

**THE CRITICAL ISSUE OF STANDING UNDER  
SECTION 11 OF THE SECURITIES ACT OF 1933**

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The Private Securities Litigation Reform Act of 1995 was intended to raise a plaintiff's burden of pleading scienter under Section 10 and Rule 10b-5. Perhaps as a result, practitioners have observed an increase in the filing of suits under Section 11 of the Securities Act of 1933 (the "1933 Act"),<sup>1</sup> which ordinarily does not require a plaintiff to plead scienter or reliance, or comply with the heightened pleadings standards applicable to fraud claims.<sup>2</sup> The difficulties experienced by a number of high profile initial public offerings ("IPOs") may be expected to continue or increase this trend making this a particularly appropriate point to address the issue of standing under Section 11.

There are two schools of thought on who has standing to file under Section 11. One is that a plaintiff must have purchased shares in the actual offering itself. The second is that a plaintiff has standing even if his or her shares are purchased in the secondary market within a certain number of days after the offering, or are somehow otherwise "traceable" to the offering.

This article examines the origins of the so-called "tracing" doctrine, the development of Section 11 jurisprudence and reasons why Section 11 should be construed to confer standing only upon purchasers who acquired securities directly in a public offering.

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<sup>1</sup> 15 U.S.C. § 77k.

<sup>2</sup> Dissenting in *Gustafson v. Alloyd Company*, 513 U.S. 561, 604 n.8 (1995), Justice Ginsberg noted that litigation under the 1933 Act has increased after the Supreme Court held that scienter was an element of a cause of action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. If a Section 11 claim does sound in fraud, however, the heightened pleading standard of Federal Rule of Civil Procedure 9(b) applies. See, e.g., *Castlerock Management, Ltd. v. Ultralife Batteries, Inc.*, 68 F. Supp.2d 480, 485 (D.N.J. 1999); *Chan v. Orthologic Corp.*, No. Civ. 96-1514, 1998 WL 1018624, at \*21 (D. Ariz. Feb. 5, 1998) ("Rule 9(b) applies to § 11 claims that are based in fraud.").

**A. Overview of Section 11**

Section 11 of the 1933 Act affords a remedy to civil litigants for materially false or misleading statements or omissions in a registration statement.<sup>3</sup> Enacted to ensure compliance with the disclosure provisions of the 1933 Act, Section 11 specifies the class of defendants subject to suit under its provisions imposing liability only on persons with a direct connection to a registered offering.<sup>4</sup> The class of defendants subject to liability under Section 11 includes: (1) every person who signed the registration statement; (2) all directors or partners of the issuer at the time the registration statement was filed; (3) all persons who, with their consent, are named in the registration statement as about to become a director or partner of the issuer; (4) experts who prepared or certified portions of the registration statement; and (5) the underwriters of the securities offering.<sup>5</sup> For the issuer, liability under Section 11 can be “virtually absolute.”<sup>6</sup> Even an innocent misstatement subjects an issuer to liability.<sup>7</sup> For other defendants, a due diligence defense is available.<sup>8</sup>

The statute provides for damages in an amount representing the difference between the purchase price of the security and its value at the time the lawsuit was commenced, the price at which plaintiff previously sold the security, or the price at which the security was sold after suit but before judgment.<sup>9</sup> In no event shall the damages exceed the offering price.<sup>10</sup>

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<sup>3</sup> 15 U.S.C. § 77k(a). The statute provides:

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 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, sue . . . .”

Section 11 applies to newly issued shares under a registration statement. *See* 15 U.S.C. § 77k(a). As such, both initial and secondary offerings fall within its scope. *See* *Murphy v. Hollywood Entertainment*, 1996 U.S. Dist. LEXIS 22207, at \*10 n.4 (D. Or. 1996).

<sup>4</sup> *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382-83 (1983) (“The section was designed to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering.”). *See* Elisabeth Keller and Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 345 (1988) (“Section 11 acts as an ‘in terrorem’ remedy to deter violations by encouraging careful preparations”).

<sup>5</sup> 15 U.S.C. § 77k(a)(1)-(5).

<sup>6</sup> *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983).

<sup>7</sup> *See id.*

<sup>8</sup> *See* 15 U.S.C. § 77k(b).

<sup>9</sup> 15 U.S.C. § 77k(e)

<sup>10</sup> 15 U.S.C. § 77(g).

At one time, courts routinely extended standing under Section 11 to aftermarket purchasers who alleged that their shares were “traceable” to a registration statement. A majority of these courts never explained what tracing meant, how it should be pled, or the factors necessary to trace one’s share to a particular registration statement. The few courts that addressed tracing as a substantive standard generally held that a plaintiff must have purchased a security directly in an offering to maintain suit under Section 11. However, the predominant effect of “tracing” was that any open market purchaser could bring suit under Section 11 thus greatly expanding the class of plaintiffs to whom Section 11 provided a remedy.<sup>11</sup> The expansive concept of “traceability” therefore nullified the principle requiring Section 11 plaintiffs to show a demonstrable nexus between the offering and their purchase of a particular security. The failure to ascribe a rigorous definition to tracing also violated the basic tenet that a statutory remedy is available only to plaintiffs who fall within the zone of interests protected by the statute in question.<sup>12</sup>

Although the question of standing may be raised at any time, it is particularly appropriate to raise the issue at the early stages of a litigation. In securities litigation, where most suits are filed as class actions,<sup>13</sup> it is important to resolve standing questions early because they bear upon the typicality of class representatives and affect evaluation of damages and settlement considerations.<sup>14</sup> Indeed, a leading authority on class action lawsuits has recognized that the question of standing is a threshold issue on class certification motions.<sup>15</sup> While some courts have noted that traceability (and therefore standing) is a merits issue that must await trial on the Section 11 claim,<sup>16</sup> it may defeat the utility of the class action vehicle to conduct a

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<sup>11</sup> LOUIS LOSS & JOEL SELIGMAN, IX SECURITIES REGULATION 4249 (2d ed. 1992) (“Suit may be brought by any person who acquired a registered security, whether in the process of distribution or in the open market.”).

<sup>12</sup> See, e.g., *Bennett v. Spear*, 520 U.S. 154, 162 (1997) (discussing “self-imposed limits on the exercise of federal jurisdiction,” including the requirement “that a plaintiff’s grievance must arguably fall within the zone of interests protected or regulated by the statutory provision or constitutional guarantee invoked in the suit”). See also *Federal Election Comm’n v. Akins*, 524 U.S. 11, 20 (1998).

<sup>13</sup> See *Securities Fraud Litigation Sets Record in 1998* <<http://securities.stanford.edu/news/990125/pressrel.html>> (“[A]t least 235 companies were named as defendants in federal class action securities fraud lawsuits in 1998 . . . [which] indicates a litigation rate of close to ‘one-a-day’ for every trading day that the stock market is open.”).

<sup>14</sup> *In re Quarterdeck Office Sys., Inc. Sec. Litig.*, No. CV. 92-3970, 1993 U.S. Dist. LEXIS 19806, at \* 10 (C.D.Cal. Sept. 30, 1993).

<sup>15</sup> See HERBERT B. NEWBERG & ALBA CONTE, NEWBERG ON CLASS ACTIONS § 2.07 n. 49 (1992) (“The proper procedure for determining certifiability of a class is for the court to determine initially whether the named plaintiffs have standing to assert individual claims . . . .”) Indeed, “the question of standing is a threshold inquiry in all actions.” 256, 264 (3d Cir. 1998). See also *David v. Simware, Inc.*, slip. op. Index No. 602143-96, at 8-9 (N.Y. Sup. Ct. Mar. 7, 1997) (questions of standing under Sections 11 and 12 are appropriately addressed on a motion for class certification) (available at <<http://securities.stanford.edu>>).

<sup>16</sup> *In re Lilco Sec. Litig.*, 111 F.R.D. 663 (E.D.N.Y. 1986).

“mini-trial” on each plaintiff’s standing, and, therefore, it is generally more sensible to resolve issues of standing early.

## B. The Genesis of “Tracing” and Development of Section 11 Jurisprudence

### 1. *Barnes v. Osofsky*

The concept of “tracing” originated in *Barnes v. Osofsky*,<sup>17</sup> a decision that *restricted* the potential class of plaintiffs under Section 11. The facts of *Barnes* involved a public offering of newly issued shares which supplemented a preexisting market for registered shares of defendant’s stock.<sup>18</sup> The *Barnes* plaintiffs sought approval of a settlement on behalf of all shareholders regardless of whether their shares were newly issued or previously acquired on the open market. The district court concluded that the settlement class must be limited because “Section 11 of the Securities Act of 1933 and its interpretation in this Circuit, preclude participation, by shareholders whose shares were not part of the public issue complained of, in a settlement of an action maintained under that section.”<sup>19</sup> In so holding, the district court explained that any technical objections to the administration of its ruling were unfounded because the defendants were capable of identifying the shares issued in the public offering.<sup>20</sup> Accordingly, the district court approved a settlement class consisting of “the shareholders who . . . acquired any part of the 200,000 shares of the public offering which is the subject of these lawsuits. All other shareholders are excluded.”<sup>21</sup> In limiting the settlement class, the court noted that “while holders of other shares may possibly have some legal remedy, it is not to be found in an action under Section 11 of the Securities Act of 1933, and their rights will not be affected by the bar order.”<sup>22</sup> Accordingly, only purchasers who obtained shares in an offering could trace his or her securities.

The United States Court of Appeals for the Second Circuit framed the issue as: “whether the district court was right in ruling that § 11 extends only to purchases of newly issued shares,” and affirmed the district court.<sup>23</sup> The *Barnes* plaintiffs argued against the concept of tracing contending that tracing was impractical and that Section 11 should be read to apply broadly to

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<sup>17</sup> 373 F.2d 269 (2d Cir. 1967).

<sup>18</sup> *See id.*

<sup>19</sup> 254 F. Supp. 721, 726 (S.D.N.Y. 1966) (citing *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951)), *aff’d*, 373 F.2d 269 (2d Cir. 1967).

<sup>20</sup> *Id.* The district court’s explanation necessarily implies that only initial purchasers would have standing because the defendants are not capable of identifying the shares once they are subject to over-the-counter trading. *See Abbey v. Computer Memories, Inc.*, 634 F. Supp. 870, 874 ((N.D. Cal. 1986).

<sup>21</sup> 254 F. Supp. at 725.

<sup>22</sup> *Id.* at 726.

<sup>23</sup> *Barnes*, 373 F.2d at 271.

all shareholders.<sup>24</sup> The Second Circuit rejected this argument reasoning that “[s]ince . . . only individual shares are registered, it seems unlikely that the section developed to insure proper disclosure in the registration statement was meant to provide a remedy for other than the particular shares registered.”<sup>25</sup> Thus, the *Barnes* court’s concept of tracing required a plaintiff to demonstrate that shares were acquired in an offering. The court observed that “[a]ppellants’ broader reading would be inconsistent with the over-all statutory scheme,” referring to the 1933 and 1934 Acts as a whole.<sup>26</sup> The Second Circuit concluded that narrowing the class of plaintiffs under Section 11 was consistent with the “traditional limited reading” of that statute.”<sup>27</sup>

The *Barnes* court noted that its narrow interpretation of Section 11 was fully consistent with judicial precedent and the narrow construction of Section 11 employed by leading jurists in the field.<sup>28</sup> For example, in *Fischman v. Raytheon Manufacturing*, the Second Circuit stated: “A suit under Sec. 11 of the 1933 Act requires no proof of fraud or deceit, and such a suit may be maintained only by one who comes within a narrow class of persons *i.e.* those who purchase securities that are the direct subject of the prospectus and registration statement.”<sup>29</sup>

## 2. Implementation of “Tracing”

Immediately following *Barnes*, courts held that only those who purchased shares that are the “direct subject” of the registration statement could maintain a cause of action under Section 11. “Direct subject” was interpreted to mean initial purchasers. For example, in *Wolfson v. Solomon*, the court cited *Barnes* in certifying a Section 11 class consisting of plaintiffs who

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<sup>24</sup> The *Barnes* plaintiffs offered three arguments against constricting Section 11 standing through the concept of tracing: (1) it is unreasonable to distinguish old shares from new shares because an unduly optimistic offering documents would affect shares in the marketplace; (2) “to read that section 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 brokers who neither know nor care whether they are getting newly registered or old shares”; and (3) “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.” *Id.* at 271-72.

<sup>25</sup> *Id.* at 272.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* at 273.

<sup>28</sup> *Id.* (citing *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 738 (2d Cir. 1951); *Colonial Realty Corp. v. Brunswick Corp.*, 257 F. Supp. 875 (S.D.N.Y. 1966)).

<sup>29</sup> *Fischman*, 188 F.2d at 786. Judge Frank — “a leading member of the SEC in its early days,” *Barnes*, 373 F.2d at 273 — authored the *Fischman* opinion. The *Barnes* court accorded Judge Frank’s view considerable deference. *Id.* Other authority cited by *Barnes* recognized that the 1933 Act applies “only on the occasion of a public offering.” Milton H. Cohen, “*Truth in Securities*” Revisited, 79 HARV. L. REV. 1340, 1341 (1966). Cohen advocates the abolition of the 1933 Act due to its limited applicability “on the special occasion of a public offering.” *Id.* at 1340. As an alternative, the author proposes an expansion of the 1934 Act to incorporate the 1933 Act’s disclosure provisions. *Id.* at 1342.

purchased their shares directly from the underwriters.<sup>30</sup> The *Wolfson* Court also certified a separate class of aftermarket purchasers to pursue causes of action under Section 17(a) of the 1933 Act<sup>31</sup> and Section 10(b) of the Securities Exchange Act of 1934 (the “1934 Act”) – the remedy for aftermarket purchasers.<sup>32</sup> The same result was reached in *Langert v. Q-1 Corporation*, where the court held that “[t]hose who purchased stock directly from the underwriter on the basis of the registration statement and prospectus possess a right of action under Sections 11 and 12.” Accordingly, the *Langert* court certified one class of initial purchasers and a second class of aftermarket purchasers with claims arising under Section 17(a) of the 1933 Act and Section 10(b) of the Securities Exchange Act of 1934.<sup>33</sup>

Although early application of “tracing” limited standing to initial purchasers, as courts confronted arguments regarding the meaning of tracing, four new theories evolved.<sup>34</sup> *Kirkwood v. Taylor*<sup>35</sup> is the seminal case describing the tracing methods.

