 'direct chain of title' from the IPO," even though it was arguably "possible that some putative class member who purchased in the secondary market indeed has 'proof' of traceability." *Id.* at 62. For these reasons, the court declined to "exclude all aftermarket purchasers from the section 11 class at this time," *id.*, preserving the possibility that it would later preclude all aftermarket purchasers from the class. The litigation was subsequently settled, and the court did not proceed to address the question of the aftermarket purchasers' right to pursue their claim. Judgement Approving Class Action Settlement, *In re SMART Techs., Inc. S'holder Litig.* Docket No. 1:11-cv-07673 (S.D.N.Y. Sept. 17, 2013).

281. See, e.g., *Joseph v. Wiles*, 223 F.3d 1155, 1159 (10th Cir. 2000) ("We conclude that an aftermarket purchaser has standing to pursue a claim under section 11 so long as he can prove the securities he bought were those sold in an offering covered by the false registration statement.").



defective filing without regard to the initial holder's ability to assert a section 11 claim? Put another way, is it sufficient for purposes of section 11 to trace to shares that Congress never intended to be covered by section 11 liability because those shares were transacted offshore? This looser interpretation of the tracing requirement requires that courts invent a "springing" section 11 right of action—a right of action that does not exist in the hands of the security's initial purchaser, but that comes into being upon the occurrence of a later transaction on a United States exchange.

Significant practical implications follow from this choice. If tracing requires evidence of a provenance originating from a domestic distribution within section 11's territorial reach, then no aftermarket purchaser will be able to successfully trace in any situation in which even one share of the initial distribution occurs through non-domestic transactions and immediately enters the aftermarket. The plaintiff class would then be limited to domestic purchasers in the initial distribution. But if the courts recognize the existence of a springing section 11 right of action, then the plaintiff class will include all aftermarket purchasers on U.S. exchanges, together with all domestic purchasers in the initial distribution, and will exclude only purchasers in the initial distribution who acquired in non-domestic transactions. Although there is no precedent squarely on point, the better interpretation of the law would require that aftermarket purchasers trace to initial holders to whom Congress intended to extend section 11 rights. Any other approach would require that courts invent a "springing" section 11 right of action for which there is no precedent in the statute, its legislative history, or in any judicial decision. Four distinct arguments support this conclusion.

As explained in greater detail below, the first objection to the invention of a springing section 11 right of action is that it would give the Securities Act an extraterritorial effect contrary to the teachings of *Morrison*. Second, because the aftermarket section 11 right of action is implied, not express, and because implied rights of action are to be narrowly construed, the tracing requirement should not be expanded to create section 11 rights in favor of aftermarket purchasers who acquire from non-domestic purchasers whom Congress never intended to protect through section 11. Indeed, any such construction of section 11 could hardly be construed as a narrow interpretation of an implied right because it would create tension with *Morrison* and would require the invention of a springing right of action that has no precedent in the federal securities laws. Third, the structure of the federal securities statutes focuses Securities Act remedies on the initial distribution of shares and Exchange Act remedies on violations that affect the aftermarket. Aftermarket purchasers who cannot trace to initial domestic distributions continue to have all their Exchange Act remedies, including the ability to pursue claims under section 10(b) and Rule 10b-5 in a manner consistent with the statutory structure. Fourth, while section 11's text is admittedly cryptic, the rationale applied by the courts when adopting the tracing requirement more naturally supports a reading that rejects the notion of a "springing" section 11 cause of action. As a final consideration, the statute's legislative history is silent as to these matters and does not lean in either direction.<sup>282</sup>

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282. Section 11(a) provides that any person who "at the time of . . . acquisition . . . knew of such untruth or omission" may not assert a section 11 claim. 38 U.S.C. § 11(a) (2011). "A plaintiff's knowledge is therefore an affirmative defense under [s]ection 11." Fed. Hous. Fin. Agency v. UBS Americas, Inc., 2013 WL 3284118, at \*13 (S.D.N.Y. June 28, 2013) (citing *In re Initial Pub. Offering Sec. Litig.*, 483 F.3d 70, 73 n.1 (2d Cir. 2006)). The analysis in this Section, arguing that aftermarket purchasers who trace to non-domestic initial purchasers

The decision to require tracing to an initial domestic distribution within section 11's reach has potentially significant public policy implications, many of which could be viewed as adverse by the SEC and other market observers. Some courts may also not favor the public policy implications of a narrower post-*Morrison* interpretation of the section 11 cause of action. The Commission can, however, respond to these concerns through a variety of administrative channels in order to preserve and extend section 11 rights of action for aftermarket purchasers under specified conditions. Just as importantly, the Commission can use its rulemaking authority to engage in market-wide fact-finding, and then it can act with a policy-oriented precision that cannot be achieved by the courts. Public policy concerns over the implications of a stricter tracing requirement should, therefore, not motivate the courts to invent a "springing" section 11 right of action when administrative remedies available to the Commission provide a more effective means of defining the scope of section 11 remedies in a post-*Morrison* world.

#### *A. Morrison and the Rule Against Extraterritorial Application*

*Morrison* is rooted in a presumption against extraterritorial application of the federal securities laws. Allowing aftermarket purchasers of shares originally acquired in non-domestic transactions to raise section 11 claims would, however, generate a de facto extraterritorial effect even if the initial offshore purchasers do not themselves have valid section 11 claims. If aftermarket purchasers need only trace to securities that are issued pursuant to the allegedly defective registration statement, then every aftermarket purchaser in an IPO will be able to satisfy the tracing requirement. The issuer's exposure to liability could thus exceed the distribution to which section 11 *originally applied* (i.e., the domestic portion of the initial distribution), and would therefore include possible liability for shares distributed outside of section 11's scope. This consequence can be avoided only if the courts require that aftermarket purchasers trace to initial domestic distributions that Congress intended to reach with section 11 liability.

This state of affairs can be viewed as presenting courts with a choice between an under-inclusive alternative (restricting claims to initial purchasers in domestic transactions) and an over-inclusive alternative (allowing claims by aftermarket purchasers who acquire from initial non-domestic holders of shares that section 11 did not originally reach). This choice, however, presents a dilemma familiar to the courts since the earliest days of the tracing doctrine when they had to choose between alternatives that were also framed as under-inclusive (imposing a tracing doctrine that makes it de facto impossible for aftermarket purchasers to assert valid claims if there was a pre-existing market for the securities) or over-inclusive (allowing all aftermarket purchasers to assert valid claims without regard to the registration statement pursuant to establish the fungible shares entered

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cannot assert section 11 claims, can also be extended to support the conclusion that it is inappropriate to extend section 11 liability to aftermarket purchasers who can trace only to initial purchasers who had actual knowledge of the alleged defect in the registration statement. Indeed, such an extension of section 11 liability would also require the invention of a "springing" private right of action and would expand the secondary market claims so that they would be larger than the claims that could be brought by a set of buy-and-hold initial purchasers. Such an expansion of liability would also conflict with the Supreme Court's admonition that implied private rights be narrowly construed. Lastly, this reading of the statute is more consistent with the allocation of liability contemplated by the Securities Act and by the Exchange Act because such an interpretation would preserve the rights of secondary market purchasers to pursue claims under section 10(b) of the Exchange Act.

the market). Indeed, this dilemma is at the root of repeated judicial calls for congressional attention to the question of tracing.<sup>283</sup>

Resorting to Congress may, however, be unnecessary. As explained in greater detail below,<sup>284</sup> the Commission has the administrative authority to address this challenge with precision through a variety of different techniques, and can, consistent with *Morrison* and the text of section 11, define the scope of section 11 in a manner that is responsive to current market realities. The courts do not have any such fine-tuned capacity and, for that reason, the Commission is likely a superior venue for the resolution of the difficult policy challenges posed by *Morrison*'s interaction with section 11's tracing requirement.

*B. The Narrow Construction of Implied Private Rights of Action*

The purchaser in the initial distribution of an IPO has an unambiguous express private right of action under section 11. In contrast, an aftermarket purchaser's right to pursue a section 11 claim is not expressly articulated in the statute. Instead, in order to create such a right, the lower courts invented a tracing doctrine that exists nowhere in the text or legislative history of the statute. The aftermarket purchaser's section 11 claim is therefore an implied private right of action.<sup>285</sup>

The Supreme Court has repeatedly cautioned that implied private rights of action are

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283. *Wiles*, 223 F.3d at 1159; *Barnes v. Osofsky*, 373 F.2d 269, 273 (2d Cir. 1967).

284. *See infra* Part VI (discussing reforms to the CUSIP numbering system and other administrative measures that would obviate the need for legislation).