- *Direct Trace*. Under the direct trace method standing is conferred only when the stock at issue “is directly purchased in the underwritten public offering.”<sup>36</sup> Indicia documenting the “trace” would include “an indication of interest by the broker on behalf of the customer, the customer’s receipt of a preliminary prospectus with a legend in red ink (called a ‘red herring’), a notation on the purchase order ticket showing purchase in the offering, purchase at the offering price, lack of commission,

<sup>30</sup> 54 F.R.D. 584, 588 (S.D.N.Y. 1972). See also *id.* at 591 (noting distinctions between the Section 11 class comprised of purchasers who acquired securities directly in a public offering and the class consisting of persons who acquired shares in over the counter transactions).

<sup>31</sup> Only one provision of the 1933 Act – Section 17(a) – extends beyond public offerings. *Gustafson*, 513 U.S. at 576.

<sup>32</sup> *Wolfson*, 54 F.R.D. at 588 (“If the instant action is to be a class action, then it must embrace two classes, for there will be persons who purchased on the open market and cannot avail themselves of the remedies of the Section 11 class.”).

<sup>33</sup> Fed. Sec. L. Rep. ¶ 94,445 [1973-74 Transfer Binder] (S.D.N.Y. Mar. 15, 1974). See also *Lorber v. Beebe*, 407 F. Supp. 279, 287 (S.D.N.Y. 1975) (shares purchased in the open market cannot be traced therefore aftermarket purchasers could not invoke Section 11).

<sup>34</sup> See *Kirkwood v. Taylor*, 590 F. Supp. 1375 (D. Minn. 1984), *aff’d*, 760 F.2d 272 (8<sup>th</sup> Cir. 1985) (discussing the direct, fungible mass, contrabroker, and heritage methods of tracing). See also Bruce G. Vanyo & Terry T. Johnson, *Restrictions on the Scope of the Civil Liability Provisions of the Federal Securities Laws*, 313 PLI/Lit 255, 270 (Sept. 1, 1986) (arguing that “if direct tracing were not required, anyone who purchased any shares at any time subsequent to a public offering could sue under Section 11 . . . such a result would be inconsistent with the overall statutory scheme of the 1933 Act.”) (quotations omitted).

<sup>35</sup> 590 F. Supp. 1375 (D. Minn. 1984), *aff’d*, 760 F.2d 272 (8<sup>th</sup> Cir. 1985).

<sup>36</sup> *Id.* at 1378.

language regarding the prospectus on the customer's confirmation slip, and special coding of the transaction by the brokerage firm."<sup>37</sup>

- *Fungible Mass*. The fungible mass theory requires a court to determine that a proportionate number of shares on the market are "new" shares issued pursuant to a registration statement. Under the fungible mass theory, the court may then impute that a corresponding number of share held by plaintiffs are "traceable to the offering."<sup>38</sup>
- *Contrabroker*. Under the contrabroker method, shares would be traceable when a plaintiff purchases shares from his or her own broker, who had previously purchased the securities from a market maker.<sup>39</sup>
- *Heritage*. The "heritage" method of tracing requires a plaintiff to demonstrate that the certificate numbers of their shares corresponded to shares issued in an offering.<sup>40</sup>

Having examined each method, the *Kirkwood* court concluded that the direct trace method was the only viable means of "tracing" a purchase to an offering.<sup>41</sup> Among the advantages of this method is that it is easy to understand and prove<sup>42</sup> because the indicia establishing the trace is easily established and generally uncontroverted.<sup>43</sup> Moreover, the direct trace method is consistent with the legislative intent<sup>44</sup> and the traditional limited construction of Section 11.<sup>45</sup>

The *Kirkwood* court also noted the other methods "violate common sense."<sup>46</sup> The fungible mass theory reduces the question of standing to a mathematical formula that, in the final analysis, requires a court to presume that plaintiffs have standing.<sup>47</sup> Similarly, the

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<sup>37</sup> *Id.*

<sup>38</sup> *Id.* at 1379.

<sup>39</sup> *Id.* at 1381.

<sup>40</sup> *Id.* at 1382.

<sup>41</sup> *Id.* at 1378.

<sup>42</sup> *Id.* at 1378.

<sup>43</sup> *Id.* at 1378.

<sup>44</sup> *See infra* notes 178 to 206 and accompanying text (discussing legislative intent).

<sup>45</sup> *See supra* notes 17 to 33 and accompanying text (discussing the traditional narrow interpretation of Section 11).

<sup>46</sup> *Kirkwood v. Taylor*, 590 F. Supp. 1375, 1378 (D. Minn. 1984), *aff'd*, 760 F.2d 272 (8<sup>th</sup> Cir. 1985).

<sup>47</sup> *Id.* at 1380. Notwithstanding the judicial rejection of the fungible mass theory, one commentator has attempted recently to resurrect it. *See* Hillary A. Sale, *Disappearing Without a Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act*, 75 WASH. L. REV. 429 (Apr. 2000). Professor Sale contends that the "tracing"

contrabroker and heritage methods confer standing upon plaintiffs based upon speculation and conjecture. The *Kirkwood* court explained that the “contrabroker” method was flawed because “anyone who ever purchased from a participant in the underwriting after the offering date could claim he or she bought ‘new’ shares.”<sup>48</sup> This result would undermine the limited scope of Section 11. Similarly, the “heritage” method does not account for market realities because, due to conversions and surrenders, plaintiffs can only demonstrate that they “might have purchased” offering stock.<sup>49</sup>

Perhaps due to these problems, it appears that no court has adopted the fungible mass, contrabroker, or heritage methods of tracing. As courts have recognized, the common flaw in all three methods is that the question of standing is reduced to speculation.<sup>50</sup> Conjecture cannot form the predicate for standing because “[Section] 11 requir[es] more than a showing that a plaintiff’s stock ‘might’ have come from the relevant offering.”<sup>51</sup>

Thus, a body of caselaw developed holding that only purchasers who could trace their shares via the “direct trace” method — *i.e.*, purchased through an underwriter in an offering — have standing under Section 11.<sup>52</sup> To establish the traceability of shares, courts suggested

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requirement is underinclusive and that Section 11 should provide a cause of action to aftermarket purchasers. *See id.* at 464. Thus, Professor Sale proposes that the statistical method — rejected by the *Kirkwood* and *Elscint* courts — be employed to confer standing on aftermarket purchasers. *See id.* at 485. To support this thesis, Professor Sale analogizes securities fraud to toxic torts positing that the statistical evidence method employed to establish causation in the Agent Orange products liability litigation should apply to Sections 11 and 12. *See id.* at 484-88. Not only is this policy-driven approach inconsistent with the judicial precedent and legislative history of the Securities Act, it also fails to acknowledge that there may be a difference between toxic tort plaintiffs and securities fraud litigants. Not the least of these differences is that the aftermarket purchaser has an explicit statutory remedy: Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. *See infra* notes 160 to 177 and accompanying text for a discussion of the statutory scheme. Conversely, without resorting to statistical evidence, the toxic tort plaintiff is without a remedy. Professor Sale’s analogy is also flawed because court has inherent flexibility in establishing the parameters of common law tort claims. Statutory rights of action — such as Sections 11 and 12 — must be construed in accordance with the statutory language and legislative intent. *See Pinter v. Dahl*, 486 U.S. 622, 652 (1988) (“The broad remedial goals of the Securities Act are insufficient justification for interpreting a specific provision ‘more broadly than its language and the statutory scheme reasonably permit’”) (quoting *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979)). Extending standing to aftermarket purchasers based upon statistical probabilities would contravene the Supreme Court’s mandate.

<sup>48</sup> *Kirkwood*, 590 F. Supp. at 1378.

<sup>49</sup> *Id.*

<sup>50</sup> *In re Quarterdeck Office Sys., Inc. Sec. Litig.*, No. Civ. 92-3970, 1993 U.S. Dist. LEXIS. 19806, at \*8 (C.D. Cal. Sept. 30, 1993).

<sup>51</sup> *Id.*

<sup>52</sup> *See id.*; *see also Lorber v. Beebe*, 407 F. Supp. 279, 287 (S.D.N.Y. 1975) (shares purchased in the open market cannot be traced therefore aftermarket purchasers could not invoke Section 11); *Franklin Life Ins. Co. v. Commonwealth Edison Co.*, 451 F. Supp. 602, 607 n.1 (S.D. Ill. 1978) (“Section 11 . . . has been interpreted



pleading facts such as “who purchased what, when the purchases occurred, and from whom.”<sup>53</sup> From these basic facts (in addition to the purchase price), courts would be able to adjudicate the standing question under a substantive legal standard at an early stage of the litigation. The issue may also be determined by reference to the underwriters’ records which show who purchased shares in the offering.<sup>54</sup> Courts employing this analysis reached the conclusion that plaintiffs who purchased in the secondary market do not have standing under Section 11.<sup>55</sup>

However, while the reasoning of the “direct trace” cases is consistent with the limited view of Section 11 standing, the concept of tracing soon became separated from the restrictions of the “direct trace” theory. Subsequent courts rejected the reasoning and limitations of the “direct trace” cases, and simply accepted conclusory allegations that shares could be traced without any explanation of what “tracing” meant.<sup>56</sup> These decisions neither probe the practicality of “tracing,” nor consider the 1933 Act’s fundamental purpose to regulate the distribution of newly issued securities. Rather, the courts accepted mere allegations of

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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.”), *aff’d*, 598 F.2d 1109 (7<sup>th</sup> Cir. 1979); *Ackerman v. Clinical Data, Inc.*, Fed. Sec. L. Rptr. ¶ 92,207 (S.D.N.Y. July 8, 1985) (dismissing Section 11 claims for failure to allege that shares were purchased in the offering); *Abbey v. Computer Memories, Inc.*, 634 F. Supp. 870, 874 (N.D. Cal. 1986) (dismissing Section 11 claim for a failure to demonstrate that shares could be directly traced to an initial public offering); *Rice v. Windsor Indus.*, No 85 C 4196, 1986 WL 2728 (N.D. Ill. Feb. 27, 1986) (dismissing Section 11 claim for failure to allege that the securities were the “direct subject” of the offering or facts sufficient to warrant an inference that the shares could be “traced” to the registration statement); *In re Elscint Ltd. Sec. Litig.*, 674 F. Supp. 374, 380 (D. Mass. 1987) (tracing requires proof by a preponderance of the evidence that the plaintiff “be a purchaser of a determinate number of new shares at a determinate price”); *Guenther v. Cooper Life Sciences*, 759 F. Supp. 1437, 1439 (N.D. Cal. 1990) (holding that “[a] cause of action under section 11 is available only to purchasers of ‘stock actually issued in the offering for which the plaintiff claims there was a false or misleading registrations statement,’ and dismissing plaintiffs’ claims for failure to show that the shares were the direct subject of the offering) (quoting *Abbey*, 634 F. Supp. at 872); *In re Newbridge Networks Sec. Litig.*, 767 F. Supp. 275, 279 (D.D.C. 1991) (indicating that plaintiffs alleged facts sufficient to “trace” their shares because they purchased on the date of the offering).

<sup>53</sup> See *Rice v. Windsor Indus.*, No 85 C 4196, 1986 WL 2728 (N.D. Ill. Feb. 27, 1986) (dismissing Section 11 claim for failure to allege that the securities were the “direct subject” of the offering or facts sufficient to warrant an inference that the shares could be “traced” to the registration statement).

<sup>54</sup> *In re Lilco Sec. Litig.*, 111 F.R.D. 663 (E.D.N.Y. 1986).

<sup>55</sup> See, e.g., *Franklin Life Ins. Co. v. Commonwealth Edison Co.*, 451 F. Supp. 602, 607 n.1 (S.D. Ill. 1978) (“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.”), *aff’d*, 598 F.2d 1109 (7<sup>th</sup> Cir. 1979). See also *Lorber v. Beebe*, 407 F. Supp. 279, 287 (S.D.N.Y. 1975) (shares purchased in the open market cannot be traced therefore aftermarket purchasers could not invoke Section 11).

<sup>56</sup> See *In re AES Corp. Sec. Litig.*, 825 F. Supp. 578, 592 (S.D.N.Y. 1993) (general allegation of “traceability” sufficient to state a claim under Section 11); *In re Crazy Eddie Sec. Litig.*, 747 F. Supp. 850, 854-55 (E.D.N.Y. 1990) (finding sufficient an allegation that plaintiffs ‘purchased or otherwise acquired Crazy Eddie securities issued pursuant to and traceable to those defective Registration Statements’); *Gibb v. Delta Drilling Co.*, 104 F.R.D. 59, 70 (N.D. Tex. 1984).

“tracing” and consequently expanded the scope of the 1933 Act to aftermarket trading.<sup>57</sup> This line of authority resulted in a departure from the legislative intent and the structure of the statutory scheme.<sup>58</sup>

### C. Development of Section 12 Jurisprudence

It is difficult to address Section 11 without an examination of the jurisprudence developed under its companion statute, Section 12. The two sections share the same legislative history and canons of statutory construction mandate that provisions of a statute be read as a whole.<sup>59</sup> Indeed, the caselaw construing Section 12 largely has been influenced by a recognition of Section 11's exclusive application to initial distributions.<sup>60</sup>

Recognizing the limited reach of the 1933 Act, courts have construed Section 12 to apply solely to initial distributions of securities.<sup>61</sup> In a case of first impression among federal appellate

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<sup>57</sup> *In re Ramtek Securities Litigation*, No. C 88020195, 1991 WL 56067, at \*10 (N.D. Cal. Feb. 4, 1991), provides a striking example of the broad interpretation of tracing used to expand Section 11. In that case, the court held “a Section 11 claim can be brought by any person regardless of whether they had purchased a registered security in the original offering or months later in the open market. . . . All a debenture subclass member needs to do to assert standing to pursue a Section 11 claim is demonstrate his debentures are ‘traceable’ to the debentures issues on the initial public offer.” *Id.* (citing *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967)). *Ramtek’s* expansive use of the “tracing” concept to broaden a plaintiff class illustrates the problems engendered by the failure to attribute a substantive meaning to “tracing.”

<sup>58</sup> *See Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 171 (1994) (“The 1933 Act regulates initial distributions of securities, and the 1934 Act for the most part regulates post-distribution trading.”).

<sup>59</sup> *Gustafson v. Alloyd Co.*, 513 U.S. 561, 570, 572 (1995).

<sup>60</sup> *See, e.g., First Union Discount Brokerage v. Milos*, 997 F.2d 835, 843 (11<sup>th</sup> Cir. 1993). In holding that Section 12 does not provide aftermarket purchasers with a right of action, the United States Court of Appeals for the Eleventh Circuit explained:

[S]ection 12 is structurally positioned after sections 11 and 12(1), which respectively govern the registration of securities and create civil liability for sales of unregistered securities, and before section 13, which establishes a limitations period for sections 11 and 12. Because section 12(2) is sandwiched between sections that deal exclusively with initial distributions, it too must be so limited.

*Id.* (citing *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d Cir. 1991)). *See also* Elliott J. Weiss, *The Courts Have It Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 BUS. LAW. 1, 12 (1992) (“Analysis of sections 11 and 12 establishes that viewed functional — as a remedy directed solely at public offerings — section 12(2) nonetheless has a critical part in the statutory scheme.”).

<sup>61</sup> *See, e.g., SSH Company, Ltd. v. Shearson Lehman Brothers, Inc.*, 678 F. Supp. 1055, 1059 (S.D.N.Y. 1987) (holding that aftermarket purchasers’ Section 12 claims must be dismissed because “[t]he purpose of the ‘33 Act was the regulation of the distribution of securities”); *Grinsell v. Kidder, Peabody & Co.*, Fed. Sec. L. Rptr. ¶95,437 (N.D. Cal. Aug. 7, 1990) (concluding that Section 12 applies only to initial distributions and explaining “[i]n light of Congress’ clear intent to focus the 1933 Act primarily on initial offerings . . . [t]his Court can find no logical reason in policy or equity for assuming . . . an odd departure from the Act’s

courts, the United States Court of Appeals for the Third Circuit, in *Ballay v. Legg Mason Wood Walker*, held Section 12 “provides a remedy to buyers of securities only in the initial distributions.”<sup>62</sup> In so holding, the *Ballay* court stated: “We believe that the language and the legislative history of section 12(2) demonstrate that Congress did not there intend to protect buyers in the aftermarket.”<sup>63</sup> According to the *Ballay* court, this is consistent with the narrow scope of the 1933 Act because “[t]he legislative history is devoid of any indication that the reach of section 12(2) was intended to be broader than the limited scope of sections 11 and 12(1).”<sup>64</sup> Thus, Section 11’s limited reach was significant to the *Ballay* court’s analysis.<sup>65</sup> As the court explained, Section 12 is positioned between Section 11 and Section 13 which “deal with initial distributions.”<sup>66</sup> Accordingly, the Third Circuit recognized that “Congress’ placement of section 12(2) squarely among 1933 Act provisions concerned solely with initial distributions of securities indicates that it designed section 12(2) to protect buyers of initial offers against fraud and misrepresentation.”<sup>67</sup>

The Third Circuit further reasoned that a broad reading of Section 12 “would permit a buyer to recover under section 12(2) for mere misrepresentations where that same buyer could not meet the scienter, reliance, and causation elements of a section 10(b) claim [of the Securities Exchange Act of 1934].”<sup>68</sup> Accordingly, the court concluded, Section 12(2) does not “protect buyers in the aftermarket,” but instead “provides a remedy to buyers of securities only in the initial distributions.”<sup>69</sup>

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focus”); *Cox v. Eichler*, 765 F. Supp. 601, 609 (N.D. Cal. 1990) (“This court also reads the legislative history of the Securities Act of 1933 to restrict liability under section 12(2) to initial offerings of securities and not to trades of listed securities already in the marketplace”); *T. Rowe Price New Horizons Funds v. Preletz*, Fed. Sec. L. Rptr. ¶ 95,769 (D. Md. 1990) (citing the legislative history in concluding that “[Section] 12 is inapplicable to sales of stock in the secondary market”).

<sup>62</sup> 925 F.2d 682, 684 (3d Cir. 1991).

<sup>63</sup> *Id.* at 684.

<sup>64</sup> *Id.* at 691. A cause of action under Section 12(1) may only be maintained against a “seller” of securities. See *Pinter v. Dahl*, 486 U.S. 622 (1988). This limitation means that a plaintiff may recover only from those who pass title or were a “substantial factor” in the sale. See *id.*

<sup>65</sup> *Id.* at 691.

<sup>66</sup> *Id.*

<sup>67</sup> *Id.*

<sup>68</sup> *Ballay*, 925 F.2d at 688-89.

<sup>69</sup> *Id.* at 684.

Relying on *Ballay's* reasoning, several federal courts restricted standing under Section 12 to initial purchasers.<sup>70</sup> This same reasoning compelled courts to limit Section 11 standing to initial purchasers.<sup>71</sup>

In *Pacific Dunlop Holdings Incorporated v. Allen & Company Incorporated*, the United States Court of Appeals for the Seventh Circuit expressly disagreed with *Ballay* and concluded that Section 12 applied to aftermarket transactions.<sup>72</sup> The circuit split regarding Section 12's scope was resolved by the United States Supreme Court's landmark decision in *Gustafson v. Alloyd Company* which rejected *Pacific Dunlop*, confirmed the reasoning of *Ballay*, and signaled a return to the 1933 Act's intended purpose.<sup>73</sup>

#### D. The *Gustafson* Decision

In *Gustafson v. Alloyd Company*, the Court considered whether Section 12(2)<sup>74</sup> could afford a remedy to a buyer challenging misrepresentations allegedly made in a private sale transaction. The district court relying on *Ballay v. Legg Mason Wood Walker, Inc.*,<sup>75</sup> had granted the defendants' motion for summary judgment. The Supreme Court upheld the district court's

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<sup>70</sup> *First Union Discount Brokerage Serv., Inc. v. Milos*, 997 F.2d 835, 843-44 (11<sup>th</sup> Cir. 1993) ("we are persuaded by the Third Circuit's reasoning and hold that section 12(2) of the 1933 Act does not apply to aftermarket transactions."); *Reed v. Prudential Securities Inc.*, 875 F. Supp. 1285, 1291, 1292 (S.D. Tex. 1995) ("Courts throughout the nation have followed the Third Circuit's reasoning in *Ballay*" in holding that "§ 12(2) applies only to initial offerings"), *aff'd*, 87 F.3d 1311 (5<sup>th</sup> Cir. 1996); *Bennett v. Bally Manufacturing Corp.*, 785 F. Supp. 559, 561-62 (D.S.C. 1992) ("the clear weight of authority supports [the] contention that § 12(2) does not apply to secondary market transactions."); *Professional Serv. Indus., Inc. v. Kimbrell*, Civ. A. No. 90-1326-B, 1992 WL 403639 (D. Kan. 1992) ("We hold that § 12(2) does not provide a cause of action to a purchaser in the secondary trading of securities.") (citations omitted); *See also Newman v. Comprehensive Care*, 794 F. Supp. 1513, 1524 (D. Or. 1992) (dismissing Section 12 claim because "the legislative history indicates that the 1933 Act was designed to affect only new offerings of securities") (internal quotation omitted) (citing *Ballay*).

<sup>71</sup> *Delmarva Sec. Litig.*, 794 F. Supp. 1293, 1311 (D. Del. 1992) ("Congress' intent in enacting the entire Securities Act was to regulate initial offerings. . . According to *Ballay*, Section 11 'deals with initial distributions . . .' not with secondary offerings. Plaintiffs have not alleged they purchased newly issued shares in an offering. Therefore, the Section 11(a) claims will be dismissed for lack of standing.") (internal citation omitted).

<sup>72</sup> 993 F.2d 578 (7<sup>th</sup> Cir. 1993), *abrogated by Gustafson v. Alloyd Company*, 513 U.S. 561 (1995).

<sup>73</sup> 513 U.S. 561 (1995).

<sup>74</sup> Subsection 12(2) was recodified as Section 12(a)(2) in 1995. *See* 15 U.S.C. § 771, *as amended* Pub. L. No. 104-67, Title I § 105, 109 Stat. 757 (Dec. 22, 1995).

<sup>75</sup> 925 F.2d 682, 684 (3d Cir. 1991) (holding that "section 12(2) provides a remedy to buyers of securities only in the initial distributions").

decision finding: “The intent of Congress and the design of the statute require that § 12(2) liability be limited to public offerings.”<sup>76</sup>

The Supreme Court reached this conclusion after noting that Section 12(2) provides an express cause of action against sellers who make material misstatements “by means of a prospectus.”<sup>77</sup> Noting that principles of statutory construction required the term “prospectus” to be interpreted consistently among the various provisions of the 1933 Act, the Court found that the term “prospectus” – like a registration statement<sup>78</sup> – referred to a document prepared by an issuer in conjunction with a public offering.<sup>79</sup>

The Supreme Court also noted that Section 12(2) exempts sales of government-issued securities.<sup>80</sup> This exemption would make no sense if Congress intended Section 12(2) to create liability for secondary market transactions, because there could be no explanation for immunizing private sellers of government-issued securities in the secondary market.<sup>81</sup> “The exemption for government-issued securities makes perfect sense” only when Section 12(2) is construed to apply solely to new offerings, because “it then becomes a precise and appropriate means of giving immunity to governmental authorities.”<sup>82</sup>

The Supreme Court further noted that 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.”<sup>83</sup> The Court was therefore “reluctant to conclude that § 12(2) creates vast additional liabilities” – *i.e.*, regulation of the secondary market –

that are quite independent of the new substantive obligations the Act imposes. It is more reasonable to interpret the liability provisions of the 1933 Act as designed for the primary purposes of

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<sup>76</sup> *Id.* at 578.

<sup>77</sup> *Id.* at 564 (quoting Section 12(2)).

<sup>78</sup> *Id.* at 569 (“By and large, only public offerings by an issuer of a security, or by controlling shareholders of an issuer, require the preparation and filing of registration statements.”).

<sup>79</sup> *Id.* at 568, 569.

<sup>80</sup> *Id.* at 571.

<sup>81</sup> *Id.* at 571.

<sup>82</sup> *Id.* at 571.

<sup>83</sup> *Id.* at 571. For this proposition *Gustafson* cites the following: *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (the 1933 Act “was designed to provide investors with full disclosure of material information concerning public offerings”); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 (1975) (“The 1933 Act is a far narrower statute [than the Securities Exchange Act of 1934] chiefly concerned with disclosure and fraud in connection with offerings of securities – primarily, as here, initial distributions of newly issued stock from corporate issuers”); *United States v. Naftalin*, 441 U.S. 768, 777-78 (1979) (“[T]he 1933 Act was primarily concerned with the regulation of new offerings”).

providing remedies for violations of the obligations it had created. Indeed, §§ 11 and 12(1) – the statutory neighbors of § 12(2) – afford remedies for violations of those obligations.<sup>84</sup>

Finally, the Supreme Court concluded that it was “understandable” that Congress would give buyers the extraordinary remedy of rescission under Section 12 without requiring proof of fraud only if the scope of that rule were limited to new offerings, because those transactions are based on “documents prepared with care, following well established procedures,” such as a prospectus (or a registration statement).<sup>85</sup> To make the remedy of rescission under Section 12 available to buyers in the secondary market, where communication is less deliberate, would have the “practical effect” of giving buyers an “option to rescind,” thereby “impairing the stability” of the securities market.<sup>86</sup>

In reaching its conclusion, the Court relied heavily upon the legislative history shared by Sections 11 and 12 noting that Section 12’s “statutory neighbo[r]” – Section 11 – applies only to new distributions.<sup>87</sup> Indeed, even the dissenters in *Gustafson*, while disagreeing on the scope of Section 12(2), conceded that Section 11 was limited to public offerings. Justice Ginsburg, in dissent, noted that “[t]here is no dispute that [Sections 11 and 12(1)] apply only to public offerings – or, to be precise, to transactions subject to registration.”<sup>88</sup> Justice Thomas, in a separate dissenting opinion, agreed: “Nor did Congress limit § 12(2) to issuers, as it chose to do with other provisions that are limited to initial distributions. *See* § 11 of the 1933 Act . . . .”<sup>89</sup>

In reasoning that Section 12 applied exclusively to public offerings of securities, the Supreme Court emphasized that “[t]he 1933 Act, like every Act of Congress, should not be read

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<sup>84</sup> *Id.* at 572 (emphasis added).

<sup>85</sup> *Id.* at 578.

<sup>86</sup> *Id.* A registration statement likewise is prepared with established procedures and required information. *See Shaw v. Digital Equipment*, 82 F.3d 1194, 1204 (1<sup>st</sup> Cir. 1996).