285. The fact that the aftermarket section 11 right of action is implied, not express, is obvious from the fact that the lower courts have had to infer its existence, as well as the contours of the tracing doctrine, from statutory text and legislative history that are silent as to that right of action and as to the conditions associated with the right to assert any such claim.

to be narrowly construed,<sup>286</sup> and that their very recognition is now disfavored.<sup>287</sup> It is

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286. See, e.g., *Janus Capital Corp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011) (explaining how the Court is “mindful that [it] must give ‘narrow dimensions . . . to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law’”) (quoting *Stoneridge Inv. Partners LLC v. Scientific Atlanta*, 552 U.S. 148, 167 (2008)). Consistent with this principle, the Court has restricted the scope of even firmly entrenched implied private rights of action. See *HAZEN*, *supra* note 2, § 12.2[1] (“[T]here are some firmly entrenched implied rights of action for securities law violations; however, even they have been significantly narrowed since the mid 1970s.”); see also *Morrison v. Nat’l Austl. Bank*, 561 U.S. 247, 264 (2010) (limiting extraterritorial jurisdiction of section 10(b)); *Stoneridge*, 552 U.S. at 158 (“The [section] 10(b) implied private right of action does not extend to aiders and abettors. The conduct of a secondary actor must satisfy each of the elements or preconditions for liability . . . .”); *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177 (1994) (concluding “that the text of the 1934 Act does not itself reach those who aid and abet a [section] 10(b) violation”); *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1099–108 (1991) (confining the section 14(a) implied private right of action for proxy fraud to those plaintiffs who control votes required to authorize the corporate action subject to the challenged proxy solicitation); *id.* at 1115 (Kennedy, J., dissenting in part and concurring in part) (noting that the Court’s decision “is a sort of guerrilla warfare to restrict a well-established implied right of action. If the analysis adopted by the Court today is any guide, Congress and those charged with enforcement of the securities laws stand forewarned that unresolved questions concerning the scope of those causes of action are likely to be answered by the Court in favor of defendants”); *Lampf v. Gilbertson*, 501 U.S. 350, 364 (1991) (“Litigation instituted pursuant to [section] 10(b) and Rule 10b-5 therefore must be commenced within one year after the discovery of the facts constituting the violation and within three years after such violation.”); *Malack v. BDO Seidman, LLP*, 617 F.3d 743, 754 (3d Cir. 2010) (“In *Stoneridge*, [552 U.S. at 157] the Supreme Court noted that, at least since *Central Bank*, Congress has approved of narrowing the scope of [section] 10(b) liability.”).

287. See, e.g., *Ashcroft v. Iqbal*, 556 U.S. 662, 675 (2009) (noting that “implied causes of action are disfavored”); *Alexander v. Sandoval*, 532 U.S. 275, 293 (2001) (holding that private individuals do not have a right to sue to enforce regulations created under Title VI of the Civil Rights Act); *Corr. Servs. Corp. v. Malesko*, 534 U.S. 61, 83 n.3 (2001) (“[W]e have retreated from our previous willingness to imply a cause of action where Congress has not provided one . . . . Just last Term it was noted that we ‘abandoned’ the view of *Borak* decades ago, and have repeatedly declined to ‘revert’ to ‘the understanding of private causes of action that held sway 40 years ago.’”) (quoting *Sandoval*, 532 U.S. at 287)); *Thompson v. Thompson*, 484 U.S. 174, 178–79 (1988) (holding that the Parental Kidnaping Prevention Act does not create an implied private right of action in federal court to determine the validity of two conflicting custody decrees); *id.* at 190 (Scalia, J., dissenting) (stating that “this Court has long since abandoned its hospitable attitude towards implied rights of action. In the 23 years since Justice Clark’s opinion for the court in *J.I. Case Co. v. Borak*, 377 U.S. 426 . . . we have *twice* narrowed the test for implying a private right . . . . The recent history of our holdings is one of repeated rejection of claims of an implied right. This has been true in 9 of 11 recent private right of action cases heard by this Court, including the instant case.”); *Schweiker v. Chilicky*, 487 U.S. 412, 421 (1988) (“Our more recent decisions have responded cautiously to suggestions that *Bivens* remedies [an implied private action for damages against federal officers alleged to have violated a citizen’s constitutional rights] be extended into new contexts.”); *Transamerica Mort. Advisors, Inc. v. Lewis*, 444 U.S. 11, 24 (1979) (finding no implied private cause of action under section 206 of the Investment Advisors Act of 1940); *Touche Ross & Co. v. Redington*, 442 U.S. 560, 568–79 (1979) (holding that there is no implied cause of action under section 17(a) of the Securities Act); *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 42 (1977) (finding no implied private right of action for damages under section 14(e) of the Securities Exchange Act of 1934); *Sec. Investor Prot. Corp. v. Barbour*, 421 U.S. 412, 415 (1975) (holding that a customer of a failed brokerage firm has no implied cause of action against a federal insurance entity); *Cort v. Ash*, 422 U.S. 66, 68–69 (1975) (holding that there is no implied private right of action for the violation of a criminal corporate political campaign contribution statute), *overruled on other grounds by Touche Ross*, 442 U.S. 560, and *Transamerica*, 444 U.S. 11; *HAZEN*, *supra* note 2, § 12.2[1] (“Outside of the securities context, the Supreme Court decisions beginning in the mid-1970s have shown a definitely negative disposition towards implication of rights of action . . . .”); Lisa E. Key, *Private Enforcement of Federal Funding Conditions under 1983: the Supreme Court’s Failure to Adhere to the Doctrine of Separation of Powers*, 29 U.C. DAVIS L. REV. 283, 286 (1996) (“[T]he scope of implied causes of action has been so restricted that private suits to enforce federal funding conditions based on the existence of an implied cause of action have essentially been foreclosed.”); David

therefore significant to recognize that in considering the interpretation of the aftermarket section 11 private right of action, a court would be interpreting an implied private right of action that has yet to be recognized by the Supreme Court.

A narrow interpretation of the implied aftermarket section 11 cause of action would, at a minimum, have two components.<sup>288</sup> First, it would reject a new, expansive interpretation of the section 11 right that does not already exist in the law. Inasmuch as no existing precedent suggests the existence of a springing section 11 private right, a narrow construction would not invent one. Second, a narrow construction would respect the implications of *Morrison*'s territorial doctrine. It would recognize that, even if one sees ambiguity in the application of *Morrison* to the case of aftermarket purchasers who acquire from offshore initial purchasers, that ambiguity should be resolved in favor of a reading that rejects aftermarket section 11 claims by purchasers who acquire shares that are initially distributed outside of section 11's territorial reach. A narrow construction would thus conclude that section 11's text provides a private right of action only to domestic purchasers in the initial offering.

Any decision that recognizes section 11 rights in the hands of aftermarket purchasers who take from non-domestic initial acquirers would require adoption of two expansive readings of the implied section 11 right. First, a "springing" right of action must be invented. Second, the extraterritorial effect of this judicial creation must be denied. An expansion of an implied private right of action that requires the simultaneous adoption of two unprecedented interpretations of the statute hardly qualifies as a reading that is consistent with the Court's rule of narrow construction.

### C. The Structure of the Securities Statutes

Courts and scholars have long observed that the Securities Act is concerned with the initial distribution of securities, whereas the Exchange Act focuses on post-distribution, aftermarket activities.<sup>289</sup> The conclusion that an aftermarket purchaser must trace to an

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Rudovsky, *Running in Place: The Paradox of Expanding Rights and Restricted Remedies*, 2005 U. ILL. L. REV. 1199, 1239 (2005) ("The Court has followed a similar approach in narrowing the implied constitutional cause of action, first recognized in *Bivens*.").

288. A narrow interpretation of section 11 could actually lead to rejection of the aftermarket section 11 claim in all instances, not just in situations involving non-domestic distributions. As the Supreme Court has observed, "implied causes of action are disfavored," *Ashcroft*, 556 U.S. at 675, and the court has "retreated from [its] previous willingness to imply a cause of action where Congress has not provided one," *Correctional Servs. Corp.*, 534 U.S. at 67 n.3. The text proceeds on the assumption that the court recognizes the existence of a section 11 claim in the hands of aftermarket purchasers because, otherwise, this entire analysis is unnecessary.