<sup>87</sup> *Gustafson*, 513 U.S. at 571, 572. *Gustafson*’s reading of the legislative history of the 1933 Act is consistent with the Court’s earlier decision in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 (1975), the seminal decision on statutory constructions of the 1934 Act. Explaining the difference between the 1934 Act and the 1933 Act, the *Blue Chip Stamps* Court noted “[t]he 1933 Act is a far narrower statute chiefly concerned with disclosure and fraud in connection with offerings of securities – primarily, . . . initial distributions of newly issued stock from corporate issuers.” Furthermore, “Congress left little doubt that its purpose in imposing the prospectus and registration requirements of the 1933 Act was to the ‘high pressure salesmanship rather than careful counsel,’ causing inflated new issues, through direct limitation by the SEC of ‘the selling arguments hitherto employed.’” *Id.* at 752-53 (quoting H.R. Rep. No. 73-85, 2, 8 (1933)).

<sup>88</sup> *Gustafson*, 513 U.S. at 600 n.4 (Ginsburg, J., dissenting). Transactions in the secondary market are not subject to registration. *See* 1933 Act § 4(1) [15 U.S.C. § 77d(1)].

<sup>89</sup> *Id.* at 590 (Thomas, J., dissenting).

as a series of unrelated and isolated provisions.”<sup>90</sup> The canons of statutory construction espoused by the *Gustafson* court thus require consistent application of Sections 11 and 12.

Following *Gustafson*, courts uniformly have held Section 12 clearly applies only to initial public offerings.<sup>91</sup> Despite *Gustafson*’s clear statements regarding Section 11, courts have divided on that section’s scope.

## E. Post-*Gustafson* Caselaw

### 1. Rejection of “Tracing”

In concluding that the scope of Section 12 is limited to initial public offerings, the Supreme Court acknowledged in *dicta* that Section 11 is similarly restricted.<sup>92</sup> Immediately following *Gustafson*, courts interpreted Sections 11 and 12 consistently to limit standing only to those who purchase shares in an initial public offering.<sup>93</sup> These early decisions sounded the

<sup>90</sup> *Gustafson*, 513 U.S. at 570.

<sup>91</sup> Following *Gustafson*, courts have held that Section 12 liability is limited to misstatements made in connection with initial public offering of securities. See, e.g., *Maldonado v. Dominguez*, 137 F.3d 1, 8 (1<sup>st</sup> Cir. 1998) (“the Supreme Court conclusively decided that section 12(2) applies exclusively to ‘initial public offerings’”); *In re WRT Securities Litig.*, Nos. 96 CIV. 3610 (JFK), 96 CIV. 3611 (JFK), 1997 WL 576023, at \*5 (S.D.N.Y. Sept. 15, 1997) (dismissing plaintiffs’ claims under Section 12(a)(2) because plaintiffs failed to allege that they purchased notes or preferred stock in a public offering); *Weinstein v. Jain*, No. C-94-1015-EFL, 1995 WL 787549 (N.D. Cal. Oct. 23, 1995), at \*2 (“the discussion in *Gustafson* clearly indicates that the Court takes the view that Congress contemplated that Section 12(2) would apply only to public offerings by an issuer, and would not apply to the redistribution of stock in the secondary market”); *Baxter v. A.R. Baron & Co.*, Fed. Sec. L. Rptr. ¶ 98,923 (S.D.N.Y. Oct. 6, 1995) (dismissing aftermarket purchasers’ Section 12 claims); *Komanoff v. Mabon, Nugent & Co.*, Fed. Sec. L. Rptr. ¶ 98,745 (S.D.N.Y. Apr. 27, 1995) (same).

<sup>92</sup> *Gustafson*, 513 U.S. at 571, 572 (noting that Section 12(2)’s “statutory neighbo[r],” Section 11 applies only to new public offerings).

<sup>93</sup> See *Gannon v. Continental Insurance Co.*, 920 F. Supp. 566, 575 (D.N.J. 1996) (holding that “§ 11 and § 12(2) of the 1933 Securities Act apply only to stocks bought in an initial public offering and not to stocks purchased through secondary market transactions”); *Warden*, 1998 WL 725946, at \*2 (“[i]f plaintiffs’ shares were purchased in the secondary market, they would not be linked to a registration statement . . . and the § 11 claim would fail.”); *In re Summit Med. Sys. Inc., Sec Litig.*, 10 F. Supp.2d 1068, 1070 (D. Minn. 1998) (“Section 11 is applicable only to shareholders who acquired their stock in the IPO”); *Flecker v. Hollywood Entertainment Corp.*, 1997 WL 269488, at \*2 (D. Or. Feb. 12, 1997) (claims under Sections 11 and 12 dismissed because “the 1933 Act does not extend to aftermarket transactions under the reasoning of *Gustafson*”); *Murphy v. Hollywood Entertainment Corp.*, Civ. A. No. 95-1926, 1996 WL 393662, at \* 4 (D. Or. May 9, 1996) (dismissing Section 11 claims because there is “no material distinction between § 11 [claims] . . . and those raised under § 12(2) from the standpoint of the standing of aftermarket purchasers”); *Warden v. Crown Amer. Realty Trust*, No. Civ. A. 96-25J, 1998 WL 725946, at \*3 n.2 (W.D. Pa. Oct. 15, 1998) (“in a market transaction, it is difficult to conceive of how [shares] could be traced”); *Zeid v. Open Environment*, No. 96-12466-EFH, 1997 U.S. Dist. LEXIS 23469, at \*2 (D. Mass. Dec. 16, 1997) (dismissing aftermarket purchasers’ Section 11 claims); *Brosious v. Children’s Place Retail Stores*, 189 F.R.D. 138, 144 (D.N.J. 1999) (“purchasers in the secondary market have no cause of action under section 11”); *Van de Walle v. Salomon*

death knell for tracing as a means of extending standing under Section 11 to aftermarket purchasers.

*Gould v. Harris* was among the first reported decisions addressing Section 11 in light of *Gustafson*.<sup>94</sup> In that case, the court noted that the reasoning of *Gustafson* is equally applicable to Sections 11 and 12 because these statutes share the same legislative history and impose liability without proof of fraud or reliance.<sup>95</sup> Incorporating the Supreme Court's reasoning, the *Gould* court held that "neither section 11 nor section 12 extends to securities purchases that are merely 'traceable' to the offering. Under *Gustafson*, sections 11 and 12(2) apply only to purchases made in the initial offering and not those purchased in the secondary market."<sup>96</sup>

*In re WRT Energy Securities Litigation*<sup>97</sup> similarly exemplifies the strict construction employed in cases immediately following *Gustafson*.<sup>98</sup> In *WRT*, aftermarket purchasers acquired their shares four days after the initial public offering.<sup>99</sup> The *WRT* court concluded that "the standing principles the Supreme Court announced in *Gustafson* apply equally to Section 11 claims."<sup>100</sup> Despite the temporal proximity of the offering and the purchases, the *WRT* court dismissed plaintiffs' claims because plaintiffs failed to allege that they purchased shares in the offering itself.<sup>101</sup> The *WRT* court noted that its conclusion was consistent with pre-*Gustafson* caselaw acknowledging Section 11's limited scope.<sup>102</sup> Following *Gould* and *WRT*, the ability of

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*Bros., Inc.*, No. 9894, 1997 WL 633288 (Del. Ch. 1997) ("The majority of federal district courts that have considered the extent of liability under § 11 since *Gustafson* have also held that purchases made in the secondary market cannot give rise to an action under § 11.").

<sup>94</sup> 929 F. Supp. 353, 358 (C.D. Cal. 1996), *abrogated by Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076 (9th Cir. 1999).

<sup>95</sup> *Id.* at 358.

<sup>96</sup> *Id.* at 359.

<sup>97</sup> No. 96 Civ. 3610, 1997 WL 576023 (S.D.N.Y. Sept. 15, 1997).

<sup>98</sup> *See, e.g., In re Summit Med. Sys., Inc. Sec. Litig.*, 10 F. Supp.2d 1068, 1070-71 (D. Minn. 1998) ("[T]his Court adopts the position in *WRT*, and finds that Section 11 is applicable only to shareholders who acquired their stock in the IPO.").

<sup>99</sup> *WRT*, 1997 WL 576023, at \*6.

<sup>100</sup> *Id.* at \*6.

<sup>101</sup> *Id.*

<sup>102</sup> *WRT*, 1997 WL 576023, at \*6 (quoting, *inter alia*, *Langert v. Q-1 Corp.*, Fed. Sec. L. Rep. (CCH) ¶ 94,445 (S.D.N.Y. Mar. 15, 1974) ("Those who purchased stock directly from the underwriter on the basis of the registration statement and prospectus possess a right of action under §§ 11 and 12 of the 1933 Act. Those who purchased on the open market have a right of action under § 10(b) of the 1934 Act and Section 17 of the 1933 Act."); *Ballay v. Legg Mason Wood Walker*, 925 F.2d 682, 691 (3d Cir. 1992) ("section 11 and section 12(1) . . . deal with initial distributions . . . and are concerned solely with initial distributions of securities."). See also the cases cited at note 93, *supra*.



an aftermarket purchaser to maintain a Section 11 claim based on a mere allegation that shares could be traced clearly was in question.

As the concept of “tracing” initially returned to Section 11 jurisprudence, it appeared limited in its applicability to the “direct trace” theory described in *Kirkwood v. Taylor*.<sup>103</sup> As a result, only initial purchasers could “trace” their securities to the offering.<sup>104</sup>

Nevertheless, as Section 11 claims increased after the enactment of the Private Securities Litigation Reform Act,<sup>105</sup> some courts seem again to have embraced the broad concept of tracing and restricted *Gustafson*’s applicability to Section 12.<sup>106</sup> However, the decisions accepting tracing as a means of conferring standing neither define its meaning nor explain how it can or should be implemented.

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<sup>103</sup> *Chan v. Orthologic Corp.*, No. Civ. 96-1514, 1998 WL 1018624, at \*21 (D. Ariz. Feb. 5, 1998) (dismissing Section 11 claims because “Plaintiffs have failed to allege any facts tracing their purchase to the underwriters in their complaint”); *Stack v. Lobo*, 903 F. Supp. 1361, 1376 (N.D. Cal. 1995) (“[T]his Court concludes that § 11 is not applicable to aftermarket transactions. The SAC contains no allegations that Plaintiffs purchased their shares in Quickturn’s IPO or that the shares they purchased can be traced to the IPO. Therefore, Plaintiffs lack standing to assert a claim under § 11.”); *Lilley v. Charren*, 936 F. Supp. 708, 716 (N.D. Cal. 1996) (requiring plaintiffs to plead “specific dates and facts” to establish a Section 11 claim). For example, in *Fazio v. Palmieri*, slip. op., No. C96-1096D, at 7-8 (W.D. Wash. Apr. 10 1997) (available at <<http://securities.stanford.edu>>), the court explained:

[T]he mere fact that a company has had a public offering does not automatically mean that all purchasers of public shares have standing to bring a § 11 claim. Plaintiffs bear the burden of showing that their particular shares originate from the initial public offering. Plaintiffs have not alleged that they read the registration statement or prospectus, and the purchase of shares in the secondary market that were once part of an initial public offering does not, by itself, satisfy the *Gustafson* requirement that the Securities Act apply to ‘new offerings of securities.’”

(citing *Gustafson*, 513 U.S. 561).

In *Harden v. Raffensperber*, 933 F. Supp. 763, 766 (S.D. Ind. 1996), the court failed to address the applicability of *Gustafson* on the Section 11 claims, but relied on *Kirkwood* for the proposition that “[i]t is not sufficient that a security might have been issued pursuant to a defective registration statement.” The *Harden* court noted that “to be able to take advantage of the lower burden of proof and almost strict liability available under [Section] 11, a plaintiff must meet higher procedural standards,” the “most significant” of which is “tracing.” *Id.* (citing *Kirkwood*, 590 F. Supp. at 1378). Thus, to establish standing, a plaintiff must show that the shares purchased were “newly issued.” *Id.* at 767.

<sup>104</sup> See note 93, *supra*.

<sup>105</sup> See Marc J. Sonnenfeld and Karen Pielsik Pohlmann, *An Increase in Section 11 Claims Against Companies and a Potential Defense to Tracing – Part I*, METROPOLITAN CORPORATE COUNSEL 17 (Feb. 1999) (discussing an increase in Section 11 claims and the divergent lines of authority regarding the viability of tracing). See also Joseph A. Allerhand and Benjamin M. Hain, *Where Do Secondary Market Purchasers Stand After Gustafson – Part I*, METROPOLITAN CORPORATE COUNSEL 4 (Feb. 1999) (noting the lack of consensus on the issue of Section 11 standing after *Gustafson*).

<sup>106</sup> See Brian Murray, *Aftermarket Purchaser Standing Under § 11 of the Securities Act of 1933*, 73 ST. JOHN’S L. REV. 633, 643-44 (1999) (discussing a recent trend to permit tracing).

## 2. Resurgence of “Tracing”

Despite *Gustafson*'s clarity, a number of recent decisions have reinjected confusion into this area of the law. For example, *Schwartz v. Celestial Seasonings*<sup>107</sup> was one of the first decisions after *Gustafson* to conclude that tracing remained a viable means of conferring standing on aftermarket purchasers. The *Celestial Seasonings* court stated that *Gustafson* did not address “in dicta or otherwise” the scope of Section 11,<sup>108</sup> and the court presumed — on a motion to dismiss — that plaintiffs could trace their shares to the offering.<sup>109</sup> In so holding, the court noted that tracing was a merits issue that should not be resolved at the outset of the litigation.<sup>110</sup> The court, however, offered no explanation of how plaintiffs could trace their shares.

In *Adair v. Bristol Technology Systems*,<sup>111</sup> the court reviewed *Barnes* and its progeny noting that “[i]t has been the law in this Circuit for over thirty years that a plaintiff who can trace their securities to a registered offering has standing to sue under [Section 11] of the Securities Act for a defect in that registration.”<sup>112</sup> Like *Celestial Seasoning*, the *Adair* court found that *Gustafson* was limited to Section 12 and had no bearing on interpretation of Section 11.<sup>113</sup> Reviewing the legislative history so persuasive to the *Gustafson* Court, *Adair* found Congressional intent to be “at best ambiguous about whether purchasers who can trace their securities back to the defective registration statement have standing.”<sup>114</sup> Following *Adair*, a pronounced split developed among district courts regarding the aftermarket purchasers ability to maintain a cause of action under Section 11 by invoking a broad concept of traceability.<sup>115</sup>

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<sup>107</sup> 178 F.R.D. 545 (D. Colo. 1998).

<sup>108</sup> *Id.* at 555.

<sup>109</sup> *Id.* at 556.

<sup>110</sup> *Id.* at 557.

<sup>111</sup> 179 F.R.D. 126 (S.D.N.Y. 1998).

<sup>112</sup> *Id.* at 130.

<sup>113</sup> *Id.* at 132.

<sup>114</sup> *Id.* at 132.

<sup>115</sup> Compare the cases cited at *supra* note 93, with *Feiner v. SS&C Technologies, Inc.*, 47 F.Supp.2d 250, 251-52 (D. Conn. 1999) (“any purchase has standing to sue under Section 11 so long as the securities purchased can be traced back to the offering containing the allegedly defective registration statement.”) (quoting *In re Fine Host Sec. Litig.*, 25 F. Supp. 2d 61, 67 (D. Conn. 1998)); *In re Number Nine Visual Technology Corp. Sec. Litig.*, 51 F.Supp.2d 1, 11-12 (D. Mass. 1999) (“a plaintiff may satisfy Section 11 standing requirements by purchasing securities ‘traceable to’ an initial public offering.”); *In re Websecure, Inc. Sec. Litig.*, 182 F.R.D. 364 (D. Mass. 1998) (same); *Cooperman v. Individual, Inc.*, No. 96-12272, 1998 WL 953726 (D. Mass. May 27, 1998), *aff’d on other grounds*, 171 F.3d 43 (1<sup>st</sup> Cir. 1999); *Olczyk v. Cerion Technologies, Inc.*, 721 N.E.2d 732, 743 (Ill. App. Ct. 1999) (accepting allegations of traceability for purposes of Section 11 standing).

Another court has conferred standing under Section 11 on the mere allegation that shares were acquired “pursuant to” a misleading prospectus. *In re Paraclesus Sec. Litig.*, 6 F. Supp.2d 626, 631 (S.D. Tex. 1998).

The United States Court of Appeals for the Ninth Circuit was the first post-*Gustafson* federal appellate court to address aftermarket purchasers' standing under Section 11. In *Hertzberg v. Dignity Partners, Inc.*, the Ninth Circuit observed that the *Gustafson* Court "gave no indication that it intended [restrictions on standing] to apply to Section 11."<sup>116</sup> Thus, the Ninth Circuit ignored the substantial discussion regarding Section 11 in the *Gustafson* decision and purported to conduct an exercise in statutory construction. However, the *Hertzberg* court's interpretation of Section 11 focused on a single phrase of the statute which provides that suit may be maintained by "any person acquiring such security."<sup>117</sup> Based on this phrase alone, the Ninth Circuit expanded Section 11 to aftermarket purchasers.<sup>118</sup> In focusing on a single phrase to guide to its statutory interpretation, the Ninth Circuit ignored the Supreme Court's directive to interpret statutes as a whole and not rely on isolated provisions.<sup>119</sup> With citation to *Barnes*, the *Hertzberg* court also endorsed an expansive application of the so-called tracing doctrine — without any explanation of its meaning.<sup>120</sup>

The Tenth Circuit reached the same result in *Joseph v. Wiles*, holding that aftermarket purchasers could maintain an action under Section 11 provided "they can demonstrate they bought their securities pursuant to the registration statement."<sup>121</sup> Because the issuer in *Joseph* had only one offering, the inquiry ended. In reaching this conclusion, the Tenth Circuit distinguished *Gustafson* reasoning that the Supreme Court addressed neither standing nor public offerings.<sup>122</sup> The *Joseph* court further disregarded the legislative history of Section 11

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The *Paraclesus* court made no effort to distinguish between Sections 11 and 12 nor did it explain what constitutes a purchase "pursuant to" a prospectus.

<sup>116</sup> 191 F.3d 1076, 1080 (9<sup>th</sup> Cir. 1999).

<sup>117</sup> Analysis of the same statutory language has led other courts to construe the class of plaintiff under Section 11 narrowly. See *Colonial Realty Corp. v. Brunswick Corp.*, 257 F. Supp. 875, 878 (S.D.N.Y. 1966) (cited with approval in *Barnes v. Osofsky*, 373 F.2d 269, 273 (2d Cir. 1967)). In *Colonial Realty*, the plaintiffs contended that all persons who acquired a security of the same class as the security issued under the registration statement "should have a remedy under Section 11. *Id.* at 877. The court examined other provisions of the 1933 Act and concluded that "such security" as used in Section 11 "means the securities specified in the registration statement." The meaning of the phrase "such security" together with the legislative history of the 1933 Act led "to the conclusion that by the term 'such security' Congress meant the securities issued and sold pursuant to the registration statement and not all securities of the same class as those registered." *Id.* at 879.

<sup>118</sup> Given its expansive vision of tracing, the *Hertzberg* court found it unnecessary to decide whether plaintiffs who purchased a security within the applicable prospectus delivery requirements had standing under Section 11. *Hertzberg*, 91 F.3d at 1080 n.3. The flaws in the extension of an offering based upon prospectus delivery requirements are discussed, *infra*, at 134 to 149.

<sup>119</sup> See *Gustafson v. Alloyd Company*, 513 U.S. 561, 569, 570 (1995) ("The Securities Act of 1933, like every Act of Congress, should not be read as a series of unrelated and isolated provisions," it must be "interpreted as a symmetrical and coherent regulatory scheme.").

<sup>120</sup> *Hertzberg*, 91 F.3d at 1080 n.4.

<sup>121</sup> No. 99-1258, 2000 WL 1099514, at \*5 (10<sup>th</sup> Cir. Aug. 4, 2000).

<sup>122</sup> *Id.*

noting that it “cuts both ways,” however, the court pointed to the lone passage which could be construed as favoring a broad interpretation of Section 11.<sup>123</sup>

As appellate courts have addressed the issue, lower courts have reassessed earlier decisions precluding aftermarket purchasers from asserting Section 11 claims<sup>124</sup> resulting in a significant expansion of Section 11 liability.<sup>125</sup> For example, in *Danis v. USN Communications*, the court ruled that “Section 11 contains no restriction on the class of potential claimants.”<sup>126</sup>

Several recent decisions from federal courts in New York also have extended Section 11 standing to aftermarket purchasers by implementing tracing without an explanation of how such allegations can be substantiated.<sup>127</sup> These cases narrowly construe *Gustafson* to apply exclusively to Section 12. In *Salomon Smith Barney v. Asset Securitization Corporation*, the court stated that “[i]t has long been the law in this circuit that secondary market purchasers are protected against defects in the registration by § 11, provided only that they can trace their

<sup>123</sup> *Id.* at \*4. The Tenth Circuit noted that the legislative history provides that the 1933 Act “only affects new offerings of securities . . . . It does not affect the ordinary redistribution of securities.” *Id.* (quoting H.R. Rep. No. 73-85, at 5). The court further noted “the civil remedies accorded . . . are given to all purchasers . . . regardless of whether they bought their securities at the time of the original offer or at some later date.” *Id.* (quoting H.R. Rep. No 73-85, at 22).

<sup>124</sup> *In re Southern Pac. Funding Corp. Sec. Litig.*, 83 F. Supp.2d 1172, 1175 (D. Or. 1999) (“[T]he [*Hertzberg*] court concluded that plaintiffs could maintain a section 11 claim for after-market transactions. There is no dispute that this holding effectively overrules my prior order dismissing plaintiffs’ section 11 claims.”).

<sup>125</sup> See *In re Prison Realty Sec. Litig.*, Fed. Sec. L. Rptr. ¶ 90,903 (M.D. Tenn. Feb. 17, 2000) (under *Hertzberg* plaintiffs who “obtained shares issued pursuant to and traceable to” the registration statement have standing under Section 11); *In re Transcript Int’l Sec. Litig.*, 98 CV 3099, 1999 U.S. Dist. LEXIS 17540, at \*31 (D. Neb. Nov. 4, 1999) (aftermarket purchasers “have standing to pursue a claim under § 11 as long as they can trace the purchase of their shares back to the October 1997 offering”) (citing *Hertzberg*, 191 F.3d 1076); *Giarraputo v. Unumprovident Corp.*, No. Civ. 99-301-PC, 2000 WL 1701294, at \*8 (D. Me. Nov. 8, 2000) (following *Joseph* and holding that aftermarket purchasers have standing under Section 11).

<sup>126</sup> 73 F. Supp.2d 923, 932 (N.D. Ill. 1999). The *Danis* decision does not purport to limit standing to those who can “trace” their securities to a registration statement, but rather confers standing on all aftermarket purchasers.

<sup>127</sup> *Salomon Smith Barney v. Asset Securitization Corp.*, No. 98 Civ. 4186, 1999 WL 1095605, at \*3 (S.D.N.Y. Dec. 3, 1999); *Milman v. Box Hill Sys. Corp.*, 192 F.R.D. 105, 2000 WL 145745, at \*4 (S.D.N.Y. Feb. 8, 2000) (“secondary market purchasers who can trace their shares to a registered offering have standing to assert claims under § 11”); *In re Ultrafem Inc. Sec. Litig.*, 91 F. Supp.2d 678, 2000 WL 358374, at \*11 (S.D.N.Y. Apr. 6, 2000) (“Contrary to Section 12(2)’s standing requirements, standing under Section 11 is not limited to initial purchasers”); *In re American Bank Note Holographics Sec. Litig.*, 93 F. Supp.2d 424, 2000 WL 365314 (S.D.N.Y. Apr. 6, 2000) (recognizing, in dicta, the dispute over Section 11 standing); *In re Twinlab Corp. Sec. Litig.*, 103 F. Supp. 2d 193, 2000 WL 943087 (E.D.N.Y. July 5, 2000) (“Standing under Section 11 is not limited to purchasers who directly participated in the public offering covered by the allegedly misleading registration statement and prospectus.”).

security to the registered offering.”<sup>128</sup> Thus, these courts purport to follow *Barnes v. Osofsky* and allow secondary market purchasers to pursue Section 11 claims.

The decisions invoking “tracing” as a means of extending Section 11 to the aftermarket fail to provide substantive analysis, jeopardize the consistent interpretation of the statutory scheme, and allow unfounded claims to be litigated.<sup>129</sup> Additionally, as many recent Section 11 cases involve initial public offerings, courts have rejected the need to assess a “tracing” argument reasoning that all shares are “new” and therefore can be traced to the registration statement.<sup>130</sup> This superficial analysis overlooks the reality of the securities markets. Although “new” shares may be injected into the public market in an initial public offerings, there may be a pre-existing market for the securities. For example, in *In re Quarterdeck Office Systems, Inc. Securities Litigation*,<sup>131</sup> shares issued in an IPO supplemented a market of unregistered shares trading pursuant to Rule 144.<sup>132</sup> Accordingly, the court recognized that it could not assume that all shares trading in the market were issued in the IPO.<sup>133</sup>

Upon the commencement of the initial public offerings, the previously issued shares find a new market and thus are commingled with the newly issued shares. Accordingly, even in the context of an initial public offering, an assessment of standing must be undertaken. If courts allow tracing to be invoked as a means of establishing standing for aftermarket purchasers, a clear statement of what tracing means must be provided. Without undertaking this necessary analysis, courts are conferring federal jurisdiction on the basis of conjecture and speculation. Moreover, these decisions fail to account for the significant distinctions between initial purchasers and aftermarket purchasers, including, significantly, the latter’s access to superior information about the security.

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<sup>128</sup> No. 98 Civ. 4186, 1999 WL 1095605, at \*3

<sup>129</sup> *In re Fine Host Sec. Litig.*, 25 F.Supp. 2d 61, 67-68 (D.Conn. 1998) (finding that mere allegation of tracing sufficient to withstand a motion to dismiss).

<sup>130</sup> See *Joseph v. Wiles*, No. 99-1258, 2000 WL 1099514, at \*5 (10<sup>th</sup> Cir. Aug. 4, 2000); *Feiner v. SS&C Technologies Inc.*, 47 F. Supp. 2d 250, 252 n.3 (D. Conn. 1999) (summarily assuming tracing because claims involve an IPO).

<sup>131</sup> 1993 U.S. Dist. LEXIS 19806 (C.D. Cal. September 30, 1993).

<sup>132</sup> 17 C.F.R. § 230.144.

<sup>133</sup> 1993 U.S. Dist. LEXIS 19806 (C.D. Cal. September 30, 1993). Similarly, in *Lilley v. Charren*, 936 F. Supp. 708, 716 (N.D. Cal. 1996), the court dismissed a Section 11 claims without prejudice because “the market eventually contained shares that were not issued pursuant to the prospectuses, it does appear that plaintiffs must amend their pleadings to allege the specific dates and facts to establish the representative plaintiffs’ standing for a [S]ection 11 claim.” Although the *Lilley* court recognized “tracing” as a means of establishing Section 11 standing, it apparently required a “direct trace” to demonstrate the requisite nexus between the offering and the purchase of securities.