289. See, e.g., *Gustafson v. Alloyd Co.*, 513 U.S. 561, 571 (1995) ("The primary innovation of the 1933 Act was the creation of federal duties—for the most part, registration and disclosure obligations—in connection with public offerings."); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 (1975) ("The 1933 Act is a far narrower statute chiefly concerned with disclosure and fraud in connection with offerings of securities—primarily, as here, initial distributions of newly issued stock.") (citing I.L. LOSS, *SECURITIES REGULATION* 130–31 (2d ed. 1961)); *Krim v. pcOrder.com, Inc.*, 402 F.3d 489, 495 (5th Cir. 2005) ("In general, the Securities Act of 1933 . . . is concerned with the initial distribution of securities.") (quoting *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 861 (5th Cir. 2003)); HAZEN, *supra* note 2, § 1.1[4] ("Whereas the distribution process triggers the registration provisions of the 1933 Act, for the most part the extent to which securities are widely held and actively traded triggers the jurisdictional requirements of the Securities Exchange Act of 1934."); Therese H. Maynard, *Liability Under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Postdistribution Markets*, 32 WM. & MARY L. REV. 847, 848 (1991) ("[T]he 1933 Act concerns itself exclusively with the distribution

initial holder with a valid section 11 claim does not divest the aftermarket purchaser of any aftermarket remedies under the federal securities laws, such as the implied private right of action under section 10(b) of the Exchange Act. Moreover, because section 11 confers no rights on the SEC, expansion or contradiction of that remedy has no effect on the agency's enforcement program.

There is an obvious symmetry to this outcome. The aftermarket purchaser is, after all, an aftermarket purchaser. It does no violence to the statutory structure to conclude that aftermarket purchasers acquiring from initial holders who lack the ability to assert section 11 claims must proceed as what they are: aftermarket purchasers who cannot claim a springing section 11 right of action because they acquired a security that has no section 11 protection. Further, fidelity to the "Supreme Court's concern that the Securities Act remain anchored to its original purpose of regulating only public offerings"<sup>290</sup> is better served by an interpretation that requires tracing to an initial domestic distribution within section 11's reach than by an interpretation that broadly allows the assertion of section 11 claims by all aftermarket purchasers without regard to the territoriality of the initial distribution. This broader extension of section 11 rights to all aftermarket purchasers would, post-*Morrison*, effectively cause the section 11 remedy to drift far from its "purpose of regulating only public offerings,"<sup>291</sup> and would allow it to become a general aftermarket grant of a right of action in a manner wholly unrelated to conditions governing the initial public offering.

#### *D. Section 11's Text*

Nothing in the text of section 11 directly addresses the question of whether tracing to a non-domestic initial purchaser is sufficient to support a section 11 claim in the hands of an aftermarket purchaser. As already explained, the aftermarket section 11 cause of action is implied, not express. The logic applied by the lower courts in interpreting section 11's cryptic text to imply the existence of that right is, however, more consistent with the requirement that aftermarket purchasers trace to initial holders who have valid section 11 rights than with other interpretations of the statutory text.

In *Barnes*, the genesis appellate decision from which the tracing doctrine emanates, Judge Friendly observed that section 11's statutory text is ambiguous because it grants a cause of action to "any person acquiring such security," where the antecedent to "such" is unspecified.<sup>292</sup> Plaintiffs argued that "such" refers to the broad category of all persons acquiring securities of the same class as those registered pursuant to the allegedly defective filing.<sup>293</sup> Defendants urged a narrow reading that would limit "such" to purchasers of securities issued pursuant to the allegedly defective registration statement.<sup>294</sup> Defendants' reading would deny claims to holders of perfectly fungible instruments that happened to not be registered pursuant to the allegedly defective filing. Judge Friendly adopted the narrower interpretation, thereby imposing a tracing requirement on all aftermarket purchasers, notwithstanding the recognition that plaintiffs would be unable to satisfy the

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markets whereas the Securities Exchange Act of 1934 (1934 Act) focuses primarily on the trading markets.").

290. *Krim*, 402 F.3d at 496 (quoting *Rosenzweig*, 332 F.3d at 873) (internal quotation mark omitted).

291. *Id.*

292. *Barnes v. Osofsky*, 373 F.2d 269, 271 (2d Cir. 1967).

293. *Id.* at 272.

294. *Id.* at 271.

tracing requirement.<sup>295</sup>

Judge Friendly concluded that plaintiffs' broader interpretation was "inconsistent with the overall statutory scheme" and "contrary to the legislative history."<sup>296</sup> The narrower interpretation was more reasonable because, among other considerations, the alternative would impose liability that exceeded the value of the offering, contrary to statutory language that capped exposure at the value of the offering. Judge Friendly recognized the potential adverse consequences of this result, and suggested that if plaintiffs were dissatisfied they should address their concerns to Congress. The observation that section 11 tracing imposes impediments on plaintiffs that often make it impossible to establish claims is hardly new, and other courts have observed that:

[P]resent market realities, given the fungibility of stock held in street name, may render [s]ection 11 ineffective as a practical matter in some aftermarket scenarios[, but this] is an issue properly addressed by Congress. It is not within our purview to rewrite the statute to take account of changed conditions. In the words of one court, Appellants' arguments may have the sound ring of economic reality, but unfortunately, they merely point up the problems involved in the present scheme of statutory regulations.<sup>297</sup>

Significantly, *Morrison* introduces a further ambiguity in the interpretation of "such" that Judge Friendly had no cause to consider. Even if it is agreed that "such" refers to shares registered pursuant to the allegedly defective filing, does it refer to all "such" shares, or only "such" shares as are within the statute's reach given canons of construction including the presumption against extraterritorial application? Put another way, the maximum damages to which an issuer can be subject under section 11 in the absence of aftermarket trading is the total claim that can be asserted by domestic purchasers in the initial offering. Permitting aftermarket purchasers to trace back to non-domestic initial purchasers expands the scope of liability to exceed the value of the offering as to which section 11 liability was intended to attach.

The same factors that animated Judge Friendly to interpret section 11 narrowly in *Barnes* are consistent with a narrower post-*Morrison* reading that requires tracing to initial holders whom Congress intended to protect with section 11 remedies. This conclusion follows from the observation that an interpretation of "such" that grants section 11 rights to all aftermarket purchasers regardless of the initial holder's standing would, for reasons already described,<sup>298</sup> cause the issuer's section 11 liability to exceed the claims that could be asserted by the domestic purchasers in the initial distribution, and would effectively cause the offshore purchasers to be treated as though they were domestic purchasers in violation of *Morrison*. In addition, the broader reading would cause the section 11 remedy to act more like an aftermarket remedy, rather than a remedy closely anchored to the purpose of the Securities Act, which seeks to regulate the offering process. The broader interpretation could thus be viewed as less consistent "with the over-all statutory

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295. See *supra* Section IV.B (containing a more complete discussion of *Barnes*).

296. *Barnes*, 373 F.2d at 271-73.

297. *Krim v. pcOrder.com, Inc.*, 402 F.3d 489, 495, 498 (5th Cir. 2005) (quoting *Colonial Realty Corp. v. Brunswick Corp.*, 257 F. Supp. 875, 881 (S.D.N.Y. 1966)).

298. See *supra* Section V.A (discussing the issuer's exposure if aftermarket purchasers of shares originally acquired in non-domestic transactions were permitted to raise section 11 claims).

scheme”<sup>299</sup> and, for that reason, a less favored interpretation of the statutory text. Thus, while it is difficult to draw powerful definitive inferences from section 11’s text, Judge Friendly’s analysis in *Barnes* appears to be more consistent with a tracing requirement that calls for a provenance reaching back to a domestic distribution within section 11’s territorial reach than with one that pays no heed to the location of the share’s initial distribution.

#### *E. Section 11’s Legislative History*

The statute’s legislative history is of no help in considering *Morrison*’s implications for the tracing requirement. Even when it comes to the traditional tracing issue, courts have observed that the Securities Act’s legislative history contains language that could be used to support or reject the imposition of a tracing requirement. For example, a legislative report accompanying the bill states that “the civil remedies accorded by [section 11] . . . are given to all purchasers . . . regardless of whether they bought their securities at the time of the original offer or at some later date.”<sup>300</sup> However, the same report also states: “The bill only affects new offerings of securities . . . it does not affect the ordinary redistribution of securities.”<sup>301</sup> This only demonstrates how “legislative history often cuts both ways and a researcher can find a bit here and there which supports a desired view.”<sup>302</sup> It should therefore come as no surprise that the congressional debates in 1933, which could not have foreseen the complexity that would be created by the interaction of *Morrison* with modern certificate-less, fungible, and massively netted clearance and settlement mechanisms, also offer no useful guidance in considering the effects of *Morrison* on the application of the tracing doctrine.

### VI. POLICY IMPLICATIONS AND POTENTIAL REGULATORY RESPONSES

The observation that the section 11 plaintiff class in an IPO with an offshore initial distribution is limited to domestic initial purchasers raises potentially significant public policy concerns. Courts and commentators have long observed that section 11 provides a significant incentive for the exercise of due diligence in the preparation of registration statements.<sup>303</sup> Further, because registration statements in non-IPO situations permit incorporation by reference of periodic disclosure documents, such as filings on Forms 10-K, 10-Q, or 8-K, and because incorporation by references attaches section 11 liability to incorporated documents,<sup>304</sup> section 11 liability provides additional incentives for due

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299. *Barnes*, 373 F.2d at 272.

300. H.R. REP. NO. 73-85, at 22 (1933).

301. *Id.* at 5.