### 3. Extension of Offerings Based Upon Prospectus Delivery Requirements

As a recognition of Section 11's and Section 12's limitation to initial purchasers has evolved, another question is being raised in district courts: When does an offering end and secondary trading begin? Although the answer is quite simple — an offering ends once the newly issued securities are distributed by the underwriters<sup>134</sup> — proponents of an expansive interpretation of Section 11 have advanced a variant of tracing which involves extending an initial public offering for a prescribed period of time.<sup>135</sup> Consequently, some have argued that a public offering should be extended for the period set forth under Section 4(3) of the 1933 Act and Rule 174 which require *dealers* to deliver a prospectus within either 25, 40 or 90 days after the effective date of a registration statement in certain circumstances.<sup>136</sup> Some courts have accepted this argument and extended the period of an offering beyond the initial distribution of securities thereby conferring standing upon all purchasers who acquired their securities within the time prescribed for the delivery of a prospectus by dealers.<sup>137</sup>

While most courts have addressed the prospectus delivery issue in the context of Section 12, some courts have expanded the rationale to encompass Section 11 claims. In so doing, courts erroneously have stated that Section 11 limits its application to sales conducted by means of a prospectus.<sup>138</sup> This is significant error. Section 11 concerns representations and omissions

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<sup>134</sup> See, e.g., *Kenilworth Partners L.P. v. Cendant Corp.*, 59 F. Supp.2d 417, 425-26 (D.N.J. 1999) (“a distribution refers to an offering of securities . . . and is complete when the securities come to rest in the hands of the investing public”).

<sup>135</sup> See Joseph S. Allerhand and Benjamin M. Hain, *Where Do Secondary Market Purchasers Stand After Gustafson? – Part II*, 7 METROPOLITAN CORP. COUNSEL 18 (Mar. 1999) (setting forth the open issues of standing after *Gustafson*).

<sup>136</sup> See 15 U.S.C. § 77d(3). Under Section 4(3), the delivery of a prospectus is required for transactions consummated within 40 days of a security first being offered to the public by an issuer or underwriter. *Id.* §4(3)(A). When the transaction involves “securities constituting the whole or part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or through an underwriter,” the applicable period for prospectus delivery is 90 days. *Id.* §4(3)(C). Rule 174 shortens the applicable delivery period in certain circumstances. 17 C.F.R. § 230.174. See also Murray, *supra* note 106, at 648 (advocating the expansion of Section 11 standing based on prospectus delivery requirements). Murray wrongly notes that Section 4(3) applies equally to Sections 11 and 12. *Id.* at 649. There is simply no requirement that a registration statement be delivered to purchasers at any time. This significant distinction compels the conclusion that Section 4(3) is inapplicable to Section 11.

<sup>137</sup> See, e.g., *Wade v. Industrial Funding Corp.*, No. C 92-0343, 1993 WL 650837, at \*6 (N.D. Cal. Aug. 30, 1993) (conferring standing, for purposes of Section 12 alone, on all who purchased a security within 90 days of an initial public offering). See also *In re Proxima Corp. Sec. Litig.*, No. 93-1139-IEG, 1994 WL 374306, at \*11 (S.D. Cal. May 3, 1994).

<sup>138</sup> See *Murphy v. Hollywood Entertainment*, No. Civ. 94-1926, 1996 WL 393662, at \*4 (D. Or. May 9, 1996); *Chan v. Orthologic Corp.*, No. Civ. 96-1514, 1998 WL 1018624, at \*21 (D. Ariz. Feb. 5, 1998) (“Section 11 limits its application to sales conducted ‘by means of a prospectus’ indicating a connection to a prospectus delivery requirement.”). Section 11 contains no such language. See 15 U.S.C. § 77k.

in a registration statement, not a prospectus. Extension of an offering based upon prospectus delivery requirements for the purposes of Section 11 is illogical because there is no requirement that a registration statement ever be delivered to a purchaser.<sup>139</sup>

Moreover, with respect to both Sections 11 and 12, the extension of an offering based upon Section 4(3) and Rule 174 simply ignores the fact that the 1933 Act contains important exemptions from the prospectus delivery requirements. For example, Section 4(4) exempts unsolicited brokerage transactions providing:

The provisions of section 77e of this title shall not apply to . . .

(4) brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders.<sup>140</sup>

Thus, by the express terms of the statute, the prospectus delivery requirements of Section 4(3)(B) and Rule 174 apply only to a narrow class of transactions and not to an unsolicited, over-the-counter trade — the ordinary aftermarket transaction.<sup>141</sup> When enacting the 1933 Act, Congress made clear that Sections 3 and 4 exempt from its requirements “transactions by individuals [and] the execution by brokers of customer's orders in the open market.”<sup>142</sup> With respect to the blanket exemption of unsolicited customers' orders from the prospectus delivery requirements of Section 5, Congress further explained “Paragraph 2 [now Paragraph 4] exempts the ordinary brokerage transaction. Individuals may thus dispose of their securities according to the method that is now customary without any restrictions imposed either upon the individual or the broker. This exemption also assures an open market for securities at all times . . .”<sup>143</sup> Accordingly, the extension of Section 11 to aftermarket purchasers based on the prospectus delivery requirement of Section 4(3) and Rule 174 is illogical when only a small portion of those transactions — those which were solicited to buy the stock — were subject to the prospectus delivery requirements of the 1933 Act in the first place.

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<sup>139</sup> Even cases that wrongly have “extended” a public offering for the purposes of liability under Section 12 by reference to the prospectus delivery requirements have recognized that such requirements have no applicability to Section 11. *See, e.g., Brosious v. The Children's Place Retail Stores*, 189 F.R.D. 138, 144 (D.N.J. 1999).

<sup>140</sup> 15 U.S.C. § 77d(4). *See also* H.R. Rep. No. 73-85, at 16 (“Paragraph (2) [now Paragraph (4)] exempts the ordinary brokerage transaction.”); *Prospectus Delivery for Aftermarket Transactions*, 1988 SEC LEXIS 669, Release No. 33-6763, 34-25546 (April 4, 1988).

<sup>141</sup> *See* 15 U.S.C. § 77d(4) (exempting from the prospectus delivery requirements “brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders”).

<sup>142</sup> H.R. Rep. No. 73-85 at 6.

<sup>143</sup> *Id.* at 16.

The prospectus delivery requirements for dealers may make sense from an administrative standpoint. However, when applied in a judicial context to confer standing, the time frames are arbitrarily drawn. For example, securities sold pursuant to a prospectus and issued by a company subject to the reporting requirements of the Exchange Act are not subject to the prospectus delivery requirements of Section 4(3).<sup>144</sup> Accordingly, purchasers in the secondary market acquiring securities the day after the completion of the initial public offering would not have standing to pursue claims under Section 12(a)(2) because there was no waiting period and dealers were immediately exempt under Section 4(3) from the prospectus delivery requirements upon the completion of the initial public offering.

In contrast, dealers in securities issued by a company not previously subject to the reporting requirements of the Exchange Act would be subject to the secondary market prospectus delivery requirements under Section 4(3). Accordingly, those purchasers would have standing to pursue claims under Sections 11 and 12(a)(2). There is simply no logical basis for differentiating between these two groups of purchasers. The logical conclusion, and the one compelled by *Gustafson*, is that neither group of secondary purchasers has standing under Sections 11 and 12(a)(2).

Furthermore, the structure of the regulatory scheme also militates against a correlation between the prospectus delivery requirements and the civil remedy provisions of the 1933 Act. Section 4(3) and Rule 174 apply to dealers – persons outside the class of permissible defendants in a Section 11 action. The imposition of liability on issuers, directors, experts and underwriters based upon requirements applicable to dealers is absurd. Moreover, Rule 174 is not the regulation governing prospectus delivery in an offering.<sup>145</sup> Rule 434 governs delivery of prospectuses in certain firm commitment underwritten offerings and does not provide for the arbitrary “extension” of an offering.<sup>146</sup> Pursuant to Rule 434, a prospectus must be sent prior to or contemporaneously with a trading confirmation, or must accompany or precede delivery of the securities.<sup>147</sup> Accordingly, Rule 434 addresses initial distributions and not open market transactions through dealers.

The rejection of the arbitrary extension of an offering, for purposes of Section 11, based upon prospectus delivery requirements dates back to the origins of the tracing doctrine itself.<sup>148</sup>

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<sup>144</sup> Rule 174(b), 17 C.F.R. § 230.174(b).

<sup>145</sup> In proposing amendments to Rule 174, the Securities and Exchange Commission expressly noted that Rule 174 applies to “secondary market transactions” – not distributions. *See Prospectus Delivery During Quiet Period*, Release No. 33-6682, 37 S.E.C. Docket 260 (Dec. 18, 1986).

<sup>146</sup> *See* 17 C.F.R. § 230.434.

<sup>147</sup> *Id.* § 230.434(a)(2)(i) & (ii).

<sup>148</sup> *See Barnes v. Osofsky*, 373 F.2d 269, 272 n.1 (2d Cir. 1967). In *Barnes*, the Second Circuit recognized that:

Appellants note that the impracticability of determining at the moment of purchase whether old or new shares are being acquired has led dealers to comply with the requirements of § 5(b)(2) as to the delivery of a prospectus by doing this on all sales within the period



Indeed, even the Securities and Exchange Commission has rejected a correlation between the scope of the civil remedies of the 1933 Act and prospectus delivery requirements.<sup>149</sup> The prospectus delivery requirements therefore have no applicability to considerations of standing for purposes of Section 11.

**F. The Statutory Scheme Requires Section 11's Limitation to Initial Purchasers**

1. *The Express Language of Section 11 Mandates a Restriction to Initial Offerings*

Despite some courts' statements to the contrary, Congress' intent to limit the scope of the 1933 Act to new offerings of securities is reflected in the language of Section 11 itself. Damages under Section 11 are limited expressly as follows: "In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public."<sup>150</sup> With respect to underwriter liability the statute further provides: "In no event shall any underwriter . . . be liable in any suit or as a consequence of suits authorized under subsection (a) for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public."<sup>151</sup>

These limitations on damages makes sense only when standing under Section 11 is restricted to initial purchasers. An aftermarket purchaser who acquired shares at a price inflated significantly above the offering price would not be made whole under Section 11.<sup>152</sup>

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established by § 4(3). . . While this may enable a purchaser of shares other than those registered to rely on § 12(2) upon an appropriate showing, it does not lead to the conclusion that § 11 applies.

*Id.*

<sup>149</sup> See 63 Fed. Reg. 67174, 67228-29 (Dec. 4, 1998) ("When we adopted Rule 174, we intended simply to express when prospectus delivery was needed. We did not intend to delineate when the remedies provisions in the Securities Act would or would not apply"). As *amicus* in *Gustafson*, the SEC argued that Section 12 should extend to aftermarket trading. See *Gustafson*, 513 U.S. at 579. The Supreme Court expressly considered and rejected that argument.

<sup>150</sup> 15 U.S.C. § 77k(g).

<sup>151</sup> *Id.* § 77k(e). The sole exception to the limitation on the underwriter's total liability applies where the "underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting" *Id.* Thus, the damages from an underwriter relate exclusively to the benefit participation in or benefit derived from an initial offering.

<sup>152</sup> Although the limitations on the damages under Section 11 make sense only when restricted to initial purchasers, some have argued that the damages provisions require an expansive reading of the statute. See Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 62-64 (1999); see also *Joseph v. Wiles*, No. 99-1258, 2000 WL 1089514, at \*4 (10<sup>th</sup> Cir. Aug. 4, 2000). Professor Palmiter asserts that the *Gustafson* court improperly "rewrote" the 1933 Act, and that Section 11's damages provision contemplates an extension to secondary market transactions. Palmiter, *supra*, at 64. This reading of the statute, however, contorts the statutory language.

Under this likely scenario, an aftermarket purchaser would not be fully compensated for his or her loss under Section 11. Given the remedial purposes of the federal securities laws,<sup>153</sup> it is illogical to presume that Congress intended such a result if Section 11 was meant to apply to aftermarket purchasers.<sup>154</sup> In contrast, under Section 10(b) action, damages are commonly calculated as the difference between the price paid or received and the security's true value at the time of the transaction thus fully compensating the aftermarket purchaser for his or her loss.<sup>155</sup>

In determining the scope of the federal securities laws, the Supreme Court traditionally has examined the available damages to define the parameters of the potential plaintiff class. For example, in *Gustafson*, the Court concluded that the right of rescission would make no sense as a remedy for Section 12 if that statute provided a cause of action for secondary market transactions.<sup>156</sup> Similarly, in limiting the availability of Section 10(b) and Rule 10b-5 to actual purchasers and sellers of securities, the *Blue Chip Stamps* Court examined the damages available under the 1933 and 1934 Acts.<sup>157</sup> Because speculative damages are not contemplated by the securities laws, the *Blue Chip Stamps* Court concluded that standing must be limited to those who actually traded in a security.<sup>158</sup> Thus, the Supreme Court has recognized that damages provisions are important – if not determinative – indicia of the class of persons who fall within the zone of interests protected by a statute. Following this reasoning, an examination of the damages provisions of Section 11 compels the conclusion that only those who purchased at the offering price are within the protection of the statute.

The imposition of liability without proof of scienter or reliance also supports the conclusion that Section 11 has limited availability as a remedy. Recognizing the different stance in which access to additional information places subsequent purchasers, Congress required that

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<sup>153</sup> See, e.g., *Shonts v. Hirliman*, 28 F. Supp. 478, 482-83 (S.D. Cal. 1939) (“It is evident that the Congress intended to make the action, notwithstanding its origin in fraud, purely compensatory. And so, it provided for the recovery of the price paid.”). Only those who purchased at the offering price will receive compensatory damages. See *id.* at 493 (“The object of the Congress was to compensate a person for the depreciation in the value – the actual value of his security.”).

<sup>154</sup> In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 753-54 (1975), the Court noted that the restrictive recovery available under the 1933 Act confirmed that “Congress did not intend to extend a private cause of action for money damages to the nonpurchasing offeree of a stock offering registered under the 1933 Act for loss of the opportunity to purchase due to an overly pessimistic prospectus.”

<sup>155</sup> See *Sowell v. Butcher & Singer, Inc.*, 926 F.2d 289, 297 (3d Cir. 1991); see also *Harris v. American Investment Company*, 523 F.2d 220, 224-25 (8th Cir. 1975).

<sup>156</sup> 513 U.S. 561, 576 (1995) (“The use of the term ‘prospectus’ to refer to public solicitations explains as well Congress’ decision in § 12(2) to grant buyers a right to rescind without proof of reliance.”).