302. *Joseph v. Wiles*, 223 F.3d 1155, 1160 (5th Cir. 2000) (quoting *United States v. Richards*, 583 F.2d 491, 495 (10th Cir. 1978)); *Barnes*, 373 F.2d at 273 (“But this [report] can be read to relate only to the extension of liability to open-market purchasers of the registered shares and the same report, in speaking of sections 11 and 12, said that ‘Fundamentally, these sections entitle 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.’” (quoting H.R. REP. NO. 73-85, at 9)).

303. See, e.g., Milton Cohen, “*Truth in Securities*” Revisited, 79 HARV. L. REV. 1340, 1355 (1966) (noting the incentive to exercise due diligence).

304. HAZEN, *supra* note 2, § 3.4[1]. Companies subject to the reporting requirements of sections 13 or 15(d) of the Exchange Act are permitted to incorporate by reference information from their periodic reports filed under



diligence in the preparation of periodic filings that issuers expect to incorporate by reference.<sup>305</sup> The narrowing of the class of plaintiffs with valid section 11 claims so as to be composed exclusively of domestic purchasers in the initial placement could arguably dilute the incentive to engage in due diligence by reducing the section 11 exposure all defendants face.<sup>306</sup> If section 11 exposure is limited exclusively to domestic purchasers in the initial placement, and if this exposure is deemed insufficient to generate adequate due diligence, then the result could be a decline in the accuracy of disclosures, both in registration statements themselves and in periodic reports that are to be incorporated by reference into those registration statements.

These concerns are amplified by the prospect of opportunistic behavior on the part of issuers, underwriters, and others who might seek to minimize or avoid section 11 liability. In particular, once registrants and underwriters recognize that section 11 liability can be significantly reduced through offshore placements in initial distributions, registrants and underwriters who might otherwise not have engaged in the offshore distribution of an initial placement may rush to engage in these transactions. They might also seek to ensure that securities placed offshore enter the aftermarket as quickly as possible in order to reduce section 11 exposure. In the extreme, registrants and underwriters seeking to minimize section 11 liability might place all of an initial distribution offshore, thereby arguably eliminating all section 11 exposure because there would be no domestic purchasers with valid section 11 standing, and no aftermarket purchasers on U.S. exchanges would then be able to trace to initial holders with valid section 11 standing.

This concern over the hypothetical potential for opportunistic conduct may, however, be overstated. Under current law, because of the complexities that arise with aftermarket tracing requirements, issuers interested in minimizing their section 11 liability could arrange to have securities registered pursuant to other registration statements that come to market as quickly as possible in order to cut off section 11 exposure from aftermarket trading. Alternatively, holders who own unrestricted, freely tradable securities could sell them in exchange transactions, thereby also making it impossible to satisfy the pre-*Morrison* tracing requirement. As a practical matter, however, there appears to be no evidence that issuers regularly engage in these practices so as to reduce section 11 exposure. Thus, the question arises as to why issuers might be more prone to rely on *Morrison*'s interaction with the tracing requirement than on other, well established techniques that could have, for decades, achieved an equivalent result. Nonetheless, the possibility may be a cause of concern to the Commission.

As the Commission contemplates these implications of *Morrison*'s interaction with section 11's tracing requirement, the Commission's inquiry could also rationally expand to take into account broader concerns regarding the tracing doctrine that have been expressed by courts and scholars since the doctrine's inception.<sup>307</sup> It has often been

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the Exchange Act. This information is deemed to be part of the registration statement for purposes of section 11 liability.

305. HAZEN, *supra* note 2, § 3.4[3].

306. The precise extent to which exposure is reduced depends on the percentage of shares placed domestically in the initial distribution, the average holding period of these domestically placed shares, and the price of the issuer's shares over the domestic purchaser's holding periods.

307. See, e.g., Hillary A. Sale, *Disappearing Without a Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act*, 75 WASH. L. REV. 429 (2000) (noting concerns about the tracing doctrine).

observed that if a registration statement covers securities of a class that is already traded in the market, then it is impossible, as a practical matter, for any aftermarket purchaser to successfully trace their shares. Scholars and plaintiffs' counsel have also complained that the rule against statistical tracing unreasonably restricts the ability of aftermarket purchasers to satisfy section 11's standing requirement.<sup>308</sup> In addition, courts and scholars have observed that there is an element of randomness in plaintiffs' ability to bring section 11 actions when securities are sold into a pre-existing liquid market, because underwriters typically pay little attention to the decision as to how to allocate the newly issued shares, which are typically offered as a fungible mass and at a price identical to that at which the pre-existing substitutable securities are trading.<sup>309</sup>

Taken together, these observations suggest that *Morrison's* interaction with section 11's tracing requirement provides an opportune occasion for a more systematic policy-oriented reconsideration of certain rules and procedures governing the distribution and secondary market trading practices of placements subject to section 11 liability. A major objective of any such reconsideration could be to preserve the incentive to engage in due diligence that might otherwise be eroded by *Morrison's* domestic transactions requirement. The suggestion that *Morrison's* challenges might be best addressed by SEC rulemaking or congressional action is not novel. As the Second Circuit observed:

Perhaps, in the final analysis, Congress and the [SEC] might be in a better position to craft broader rules in this area in light of their access to hearings, including the testimony of experts, their competence to make policy decisions, and their constitutionally and statutorily ordained roles as makers of law and rules.<sup>310</sup>

The Commission has at least three strategies that it could deploy, in different combinations and variations, to address the challenges presented by post-*Morrison* offshore initial distributions. First, and perhaps most simply, the Commission could, through the exercise of its authority over acceleration requests, require that all initial distributions occur in transactions that qualify as domestic for the purposes of *Morrison*. Registrants and underwriters would continue to be able to sell to any purchaser in the initial distribution, and there would be no constraint on sales to foreigners, but all sales in the initial distribution would have to occur in a manner that supports the conclusion that the transaction is domestic for purposes of *Morrison*. All initial purchasers would then be able to assert valid section 11 claims, as would all aftermarket purchasers on U.S. exchanges. This approach would effectively return the law to the pre-*Morrison* status quo.

A second approach would also rely on the Commission's authority over requests for acceleration to require that all persons subject to section 11 liability in connection with the offering consent to an undertaking pursuant to which they agree not to challenge plaintiffs' right to assert a section 11 claim in cases involving an offshore distribution. This approach could again return the law to the pre-*Morrison* status quo. More broadly, the Commission could also structure the undertaking to require a waiver of all challenges based on tracing to section 11 liability, provided the defendants' aggregate exposure does not exceed the

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308. Steinberg & Kirby, *supra* note 4, at 3.

309. See, e.g., *Barnes v. Osofsky*, 373 F.2d 269, 269 (2d Cir. 1967) (noting randomness in the allocation of shares).

310. *Parkcentral Glob. Hub Ltd. v. Porsche Auto. Holdings SE*, 763 F.3d 198, 217 (2d Cir. 2014).

maximum contemplated by the statute. This approach could address issues far beyond those created by *Morrison*'s interaction with section 11's tracing requirement. The courts are, however, divided as to whether challenges to section 11's scope can be waived by defendants, and this uncertainty generates litigation risk in connection with any such "undertaking" strategy.

A third approach relies on the Commission's authority to regulate the clearance and settlement process to reform the CUSIP numbering regime that would create a unique identifier for securities offered pursuant to specific registration statements, even if those securities are entirely fungible with other securities of the same class that are already publicly traded. With this new, more precise unique identifier, aftermarket purchasers would be able to unambiguously trace their shares to an allegedly defective registration statement, although the resulting pattern of standing would likely be random among stockholders and potentially complex to establish. This CUSIP-reform approach could also be expanded to provide unique identifiers to shares initially distributed offshore, and could thereby be adapted to specifically address the challenges created by *Morrison*. A fourth approach, long suggested by the earliest courts that imposed section 11's tracing restriction, is to look to Congress for reform.<sup>311</sup>

#### A. The Domestic Distribution Requirement

The Commission has extensive control over the public offering process, particularly through the exercise of its discretionary ability to grant acceleration of a registration statement's effective date. Section 8(a) of the Exchange Act states that the Commission may accelerate the effective date of a registration statement—and thereby permit sales activity to commence—“having due regard . . . to the public interest and to the protection of investors.”<sup>312</sup> As a practical matter, issuers cannot today sell securities that are to be registered unless the Commission's staff, acting through delegated authority,<sup>313</sup> agrees to accelerate the registration's statement's effective date.<sup>314</sup>

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311. *Barnes*, 373 F.2d at 273; cf. *Joseph v. Wiles*, 223 F.3d 1155, 1161 (10th Cir. 2000) (looking to Congress' use of language in addressing the question).

312. 15 U.S.C. § 77h (2012).

313. See 17 C.F.R. § 200.30-1 (2015) (stating the rules for delegation of authority).

314. Several factors make it de facto impossible to sell securities in a registered offering absent the grant of acceleration. Rule 473 requires that every registration statement include a provision agreeing that the registration statement shall not become effective until “such date as the Commission acting pursuant to section 8(a), may determine.” 17 C.F.R. § 230.473. Registrants thus commit at the outset of the registration process not to go effective until the Commission, at its discretion, agrees that the issue can go effective. Under section 8(a), a registration statement will automatically become effective 20 days after filing. This 20-day period restarts each time the issuer files an amendment to the registration statement. Sections 8(b) and 8(d), however, give the SEC the authority to issue a refusal or stop order to prevent the registration statement from going effective. In addition, the issuer will often omit the price from the preliminary prospectus until after it corrects the deficiencies in the registration statement, at which point it will file a pricing amendment. HAZEN, *supra* note 2, § 3.7[1]. “As a practical matter, since an underwriter is seldom willing to be committed to a price for any substantial length of time prior to the public offering, issuers normally request ‘acceleration’ by the Commission . . . [T]his places in the hands of the Commission a ‘club’ over the issuer, a power which the proponents of the statutory amendment believe the Commission should not have, even though they do admit that the ‘power is not being used in a manner which seriously hampers the investment banking industry.’” Edward N. Gadsby & Ray Garrett, Jr., “Acceleration” Under the Securities Act of 1933 – A Comment on the A.B.A.'s Legislative Proposal, 13 BUS. LAW. 718, 719–20 (1958). “The practitioner may occasionally feel exasperated at the practical absence of

There is no meaningful judicial precedent regarding the scope of the Commission's authority to exercise its discretion in connection with requests for acceleration, and this lack of precedent should be unsurprising.<sup>315</sup> If a registrant believes that the agency is violating the Securities Act or the Administrative Procedures Act by refusing to accelerate a registration statement's effective date, then the registrant can sue the agency; but while the litigation is pending, the registrant cannot sell its securities.<sup>316</sup> The registrant thus has a choice. It can either engage in years of litigation with the SEC, with no assurance of success and without the ability to sell its shares while the litigation is pending, or it can accede to the Commission's requests and become able to sell the registered securities, but thereby abandoning the ability to challenge the exercise of the Commission's authority under section 8(a). Inasmuch as registrants are more interested in selling securities than in litigating the fine points of administrative law with the SEC, the absence of litigated cases addressing the scope of the agency's discretion in connection with its acceleration authority is understandable.

The Commission imposes several conditions on effectiveness, ranging from a requirement that the prospectus be presented in "plain English,"<sup>317</sup> to a requirement that registrants agree to litigate certain questions regarding the indemnification of directors, officers, or other control persons of the registrant for violations of the Securities Act as "against public policy as expressed in the Act."<sup>318</sup> Given the literature regarding section 11's significant role in providing incentives for the exercise of due diligence in the preparation of registration statements,<sup>319</sup> and the significant potential reduction in the scope of section 11 liability that can be caused by *Morrison* and its interaction with section 11's tracing requirement, the Commission could readily conclude that *Morrison* presents a challenge to the "public interest and protection of investors." Having reached that conclusion, the Commission could then respond through the exercise of its control over acceleration authority.

One form of response would make it a formal condition of acceleration that issuers and underwriters commit that all sales in the initial distribution will occur through "Domestic Transactions" designed to comply with *Morrison*'s strictures against extraterritorial application of U.S. securities law. While the Commission might explore

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opportunity for judicial review of adverse exercise of administration discretion, but he should reflect that in the field of public, underwritten securities offerings, it is the exigencies of the financing process rather than the law that make appeal impractical." *Id.* at 724.

315. "The full and precise meaning of this very general language [i.e., the public interest and the protection of investors] has never been considered by the courts." *Id.* at 722; see also HAZEN, *supra* note 2, § 3.7[3] (recognizing that there are "no express statutory guidelines for acceleration and the few guides that have been prepared by the Commission are exceedingly vague").

316. See generally *Crooker v. SEC*, 161 F.2d 944 (1st Cir. 1947) (illustrating that an acceleration order is not appealable to the courts).

317. Plain English Disclosure, Exchange Act Release No. 33-7497 (Oct. 1, 1998), <http://www.sec.gov/rules/final/33-7497.txt>.

318. 17 C.F.R. § 229.512(h) (2014). Before acceleration, the issuer must make available to the underwriter as many copies of the preliminary prospectus as reasonable to assure adequate distribution. Distribution of Preliminary Prospectus, 17 C.F.R. § 230.460 (2011). It is also deemed a deceptive act for an underwriter to participate in distribution of an IPO unless a current preliminary prospectus is sent to the investors at least two days prior to sending a confirmation. 17 C.F.R. § 240.15c2-8 (2014).

319. See *supra* note 297 (recounting that section 11 tracing imposes impediments on plaintiffs that often make it impossible to establish claims).

several potential definitions of a Domestic Transaction, one approach would require that initial distributions occur through U.S.-registered broker-dealers, regulated by the SEC, where the relevant account agreements are governed by U.S. law, and where forum selection provisions designate a judicial or arbitral forum in the United States. This restriction would not prohibit any foreign entity from participating in any initial distribution, it would only require that the participation occur through a Domestic Transaction.

Administrative precedent supports the SEC's exercise of acceleration authority to preserve purchasers' ability to litigate federal securities claims in federal court. The Carlyle Group in 2012 filed a registration statement disclosing that its limited partnership agreement required that purchasers of its securities arbitrate all claims against the issuer in a confidential proceeding that would also bar class actions and other aggregate litigation claims.<sup>320</sup> In support of the legality of this mandatory arbitration provision, Carlyle could cite a long list of Supreme Court decisions upholding a contracting party's right to insist on mandatory arbitration, even in situations involving contracts of adhesion and provisions effectively eliminating the right to pursue class claims.<sup>321</sup>

Carlyle's proposal to limit holders' rights to litigate securities law claims in federal court, however, drew strong opposition from legislators and stockholder rights groups.<sup>322</sup> Three senators wrote to the Commission complaining that the proposed language "would deprive investors of important, congressionally-established rights"<sup>323</sup> and observing that the Commission could exercise its authority under section 8(a) of the Exchange Act "to deny the acceleration of the registration statement . . . based on considerations for [sic] the public interest and the protection of investors."<sup>324</sup>

The Commission's staff objected to Carlyle's proposal and telephonically informed Carlyle that "the Division of Corporation Finance does not anticipate that it will exercise

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320. THE CARLYLE GROUP LP, U.S. SEC. & EXCHANGE COMMISSION, REGISTRATION STATEMENT (FORM S-1/A) at 287-88 (Jan. 10, 2012), <http://www.sec.gov/Archives/edgar/data/1527166/000095012312000638/w83442a2sv1za.htm#151>; see also Steven Davidoff Salomon, *Carlyle Readies an Unfriendly IPO for Shareholders*, N.Y. TIMES (Jan. 18, 2012, 3:19 PM), [http://dealbook.nytimes.com/2012/01/18/carlyle-readies-an-unfriendly-i-p-o-for-shareholders/?\\_php=true&\\_type=blogs&\\_r=0](http://dealbook.nytimes.com/2012/01/18/carlyle-readies-an-unfriendly-i-p-o-for-shareholders/?_php=true&_type=blogs&_r=0) (discussing Carlyle's arbitration provision).

321. See, e.g., *Am. Exp. Co. v. Italian Colors Rest.*, 133 S. Ct. 2304, 2308-12 (2013) (holding that the Federal Arbitration Act does not permit courts to invalidate a contractual waiver of class arbitration on the ground that the plaintiff's cost of individually arbitrating a federal statutory claim exceeds the potential recovery); *Compucredit Corp. v. Greenwood*, 132 S. Ct. 665, 673 (2012) ("Because the CROA is silent on whether claims under the Act can proceed in an arbitrable forum, the FAA requires the arbitration agreement to be enforced according to its terms."); *ATT Mobility v. Concepcion*, 131 S. Ct. 1740, 1749-53 (2011) (reversing lower court's denial of the company's motion to compel arbitration and holding that the Federal Arbitration Act preempts California's judicial rule regarding the unconscionability of class arbitration waivers in consumer contracts).

322. Kevin Roose, *Carlyle Drops Arbitration Clause from IPO Plans*, N.Y. TIMES (Feb. 3, 2012, 2:06 PM), <http://dealbook.nytimes.com/2012/02/03/carlyle-drops-arbitration-clause-from-i-p-o-plans/>; Miles Weiss et al., *Carlyle Drops Class-Action Lawsuit Ban as Opposition Mounts*, BLOOMBERG (Feb. 3, 2012, 4:57 PM CST), <http://www.bloomberg.com/news/2012-02-03/carlyle-drops-class-action-lawsuit-ban.html>; Letter from Public Citizen and other organizations to the Honorable Mary L. Shapiro, Chairman, SEC (Feb. 3, 2012), <http://www.citizen.org/documents/Letter-to-SEC-Arbitration-of-Shareholder-Claims.pdf>; see also *infra* note 323 (outlining opposition to Carlyle's "forced arbitration provision").