<sup>157</sup> 421 U.S. 723, 735-36 (1975) (“The principal express nonderivative private civil remedies, created by Congress contemporaneously with the passage of § 10(b), for violations of various provision of the 1933 and 1934 Acts are by their terms expressly limited to purchasers or sellers of securities.”).

<sup>158</sup> *Id.* at 736.

a plaintiff prove actual reliance on a registration statement when the security is acquired after the release of an earnings statement.<sup>159</sup> This difference in required proof demonstrates that Congress did not intend to provide a remedy under Section 11 for purchasers with access to additional, post-registration statement sources of information regarding a security. Accordingly, the statute itself mandates a narrow interpretation.

## 2. *The Statutory Scheme Confirms Section 11's Narrow Applicability*

The interplay of the liability provisions of the 1933 Act and 1934 Act likewise demonstrates that Section 11's protections are limited to initial purchasers. Expansion of Section 11 to aftermarket purchasers renders Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder superfluous. Section 10(b) and Rule 10b-5 govern secondary market trading and, significantly, require proof of scienter and reliance.<sup>160</sup> Indeed, the Supreme Court has recognized that the purpose of the 1934 Act is to protect investors from manipulation in transactions “upon securities exchanges and in over-the-counter markets.”<sup>161</sup> Allowing standing to aftermarket purchasers under Section 11 of the 1933 Act would result in the imposition of strict liability on issuers with respect to transactions in the secondary market – a draconian result unwarranted by the language of the statute or judicial precedent.<sup>162</sup>

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<sup>159</sup> It should be noted, that if a purchaser acquires a security more than 12 months after the effective date of the registration statement, a showing of reliance is required to prevail on a Section 11 claim. See 15 U.S.C. § 77k(a) (“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 shall be conditioned on proof that such person acquired the security relying on such untrue statement in the registration statement . . .”). Although some courts have used this language to read Section 11 expansively, see, e.g., *Joseph v. Wiles*, No. 99-1258, 2000 WL 1089514 (10<sup>th</sup> Cir. Aug. 4, 2000); *Schwartz v. Celestial Seasonings*, 178 F.R.D. 545, 556 (D. Colo. 1998), this provision is consistent with a limitation on standing to initial purchasers. Commentators have noted that, unlike today, public offerings were not completed in the course of mere hours. Rather, distribution of the shares from the initial public offering might not be completed for months. As the 1933 Act’s legislative history explicitly recognized, some offerings lasted more than *one year*. See H.R. Rep. No. 73-85, at 16 (“[generally speaking, the average public offering has been distributed *within a year* . . .”) (emphasis added); see also Pastuszewski, et. al., *Recent Developments in Standing Under Sections 12(2) and 11 of the 1933 Act: The Broad Sweep of Gustafson*, SC73 ALI-ABA 665, 674 (1998) (Congress recognized that in 1933 many public offerings were only completed over an extended period of time far longer than one day).

<sup>160</sup> See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *In re Summit Med. Sys., Inc. Sec. Litig.*, 10 F. Supp.2d 1068, 1070-71 (D. Minn. 1998) (“If secondary market purchasers are to recover for an alleged material misstatement or omission made in connection with their share purchases, they must do so under Section 10(b) and Rule 10b-5.”)

<sup>161</sup> *Ernst & Ernst*, 425 U.S. at 195.

<sup>162</sup> The distinctions between the class of plaintiffs under Section 11 and those under Section 10(b) of the 1934 Act long have been recognized. As Judge Frank observed:

To give full effect to the regulatory scheme of the federal securities laws, the 1933 Act and the 1934 Act must be construed together “so as not to eviscerate requirements for recovery under another complementary provision.”<sup>163</sup> In fact, the *Ballay* court concluded that “the different remedies available under section 10(b) and section 12(2) support restricting Section 12(2) to initial distributions.”<sup>164</sup> In so holding, the court reasoned that applying “the more lenient requirements of Section 12(2) [to secondary market trading] would effectively eliminate the use of Section 10(b) by securities purchasers. Such a construction would overrule, *sub silencio*, Section 10(b) as a remedy for purchasers.”<sup>165</sup>

In *Ernst & Ernst v. Hochfelder*, the Court contrasted the remedies available under the 1933 and 1934 Acts in concluding that actions under Section 10(b) require scienter. There, the Court held that Section 10(b) liability could not be predicated on negligent conduct because “[s]uch extension would allow causes of action covered by §§ 11, 12(2), and 15 to be brought instead under § 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.”<sup>166</sup> It is therefore clear that, if Congress had intended the scope of Section 11 to overlap to such a large degree with Section 10(b) of the 1934 Act, there either would have been either: (1) little need to create Section 10(b), or (2) Section 10(b) would reflect this intent. Moreover, had Congress intended Section 11 to overlap with Section 10(b) of the 1934 Act then certainly Congress would have made this point clear in the course of drafting the comprehensive update of the federal securities laws set forth in the recent Private Securities Litigation Reform Act of 1995.

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A suit under Sec. 11 of the 1933 Act requires no fraud of fraud or deceit, and such a suit may be maintained only by one who comes within a narrow class of persons . . . . But proof of fraud is required in suits under Sec. 10(b) of the 1934 Act . . . Congress reasonably, and without inconsistency, allowed suits of that sort which (1) are free of the restrictions applicable to a suit under Sec. 11 of the 1933 Act and (2) which are not confined to those persons who may properly sue under that section but which include all who are the victims of the fraud.

*Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 786-87 (2d Cir. 1951).

<sup>163</sup> *Ballay* 925 F.2d at 692. *United States v. Sun-Diamond Growers*, 526 U.S. 398, 119 S.Ct. 1402 (1999), confirms the reasoning of *Gustafson* and *Ballay* and makes clear that a diminution of Section 10(b) and Rule 10b-5 by expanding Sections 11 is an impermissible result. Interpreting an illegal gratuity statute, the Supreme Court instructed that when “statutes and regulations litter[]” the field, “[a]bsent a text that clearly requires it we ought not to expand this one piece of the regulatory puzzle so dramatically as to make many other pieces misfits.” *Sun-Diamond Growers*, 119 S.Ct. at 1410. The Court emphasized that when a statute “can linguistically be interpreted to be either a meat axe or a scalpel it should reasonably be taken to be the latter.” *Id.* This same reasoning requires that Section 11 be interpreted as a “scalpel” as well.

<sup>164</sup> *Id.* at 693.

<sup>165</sup> *Id.* at 692-93 (footnote omitted); accord *Gustafson*, 513 U.S. at 575 (expanding Section 12 to the secondary market would destabilize the financial markets).

<sup>166</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 210 (1976).

Finally, there is no justification rooted in necessity, fairness or common sense to extend the protections of Section 11, which regulate disclosure in a registration statement, to purchasers in the secondary market who have a remedy under Section 10(b) and who never saw a registration statement. If aftermarket purchasers believe themselves to be aggrieved, Congress has provided a remedy for them under Section 10 and Rule 10b-5.

As the Supreme Court has held, only one provision of the 1933 Act extends to aftermarket trading — Section 17(a).<sup>167</sup> Section 17(a) of the 1933 Act proscribes fraudulent conduct in connection with the sale of securities.<sup>168</sup> The Supreme Court has concluded that Section 17, which does not use the terms “prospectus” or “registration statement” at all, is the sole provision of the 1933 Act applicable to secondary market trading and is “a deliberate departure from the general scheme of the Act.”<sup>169</sup> The *Ballay* court also found the broad purpose of Section 17 inapplicable to Sections 11 and 12 noting that “[i]n contrast to section 17(a). . . [t]he legislative history is devoid of any indication that the reach of section 12(2) was intended to be broader than the limited scope of sections 11 and 12(1).”<sup>170</sup> Finally, the legislative history of Section 17 explicitly provides that “fraud or deception in the sale of securities may be prosecuted regardless of whether . . . or not it is of the class of securities exempted under sections 11 or 12.”<sup>171</sup> Thus, the history and interpretation of Section 17 confirm the narrow scope of Section 11.

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<sup>167</sup> *Gustafson*, 513 U.S. at 576. Section 17(a) is a criminal statute that can also be enforced in a civil injunctive action by the Securities and Exchange Commission. See ROBERT CHARLES CLARK, CORPORATE LAW § 17.4.3 (1986). Although courts were once split on whether Section 17 provided a private right of action, the weight of current authority holds that there is no private litigants may not bring suit under Section 17. *Id.* See also *Maldonado v. Domiguez*, 137 F.3d 1, 15-17 (1<sup>st</sup> Cir. 1998); *Finkel v. The Stratton Corp.*, 962 F.2d 169, 174-75 (2d Cir. 1992) (citing cases).

<sup>168</sup> 15 U.S.C. § 77q(a). Section 17(a) provides:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instrument of transportation or communication in interstate commerce or by use of the mails, directly or indirectly —

(1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.

<sup>169</sup> *Gustafson*, 513 U.S. at 577.

<sup>170</sup> *Ballay*, 925 F.2d at 692.

<sup>171</sup> *Gustafson*, 513 U.S. at 577-78 (quotations omitted).

Section 18 of the 1934 Act<sup>172</sup> also creates a private right of action and has been viewed as a parallel to Section 11 affording a civil remedy to secondary market purchasers injured by violations of the periodic reporting requirements.<sup>173</sup> In contrast to Section 11, to have standing under Section 18, a plaintiff must have purchased or sold a security in actual reliance upon an omission or false statement in a public filing. Commentators have recognized the difficulty inherent in maintaining a cause of action under Section 18.<sup>174</sup> Actual reliance on the allegedly false filing is necessary to satisfy Section 18; mere reliance on market information will not suffice.<sup>175</sup> Moreover, a defendant in a Section 18 case has the substantial defense that “he acted in good faith and had no knowledge that such statement was false or misleading.”<sup>176</sup> Commentators have observed that the element of actual reliance makes certification of a class under Section 18 virtually impossible.<sup>177</sup> The parallel drawn between Section 18 and Section 11, however, demonstrates the narrow applicability of private rights of action based upon false or misleading statements in documents filed with the Securities and Exchange Commission. Perhaps this is because Congress created these rights of action to effectuate increased compliance with its disclosure provisions, rather than solely compensating individuals for their losses.

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<sup>172</sup> 15 U.S.C. §78(r); Section 18 provides in pertinent part:

Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this Act or any rule or regulation thereunder . . . which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any *material* fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance on such statement, *shall have purchased or sold a security at a price which was affected by such statement*, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction.

15 U.S.C. § 78r(a) (emphasis added).

<sup>173</sup> See Keller and Gelmann, *supra* note 4, at 350; see also *W.A. Krueger Co. v. Kirkpatrick, Pettis, Polian, Inc.*, 466 F. Supp. 800, 802 (D. Neb. 1979) (“In the context of Section 13(a) annual reports and supplementary documents, actions for damages have been judicially limited to plaintiffs who have standing to proceed under Section 18(a).”).

<sup>174</sup> Alan R. Bromberg and Lewis D. Lowenfels, *Bromberg and Lowenfels on Securities Fraud and Commodities Fraud*, § 2.4(440) (2d ed. 1982 & Supp. 1998).

<sup>175</sup> *Id.*

<sup>176</sup> 15 U.S.C. § 78r(a); see also Bromberg, § 2.4(440).

<sup>177</sup> Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1, 108 (Nov. 1998); see also Linda C. Quinn et al, *Disclosing Bad News: An Overview for Securities Counsel*, 1149 PLI/Corp 329, 378 (Nov. 1999).

### G. The Purpose of the 1933 Act Confirms Congress' Intent to Limit Section 11 Standing

A review of the legislative history of the 1933 Act also makes clear that Congress intended that Section 11 would apply only to securities purchased in an initial offering.<sup>178</sup> In response to catastrophic economic events in this country after 1929, Congress began to create a statutory scheme to regulate the securities industry. As noted in *Gustafson*, the relevant Report of the House Committee on Interstate and Foreign Commerce explicitly states: “[t]he bill affects only new offerings of securities . . . .”<sup>179</sup> The restricted applicability of the bill was noted throughout the House Report as Congress reiterated that the bill “does not affect the ordinary redistribution of securities.”<sup>180</sup> One of the principal drafters of the 1933 Act noted that the 1933 Act’s “patent concern was primarily with the flow of securities from the issuer through underwriters to the public rather than with the subsequent buying and selling of these securities by the public.”<sup>181</sup>

Discussing exemptions, in particular, Congress emphasized the limited scope of the bill. For example, Congress manifested an intent to exempt from the coverage of the statute “the execution by brokers of customer’s orders in the open market”<sup>182</sup> and “transactions by a dealer in securities not connected by time or circumstance with distribution of a new offering.”<sup>183</sup> While discussing exempted securities and transactions, the House Committee noted the limited need for exemptions because of “the restriction of the bill’s application to new offerings.”<sup>184</sup> Indeed, Congress recognized that “the bill does not affect transactions beyond the need of public protection in order to prevent recurrences of demonstrated abuses” — presumably a reference to the floating of worthless new securities in the post-World War I era.<sup>185</sup> These statements are unequivocal evidence of Congressional intent that the scope of the bill reached only initial public offerings. In addition, Congress noted that it modeled the 1933 Act upon the

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<sup>178</sup> The legislative history of the 1934 confirms the limited scope of the civil liabilities of the 1933 Act. See H.R. Rep. No. 73-792. Discussing the civil liability provisions of the 1934 Act, the House Report notes that “State laws designed to prevent the exploitation of the investor by supervision of the sale of securities has demonstrated the inadequacy of criminal penalties as the sole sanction.” *Id.* at 12. By enacting the 1934 Act, Congress provided “that any person who unlawfully manipulates the price of a security or who induces transactions in a security by means of a false or misleading statements, or who makes a false or misleading statement in the report of a corporation, shall be liable in damages to those who have bought or sold the security at prices affected by such violation or statement.” *Id.* at 12-13.