323. Letter from Senators Franken, Blumenthal and Menendez, to the Honorable Mary L. Shapiro, Chairman, SEC (Feb. 3, 2012), <https://www.scribd.com/doc/80406909/Senate-Letter-on-Carlyle-I-P-O-Provisions>.

324. *Id.*

its delegated authority to accelerate the effective date of [the] registration statement.”<sup>325</sup> Thus, if Carlyle sought to proceed with its arbitration requirement, Carlyle would have to address its request directly to the Commission<sup>326</sup> and would have to argue against the staff’s position. In the face of this threat to acceleration, and the inevitable delay in its ability to sell its securities, Carlyle deleted the mandatory arbitration requirement from its limited partnership agreement.<sup>327</sup> Commentators have objected, on public policy grounds, to the staff’s application of its acceleration authority to prevent the adoption of mandatory arbitration provisions. However, the same commentators recognize the wide latitude the staff holds in these matters, and that once the decision is made not to accelerate, the registrant has “no practical alternative other than to withdraw its arbitration provision.”<sup>328</sup>

The challenge to federal enforcement of the securities laws posed by mandatory arbitration provisions is hardly new, and the SEC’s staff’s response to that challenge is hardly novel. Almost a quarter century ago, a registrant with a mandatory arbitration provision in its charter was also informed by the staff that its registration statement would not be accelerated unless it eliminated the mandatory arbitration provision.<sup>329</sup> The staff’s rationale in support of its position opposed to mandatory arbitration of federal securities law claims, then or today, is not hard to fathom, even if one disagrees with the substantive merits of the position and with the procedure by which it is expressed. The staff could rationally be concerned that a shift to an arbitral forum would lead to less vigorous enforcement of the federal securities laws, and that the elimination of class action remedies would greatly compound that effect—all in a manner that would harm the public interest by reducing the incentive to engage in due diligence in the preparation of registration statement and to avoid material misrepresentations or omissions. Thus, the same concerns that support a decision not to accelerate the registration statement of an issuer whose organic documents limit the right to litigate federal claims in federal court would also support a decision not to accelerate the registration statement of an issuer whose offering is structured in a manner that would naturally dilute section 11’s incentive to exercise due diligence in the registration process.

The cost-benefit calculation associated with this potential regulatory approach is straightforward. The costs would be largely administrative and would be measured by the cost of opening additional on-shore accounts for investors who would otherwise transact offshore and who do not already have domestic U.S. accounts. Against these costs, the Commission would weigh the benefits of due diligence induced by section 11 liability.

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325. Letter from Pamela Long, Assistant Director, Div. Corp. Fin., SEC, to Jeffrey W. Ferguson, Esq., General Counsel, The Carlyle Group, L.P. 1 (Feb. 3, 2012), <http://www.sec.gov/Archives/edgar/data/1527166/000000000012006433/filename1.pdf>.

326. *Id.*

327. The Carlyle Group LP, *Registration Statement (Form S-1/A)*, Exh. 10.21 (Amended and Restated Limited Partnership Agreement) (Feb. 13, 2012); *see also supra* note 317 (exploring the objections of legislators and stockholders).

328. Carl W. Schneider, *Arbitration Provisions in Corporate Governance Documents*, 3 *INSIGHTS* 26 (Mar. 2012).

329. Carl Schneider, *Arbitration in Corporate Governance Documents: An Idea the SEC Refuses to Accelerate*, 4 *INSIGHTS* 21 (May 1990).

*B. Undertakings Not to Challenge the Right to Assert Section 11 Claims*

The Commission could also rely on its authority under section 8(a) to condition the grant of acceleration on a requirement that issuers, underwriters, and all other persons subject to section 11 liability in the offering consent to an undertaking that binds them not to challenge the right of any plaintiff to assert a section 11 claim on grounds that the plaintiff cannot trace their shares to a domestic distribution within section 11's territorial reach. This approach would not require that the structure of any transaction or account be changed in response to *Morrison*, yet it would generate an outcome identical to a requirement that all sales in an initial distribution be conducted through Domestic Transactions. For this efficiency reason, an "Undertaking Waiver" approach might be preferable to a Domestic Transaction requirement.

This Undertaking Waiver strategy is, however, subject to litigation risk. Litigants cannot consent to vest a court with subject matter jurisdiction that the court lacks under Article III of the U.S. Constitution.<sup>330</sup> If the tracing requirement imposed on section 11 plaintiffs implicates Article III standing, then the tracing requirement cannot be waived through the proposed undertaking.<sup>331</sup> On the other hand, if the section 11 tracing requirement is viewed as statutory and not constitutional,<sup>332</sup> courts would be split as to its jurisdictional implications.<sup>333</sup> Several courts have held that statutory standing is not constitutional<sup>334</sup> and can be waived. If this conclusion holds, then the undertaking strategy

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330. FED. R. CIV. P. 12(h)(3).

331. See *Lewis v. Casey*, 518 U.S. 343, 349 n.1 (1996) (holding that constitutional standing is not subject to waiver); *United States v. Hays*, 515 U.S. 737, 742 (1995); *FW/PBS, Inc. v. City of Dallas*, 493 U.S. 215, 230–31 (1990). At least one court has suggested that a section 11 claimant's inability to trace his shares to the defective registration statement precludes him from making the causal connection between his injury and the defendant's conduct that is required by Article III. See *In re Puda Coal Sec. Inc.*, No 11 Civ. 2598, 2013 WL 5493007, at \*14 (S.D.N.Y. 2013) ("Here, [claimant] has been injured; but he cannot show a causal connection from his harm to conduct by the defendants in the *December 2010 Offering* because he cannot trace his shares to the Offering. Even if he could show a concrete injury caused by defendants, he simply does not have a [s]ection 11 (or 12) claim, and the Court could not render a decision in his favor for such a claim. Thus, since [claimant] lacks statutory standing to assert [s]ections 11 and 12 claims in this Court, he lacks Article III standing for those claims.").

332. See *In re Century Aluminum Co. Sec. Litig.*, 729 F.3d 1104, 1109 (9th Cir. 2013), *amended and superseded on denial of reh'g en banc*, 729 F.3d 1104 (9th Cir. 2013) (holding investors had Article III standing but that the claim was not plausible under section 11); *In re Zynga Inc. Sec. Litig.*, No. 12-04007, 2014 WL 721948, at \*3 (N.D. Cal. Feb. 25, 2014) (stating that failure to allege statutory standing results in failure to state a claim on which relief can be granted, not the absence of subject matter jurisdiction); see also *In re Bear Stearns Mortg. Pass-Through Certificates Litig.*, 851 F. Supp. 2d 746, 776–79 (S.D.N.Y. 2012) (treating tracing as an issue of statutory standing).

333. See Radha A. Pathak, *Statutory Standing and the Tyranny of Labels*, 62 OKLA. L. REV. 89, 92 (2014) (discussing the split); see also 13A CHARLES ALAN WRIGHT ET AL., *FEDERAL PRACTICE AND PROCEDURE* § 3531 (3d ed. 2008) ("The question whether the law recognizes the cause of action stated by a plaintiff is frequently transformed into inappropriate standing terms. The Supreme Court has stated succinctly that the cause-of-action question is not a question of standing. The Court itself, however, also has succumbed to the temptation to mingle these questions. Lower-court decisions display a number of variations. Some clearly separate standing from the questions whether the plaintiff has a claim or whether the defendant has a valid defense. Other opinions, however, invoke Article III or 'jurisdictional' concepts of standing to address the question whether the plaintiff has a claim.").

334. See Pathak, *supra* note 333, at 92 (observing that some courts use the term statutory standing "to describe the legal rule that a plaintiff cannot recover under a statutory cause of action unless he or she is the kind of person to whom Congress intended to allow recovery," and that this use of the term assumes that statutory

could succeed. Other courts, however, treat statutory standing as a prerequisite to federal court jurisdiction,<sup>335</sup> or reason that the lack of statutory standing to assert a section 11 claim due to a failure to trace also results in a lack of Article III standing because of the absence of a case or controversy.<sup>336</sup> If the tracing requirement is a predicate to federal court jurisdiction, then the Undertaking Waiver strategy will fail because lack of subject matter jurisdiction is not subject to waiver by the parties.<sup>337</sup>

The presence of this litigation risk could persuade the Commission to prefer the Domestic Transaction requirement, notwithstanding the efficiency costs inherent in that approach. Alternatively, the Commission could adopt both a Domestic Transaction requirement and an Undertaking Waiver, committing to abandon the Domestic Transaction requirement once, in the opinion of the Commission, the litigation risk inherent in the Undertaking Waiver approach is sufficiently resolved in favor of the waiver's validity. These, and other design and implementation details, could all be addressed in the relevant rulemaking.

### 1. CUSIP Reform

An entirely different approach to the challenge presented by *Morrison* and its interaction with section 11's tracing requirement would look to reform the CUSIP

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standing is merely one element of the statutory cause of action; standing thus goes to the merits of a claim and not to the jurisdictional reach of the courts); *Century Aluminum*, 704 F.3d at 1123–25 (“Plaintiff’s failure to plead the traceability of their shares means they lack statutory standing under [section] 11, but failure to allege statutory standing results in failure to state a claim on which relief can be granted, not the absence of subject matter jurisdiction.”); *Roberts v. Hamer*, 655 F.3d 578, 581 (6th Cir. 2011) (“This case concerns statutory standing, an issue we find to be a matter of statutory construction, not jurisdiction.”); *Zynga*, 2014 WL 721948, at \*3 (stating that failure to allege statutory standing results in failure to state a claim on which relief can be granted, not the absence of subject matter jurisdiction); Ezra Reuveni, *Extraterritoriality as Standing: A Standing Theory of the Extraterritorial Application of the Securities Laws*, 43 U.C. DAVIS L. REV. 1071, 1079 (2010) (“Statutory standing is nonjurisdictional in nature, meaning it has nothing to do with the court’s constitutional or statutory power to adjudicate a case.”).

335. See *Lerner v. Fleet Bank, N.A.*, 318 F.3d 113, 127 (2d Cir. 2003) (“[P]rudential considerations of standing are also generally treated as jurisdictional in nature.”); *Thompson v. County of Franklin*, 15 F.3d 245, 248 (2d Cir. 1994) (noting that “[t]he concept of standing—even in its prudential dimension—is a limitation on federal court jurisdiction”) (citation and quotation marks omitted); *Puda Coal*, 2013 WL 5493007, at \*15 (noting that “statutory standing is ‘generally treated as jurisdictional in nature’”) (quoting *Lifrak v. N.Y. City Council*, 389 F. Supp. 2d 500, 503 (S.D.N.Y. 2005)); *Lifrak*, 389 F. Supp. 2d at 503 (observing that prudential limitations on a federal court’s jurisdiction, including the principle of statutory standing, are generally treated as jurisdictional); *Krim v. pcOrder.com, Inc.*, 2003 WL 21076787, at \*2 (W.D. Tex. 2003) (dismissing claim for lack of subject matter jurisdiction where claimant’s “purchases are not directly traceable to the allegedly problematic registration statements, and thus, he has no standing to sue under [s]ection 11”). Even under this interpretation, lack of statutory standing may not divest the court of jurisdiction “if merits issues are so intertwined with the standing issue that any distinction becomes ‘exceedingly artificial.’” *Lerner*, 318 F.3d at 127–28 (quoting *Steel Co. v. Citizens for a Better Env’t*, 523 U.S. 83, 97 n.2 (1998)).

336. See *Puda Coal*, 2013 WL 5493007 at 7 (“Here, [claimant] has been injured; but he cannot show a causal connection from his harm to conduct by the defendants in the *December 2010 Offering* because he cannot trace his shares to the Offering. Even if he could show a concrete injury caused by defendants, he simply does not have a [s]ection 11 (or 12) claim, and the Court could not render a decision in his favor for such a claim. Thus, since [claimant] lacks statutory standing to assert [s]ections 11 and 12 claims in this Court, he lacks Article III standing for those claims.”).

337. FED. R. CIV. P. 12(h)(1)–(3).



numbering system.<sup>338</sup> As several courts and commentators have observed, the inability to trace is often rooted in the fact that all securities of the same class have an identical CUSIP number. It is therefore impossible to distinguish the securities issued pursuant to an allegedly defective registration statement from other securities of the same class, already trading in the market, that were not issued pursuant to that statement.<sup>339</sup>

DTC is regulated by the SEC as a clearing corporation.<sup>340</sup> Section 17A(d) of the Exchange Act empowers the Commission to adopt rules governing clearing agencies “as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes” of the Act.<sup>341</sup> DTC relies extensively on the CUSIP identification system for its own internal operations,<sup>342</sup> and most major exchanges—including the NYSE and NASDAQ—require securities be eligible for book-entry transfers by a central depository in advance of listing.<sup>343</sup> Therefore, although the Commission arguably lacks direct regulatory authority over CUSIP Global Services (CGS)—the organization responsible for the operation of the CUSIP identification process<sup>344</sup>—the Commission could exercise its section 17A(d) authority over DTC to require that it rely on a securities identification system capable of identifying both the registration statement with

338. Similar reforms are mentioned in Sirota, *supra* note 279.

339. WESTENBERG, *supra* note 32, at chs. 15–17; CUSIP GLOBAL SERVICES, INSIDE THE CGS IDENTIFICATION SYSTEM 4–5 (Aug. 2010), [https://www.cusip.com/pdf/CUSIP%20Intro\\_%2008.09.10.pdf](https://www.cusip.com/pdf/CUSIP%20Intro_%2008.09.10.pdf).

340. See SEC Registration of Clearing Agencies, Exchange Act Release 34-20221 (Sept. 23, 1983) (granting DTC full registration as a clearing agency); Standards for Clearing Agency Regulation, Exchange Act Release No. 34-16900, at 416 n.5 (June 17, 1980) (identifying DTC as one of the clearing agencies registered with the Commission); THE DEPOSITORY TRUST & CLEARING CORPORATION, AN INTRODUCTION TO DTCC 7 (July 2010), [http://3197d6d14b5f19f2f4405e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/2010/2010\\_0701\\_DTCCServices.pdf](http://3197d6d14b5f19f2f4405e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/2010/2010_0701_DTCCServices.pdf) (“All services provided through the US clearing corporations and depository are registered with and regulated by the US Securities and Exchange Commission.”); DTCC DATA REPOSITORY (US) LLC, JURISDICTIONAL NARRATIVE 1, <http://www.cftc.gov/stellent/groups/public/@otherif/documents/ifdocs/dtccjurisdictionnar.pdf> (last visited Oct. 23, 2015).

341. 15 U.S.C. § 78q-1(d)(1) (2012); Clearing Agency Standards, Exchange Act Release No. 34-68080, I.A.2, at 5 (Jan. 2, 2013). In addition, section 78q-1(f) permits the Commission to adopt rules concerning the “rights and obligations of purchasers, sellers, owners, lenders, borrowers, and financial intermediaries (including brokers, dealers, banks, and clearing agencies) involved in or affected by [the] transfers [of securities], and the rights of third parties whose interests in such securities devolve from such transfers,” if the Commission finds, among other things, that the rule is necessary for the protection of investors and the safe and efficient operation of the national system for clearance and settlement of securities transactions would be impeded in the absence of such a rule. 15 U.S.C. § 78q-1(f).

342. Issuers or their agents are required to “obtain a CUSIP number from Standards & Poor’s CUSIP Service Bureau for each of its issues. Each serial and term for municipal issues must be assigned a distinct CUSIP number. This number must be printed on each security certificate representing the Securities comprising such issue.” DEPOSITORY TRUST COMPANY, OPERATIONAL ARRANGEMENTS, *supra* note 68, at II.A, 14. DTC may also “require the Issuer or Agent to obtain a new CUSIP number from Standard & Poor’s CUSIP Service Bureau in order to facilitate the adequate processing of a corporate action event.” *Id.* Once DTC makes an eligibility determination, the securities then become available for the full range of DTC depositor and book-entry services. *Id.*

343. For changes in eligibility requirements, see American Stock Exchange LLC, Exchange Act Release No. 34-54290 (Aug. 8, 2006); The NASDAQ Stock Market LLC, Exchange Act Release No. 34-54288 (Aug. 8, 2006); New York Stock Exchange LLC, Exchange Act Release No. 34-54289 (Aug. 8, 2006).

344. *About CUSIP Global Services*, CUSIP GLOBAL SERVICES, <https://www.cusip.com/cusip/about-cgs.htm> (last visited Oct. 23, 2014). CGS is owned by the American Bankers Association and operated by Standard & Poor’s Capital IQ. *Id.*

which a security was registered with the Commission, and whether the initial placement of a specific security was foreign or domestic, for purposes of a *Morrison* analysis. As a consequence of imposing such a requirement on DTC, CGS would either have to evolve the CUSIP numbering system to comply with the Commission's new regulation, or DTC would have to craft a new securities identification system.

While identifying the registration statement pursuant to which securities are issued should not be problematic, identifying whether the initial placement is domestic for purposes of *Morrison* raises administrative challenges. One potential approach would identify as "Domestic" any initial placement in an account with a domestic broker-dealer, regulated by the SEC, occurring through a U.S. office of that broker-dealer, where the account has a U.S. choice of law and forum selection provision. If an initial placement does not qualify on this basis, then it would be tagged as a Non-Domestic Transaction. To comply with such an identification requirement, underwriters might, as a practical matter, pre-designate a pool of securities issued pursuant to a registration statement to be sold in Domestic Transactions, and also create a separate pool to be sold offshore, taking care that the supply in each pool was appropriate so that the domestic and offshore placements could be priced identically at the IPO price. In the aftermarket, these securities of the same class, but with differing CUSIP identifiers contingent on the individual security's initial placement history, would trade under a common ticker, and at a common price, and would be randomly distributed in the aftermarket among an undifferentiated mass of shares with an identical ticker (though with multiple potential CUSIPs). Only the securities with CUSIPs indicating a domestic initial placement would then be able to assert section 11 claims, and over time, these securities with valid section 11 standing should become randomly dispersed among all stockholders—absent intentional intervention by intermediaries seeking to concentrate shares with valid section 11 claims in selected accounts.

More broadly, the ability to match an individual security with the registration statement to which it was issued could also resolve many challenges to aftermarket tracing that arise as a consequence of the fungible nature of securities issued into markets that already permit secondary market trading of the same class of securities at issue. In particular, hearkening back to a pre-*Morrison* period when the locus of the initial distribution was irrelevant to the analysis, the ability to match securities with registration statements should resolve all pre-*Morrison* tracing issues, because plaintiffs would then be able to identify the CUSIP numbers associated with the allegedly defective registration statement. Furthermore, the additional ability to match aftermarket trading to the domestically placed securities issued pursuant to an allegedly defective registration statement should also resolve all tracing issues that arise in a post-*Morrison* context.

There is, however, a significant limitation to the value of this CUSIP strategy, viewed purely from a *Morrison* perspective. The CUSIP strategy does not, in and of itself, force any issuer or underwriter to engage in a domestic placement of any securities. An issuer or underwriter would remain free to maximize the initial distribution of securities in non-domestic accounts in order to limit the number of initial and aftermarket purchasers with valid section 11 standing. The new CUSIP requirement would then only make it easier to document the extent to which issuers and underwriters succeed in achieving their objectives.

To be effective in addressing *Morrison*'s challenge to section 11 standing, the CUSIP

strategy might therefore be adopted in conjunction with a Domestic Transaction or Undertaking Waiver strategy. But, as previously noted, the effect of the Domestic Transaction or Undertaking Waiver requirements is to assure section 11 standing in the hands of all initial and U.S. aftermarket purchasers in an IPO context. It follows that the major advantage of CUSIP reform is in addressing the broader challenge of tracing that exists independently of *Morrison*'s domestic transaction requirement. In a world of fungible shares that cannot, because of the current CUSIP identification system, be matched with allegedly defective registration statements, the introduction of a new CUSIP numbering system facilitating such matching effectively addresses these long-standing concerns.

## 2. Legislative Reform

Courts and commentators have long observed that concerns caused by section 11's tracing requirement can be resolved by Congressional action.<sup>345</sup> Over the last several decades, Congress has enacted a wide range of reforms relating to the securities litigation process.<sup>346</sup> None of these reforms address the challenge of tracing. Thus Congress has not signaled an appetite to address tracing concerns. Further, given data indicating the current and recent sessions of Congress are not adopting new legislation of any form,<sup>347</sup> there appears to be little objective cause to believe congressional action is a likely means of resolving the challenges posed by *Morrison*'s interaction with section 11's tracing requirement.

## VII. CONCLUSION

*Morrison* signals a profound shift in the reach of federal securities law. Non-domestic purchasers in initial distributions now have no right to pursue section 11 claims, even if the security is qualified for listing on a U.S. exchange. Aftermarket purchasers must be able to trace their shares to securities that are "covered" by the allegedly defective registration statement. Historically, shares "covered" by a registration statement were sold to initial purchasers with the ability to assert section 11 claims. Thus, no court had an incentive to explain whether it was sufficient to trace to shares that were registered pursuant to an allegedly defective registration statement regardless of whether the initial purchaser had a

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345. *Parkcentral Glob. Hub Ltd. v. Porsche Auto. Holdings SE*, 763 F.3d 198, 217 (2d Cir. 2014).

346. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (setting out financial regulations intended to "promote the financial stability of the United States by improving accountability and transparency in the financial system"); Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737 (imposing new rules on securities class action lawsuits with the goal of reducing frivolous litigation); Securities Litigation Uniform Standards Act of 1998, Pub. L. 105-353, 112 Stat. 3227 (amending portions of the Securities Act of 1933 and the Securities Exchange Act of 1934 to preempt certain class actions that alleged fraud under state law "in connection with the purchase or sale" of securities).

347. Drew Desilver, *Congress Continues its Streak of Passing Few Significant Laws*, PEW RESEARCH CENTER (July 31, 2014), <http://www.pewresearch.org/fact-tank/2014/07/31/congress-continues-its-streak-of-passing-few-significant-laws>; Brian Christopher Jones, *One Redeeming Quality About the 112th Congress: Refocusing on Descriptive Rather than Evocative Titles – Part One*, 112 MICH. L. REV. FIRST IMPRESSIONS 1, 1–2 (2013), [http://repository.law.umich.edu/mlr\\_fi/vol112/iss1/3/](http://repository.law.umich.edu/mlr_fi/vol112/iss1/3/); Derek Willis, *A Do-Nothing Congress? Well, Pretty Close*, N.Y. TIMES, May 28, 2014, at A3.

valid section 11 claim, or whether the tracing would have to be to shares initially purchased by holders who could assert valid section 11 claims.

Therefore, the question of first impression is whether, for purposes of section 11's tracing requirement, aftermarket purchasers must establish a provenance leading to an initial purchaser in a domestic transaction subject to section 11's territorial reach, or whether it is sufficient for the aftermarket purchaser to trace to the allegedly defective registration statement, regardless of the territoriality of the initial transaction. To allow aftermarket purchasers to pursue section 11 claims in these circumstances, courts will have to invent a "springing" section 11 right of action that has no precedent in current law. The effect of inventing such a right would grant aftermarket purchasers a section 11 right of action that Congress never intended to grant to initial purchasers of those same shares.

The better interpretation of the law concludes that the courts should not invent such springing section 11 rights. The invention of such a right would cause the Securities Act to have an extraterritorial effect that Congress never intended, and would run contrary to the Supreme Court's admonition that implied private rights of action be narrowly construed. On the other hand, a requirement that aftermarket purchasers trace to initial distributions within section 11's territorial reach would be consistent with the structure of the securities statutes. Aftermarket purchasers on U.S. exchanges would continue to have all remedies available to aftermarket purchasers, including the right to pursue section 10(b) claims, whereas Securities Act claims would be limited to the initial purchasers Congress intended to protect with section 11 remedies. Section 11's text, as interpreted by the courts that imposed the tracing requirement, is also more consistent with a requirement that aftermarket purchasers trace to initial distributions within section 11's territorial reach than with alternative interpretations. The legislative history provides no useful insight for the resolution of this interpretive issue.

The public policy implications of a requirement that aftermarket purchasers trace to initial holders whom Congress intended to protect with section 11 rights are, however, potentially profound. The mechanics of modern securities transactions, which rely on massive, netted, commingled, street-name accounts in which securities of the same class are identified by a common CUSIP number, without regard to the registration statement pursuant to which they were issued, or the locus of their initial sale, imply that no aftermarket purchaser of an IPO with non-domestic purchasers in the initial distribution will be able to assert a section 11 claim if any shares sold in the non-domestic distribution enter the opening cross. This reduction in the scope of section 11 liability could reduce the incentive to engage in due diligence, an outcome that may not be welcomed by the SEC.

The Commission has at least three distinct administrative strategies that it could deploy, in a variety of permutations, to address this potential concern. First, the Commission could exercise its authority over the acceleration process and require that initial distributions occur only through domestic transactions. Second, the Commission could require undertakings by all persons potentially subject to section 11 liability that they will not challenge any plaintiff's right to assert a claim under section 11 on the grounds that securities were acquired in non-domestic transactions or that they cannot be traced to shares sold in domestic transactions. Third, the Commission could cause reforms to the CUSIP numbering process that would allow purchasers to trace individual securities to the registration statement pursuant to which the security was issued and to determine whether the security was initially distributed in a domestic transaction. Congressional action could

2015]            *Section 11 Liability and Prospects for Regulatory Reform*            69

also address the public policy concerns raised by the restricted class of purchasers with the ability to pursue section 11 claims following *Morrison*. Data suggest, however, that the probability of congressional action is not high.