<sup>179</sup> *Gustafson*, 513 U.S. at 580 (citing H.R. Rep. No. 73-85, at 5).

<sup>180</sup> H.R. Rep. No. 73-85, at 5.

<sup>181</sup> James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 36 (1959).

<sup>182</sup> *Id.* at 6, 16.

<sup>183</sup> *Id.* at 6.

<sup>184</sup> H.R. Rep. No. 73-85, at 7.

<sup>185</sup> *Id.* See *id.* at 2 (discussing the new securities issued during the 1920s).

English Companies Act of 1929. Significantly, under the British law, a cause of action extended only to initial purchasers.<sup>186</sup>

Also incorporated in the House Report is the following letter to Congress from President Roosevelt:

Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit. There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public . . . . [The Securities Act of 1933] is but one step in our broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt in on exchanges, and by legislation to correct unethical and unsafe practices on the part of officers and directors of banks and other corporations.<sup>187</sup>

The House report explained: “The background of the President’s message is only too familiar to everyone. During the post-war decade some 50 billions of new securities were floated in the United States. Fully half or \$25,000,000,000 worth of securities floated during this period have been proved to be worthless.”<sup>188</sup> The language of the President’s letter, made part of the legislative history, makes unmistakably clear not only that the 1933 Act was intended to regulate only new public offerings,<sup>189</sup> but also that separate legislation would be needed to regulate subsequent trading on the exchanges, thereby presaging the Securities Exchange Act of 1934, which governs secondary trading in the post-distribution period.

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<sup>186</sup> See Robert E. Kohn, *Civil Liability for Primary Securities Distributions in the United States and the United Kingdom*, 55 LAW & CONTEMP. PROBS. 399, 417 (Fall 1992) (noting that there is no duty of care under the registration provisions of United Kingdom law to secondary market purchasers); see also H.R. Rep. No. 73-85, at 9 (“The committee is fortified in these [civil liability] sections by similar safeguards in the English Companies Act of 1929. What is deemed necessary for sound financing in conservative England ought not be unnecessary for the more feverish pace which American finance has developed.”); *Gustafson*, 513 U.S. at 582 (noting that the legislative history “confirm[s] that the civil liability provisions of the 1933, §§ 11 and 12, impose obligations on those engaged in ‘the business of issuing securities,’ in conformance, not in contradiction to, the British example.”).

<sup>187</sup> H.R. Rep. No. 73-85, at 2 (emphasis added).

<sup>188</sup> *Id.* (emphasis added).

<sup>189</sup> The one exception to this limited scope is Section 17. See note 167, *supra*.



In enacting the 1933 Act, Congress manifested its desire to provide the public with “adequate and true information” regarding newly issued securities.<sup>190</sup> Accordingly, the House Report emphasized that chief among the purposes of the legislation was “an insistence that there should be full disclosure of every essentially important element attending the issue of a new security.”<sup>191</sup> To this end, Congress prescribed the information that must be divulged to the public in connection with a new offering of securities.<sup>192</sup> The waiting period between the filing of a registration statement and its effective date was created to allow the public to digest the required information regarding the new security.<sup>193</sup> With respect to registration statements, Congress noted their importance “as a source of information to the prospective buyer.”<sup>194</sup> Thus, Congress’ paramount concern was the dissemination and availability of information attendant to a new issue.<sup>195</sup> In one of its first opinions addressing the 1933 Act, the Supreme Court confirmed that “[t]he essential purpose of the statute is to protect investors by requiring publication of certain information concerning securities *before* offered for sale.”<sup>196</sup>

<sup>190</sup> S. Rep. No. 73-47, at 1. This sentiment is echoed in President Roosevelt’s message. H.R. No. 73-85, at 2.

<sup>191</sup> H.R. Rep. No. 73-85, at 3. The other aims of the legislation included: “(2) A requirement that whatever action taken by the Federal Government for such disclosure should be limited to that purpose and should be so devised as not to be capable of being construed as an approval or guarantee of a security issue. (3) A demand that the persons, whether they be directors, experts, or underwriters, who sponsor the investment of other people’s money should be held up to the high standards or trusteeship. The achievement of these ends is the principal purpose of this bill.” *Id.*

<sup>192</sup> H.R. Rep. No. 73-85, at 3-4.

<sup>193</sup> *Id.* at 3. *See also id.* at 8 (discussing the applicable waiting periods and noting that “an underinformed public demonstrably hurts the Nation”). Dean Landis, one of the principal drafters of the 1933 Act explained that the waiting period “would give an opportunity for the financial world to acquaint itself with the basic data underlying a security issue and through that acquaintance to circulate among the buying public as well as independent dealers some intimation of its quality.” *See* James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 35 (1959).

<sup>194</sup> H.R. Rep. No. 73-85, at 7. *See also id.* at 9 (“Sections 11 and 12 create and define civil liabilities imposed by the act . . . . The committee emphasizes that these liabilities attach only when there has been an untrue statement of material fact or omission to state a material fact in the registration statement or the prospectus – the basic information by which the public is solicited.”).

<sup>195</sup> *See Securities and Exchange Comm’n v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953) (“The design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions.”).

<sup>196</sup> *A.C. Frost & Co. v. Coeur D’Alene Mines Corp.*, 312 U.S. 38, 40 (1941) (emphasis added). The restriction of the 1933 Act to new issuances of securities also was noted by the Supreme Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194-95 (1976), where the Court explained:

Federal regulation of transaction in securities emerged as part of the aftermath of the market crash in 1929. The Securities Act of 1933 . . . was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing. . . The 1934 Act was intended

Congress' regulation of the information disclosed in connection with the offer of newly issued securities bears a direct correlation to the establishment of the initial offering price. The information contained in the registration statement is explicitly prescribed because:

Liability is imposed upon [issuers] as a condition of the acquisition of the privilege to do business through the channels of interstate or foreign commerce. The statements for which they are responsible, although they may never actually have been seen by the prospective purchaser, because of their wide dissemination, determine the market price of the security, which in the last analysis reflects those manifold causes that are the impelling motive of the particular purchase. The connection between the statements made and the purchase of the security is clear, and, for this reason, it is the essence of fairness to insist upon the held assumption of responsibility for the making of these statements.<sup>197</sup>

The aftermarket purchaser does not share the initial purchaser's need for information because the secondary market provides access to superior knowledge regarding the security and therefore the aftermarket purchaser stands in different shoes from the initial purchaser. This significant distinction demonstrates that the protections of Section 11 — with its imposition of liability without proof of fraud or reliance — should not provide a remedy to the aftermarket purchaser.<sup>198</sup> In addition to the registration statement, the aftermarket purchaser acquires information from the movement of the stock price reflecting the market's reaction to the security, and also benefits from media attention and analysts' reports released after the offering. As time progresses, the aftermarket purchaser also has access to the issuer's public filings and periodic reports.<sup>199</sup> As such, the limitation of standing to initial purchasers reflects Congress' manifest intent.

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principally to protect investors against manipulation of stock through regulation of transaction upon securities exchanges and in over-the-counter markets . . . .

<sup>197</sup> H.R. Rep. No. 73-85, at 9.

<sup>198</sup> See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983) (“[A] Section 10(b) plaintiff carries a heavier burden than a Section 11 plaintiff. Most significantly, he must prove that the defendant acted with scienter, i.e., with intent to deceive, manipulate, or defraud.”) The Section 10(b) plaintiff's heavier burden counterbalances the “virtually absolute” liability imposed upon issuers under Section 11. See *id.*

<sup>199</sup> See 15 U.S.C. § 78m (prescribing the periodic reports and information that must be filed with the Securities and Exchange Commission). Pursuant to the authority granted in the 1934 Act, the SEC has adopted Rules 13a-1 and 13a-13 which require issuers to file annual and quarterly reports on Forms 10-K and 10-Q. See 17 C.F.R. § 240.13a-1, et seq. (“Rule 13”). Rule 13a-11 also provides for filing of current information on Form 8-K.

The purpose of the reporting requirements is to “insure that investors receive adequate periodic reports concerning the operation and financial condition of the corporations.”  
*Securities and Exchange Comm’n v. Kalvex, Inc.*, 425 F. Supp. 310, 316 (S.D.N.Y. 1975); *Securities*

Proponents of extending Section 11 to aftermarket purchasers focus on a single phrase in the House report to support their view. In discussing the civil remedies afforded by Section 11, the Committee noted that those remedies were available “regardless of whether buyers bought their securities at the time of the original offer or at some later date . . . .”<sup>200</sup> This statement, standing alone, does not support a broad extension of Section 11. First, James Landis, one of the principal drafters of the 1933 Act, has explained that the House bill’s concern was the dissemination of securities from the issuer through underwriters to the public, and not subsequent aftermarket trading.<sup>201</sup> However, the bill was “far from perfect on this point.”<sup>202</sup> Given the abundance of statements recognizing the limitation of the 1933 Act to initial distributions of securities, a lone provision that arguably may be construed otherwise cannot support a broad extension of Section 11. Second, Congress’ statement may simply reflect that, in 1933, the initial distribution may not be complete for weeks or months after the securities were first offered to the public. Thus, securities acquired “at the time of the original offer or at some later date” may still be part of the initial distribution.<sup>203</sup>

Similarly, reliance on the Senate report is unavailing to support an extension of Section 11 to aftermarket purchasers.<sup>204</sup> Unlike the House report, the Senate report contains no reference to the new issue of securities or initial public offerings. The bill ultimately adopted by Congress was the one sponsored in the House.<sup>205</sup> In fact, Landis reported that Congress found the Senate draft unworkable and “[i]ts draftsmanship was of decidedly inferior quality.”<sup>206</sup> Consequently, the Senate report cannot seriously be considered in determining the scope of the civil liability provisions of the 1933 Act.

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*and Exchange Comm’n v. McNulty*, Civ. No. 94-7114, 1996 WL 422259 (S.D.N.Y. July 29, 1996), *aff’d*, 137 F.3d 732 (2d Cir. 1998). Indeed, the reporting requirements “were designed to ensure that investors receive adequate information upon which to base their investment decisions.” *SEC v. World-Wide Coin Invs.*, 567 F. Supp. 724, 758 (N.D. Ga. 1983).

<sup>200</sup> H.R. Rep. No. 73-85, at 21.

<sup>201</sup> Landis, *supra* note 181, at 36.

<sup>202</sup> *Id.*

<sup>203</sup> See H.R. Rep. No. 73-85, at 16 (“[g]enerally speaking, the average public offering has been distributed within a year . . . .”) (emphasis added); see also Pastuszynski, et al., *Recent Developments in Standing Under Sections 12(2) and 11 of the 1933 Act: The Broad Sweep of Gustafson*, SC73 ALI-ABA 665, 674 (1998) (Congress recognized that in 1933 many public offerings were only completed over an extended period of time far longer than one day).

<sup>204</sup> S. Rep. No. 73-47 (1933).

<sup>205</sup> H.R. Conf. Rep. No. 73-152 (discussing the adoption of the House bill). See also Weiss, *supra* note 60, at 20 (“The Senate did not pull the laboring oar in the development of the Securities Act. It passed, with relatively few changes, the bill the Roosevelt Administration had proposed, then largely assented to the dramatically different bill the House Committee had developed.”).

<sup>206</sup> Landis, *supra* note 181, at 31. See also Keller and Gehlmann, *supra* note 4, at 339-40 (discussing the reaction to the Senate bill and the need “to have drastic changes made in the bill”).

## H. Policy Considerations Counsel in Favor of Rule Limiting Standing to Initial Purchasers

The amorphous and undefined concept of tracing creates enormous practical problems for courts adjudicating securities claims. Shares sold in a public offering, particularly in an initial public offering, are often traded many times over in the secondary market. Shares sold in an IPO can be quickly bought and resold dozens of times over by dozens of different buyers and sellers in the secondary market. Moreover, shares introduced through a public offering often supplement a public market for the securities of that issuer already in active trading. Indeed, even in initial public offerings, previously outstanding shares acquired in private offerings or restricted sales find a new public market for trading. Once the initial offering is completed, secondary trading of the “new” shares immediately mixes with trading in the “old” shares. All shares of common stock trade at the same price and are completely fungible. Because of this fungibility, the only shares that can be fairly and realistically said to be “traceable” to an IPO are shares that are actually bought in the IPO.<sup>207</sup> As the one court observed, “in a market transaction, it is difficult to conceive of how [shares] could be traced . . . .”<sup>208</sup>

The confusion and uncertainty engendered by a broad interpretation of tracing is anathema to a coherent and predictable federal securities regulatory scheme.<sup>209</sup> The need for predictability and substantive rules that can be applied at the early stages of litigation are particularly necessary in this area of the law.<sup>210</sup> As the Supreme Court has acknowledged:

[I]n the field of federal securities laws governing disclosure of information even a complaint which by objective standards may

<sup>207</sup> See *Abbey v. Computer Memories, Inc.*, 634 F. Supp. 870, 874 ((N.D. Cal. 1986).

<sup>208</sup> *Warden*, 1998 WL 72596, at \*3 n.2. Actual share certificates do not trade today. Most shares in public companies today are incorporated into a book-entry system, such as the Depository Trust Company (“DTC”). Once the shares are deposited into DTC, all shares are entirely fungible and there is no way to “trace” ownership of a particular share back to the IPO without the facts supporting a “direct trace.” See *Abbey v. Computer Memories, Inc.*, 634 F. Supp. 870, 873 (N.D. Cal. 1986). Similarly, shares held in a brokerage “house account” are completely fungible and cannot be identified as having been purchased in an offering. See *Lorber v. Beebe*, 407 F. Supp. 279, 286 (S.D.N.Y. 1975).

<sup>209</sup> See *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 12 (1985) (rejecting efforts to “inject uncertainty” into federal securities regulations); *Pinter v. Dahl*, 486 U.S. 622, 652-53 (1988) (securities industry “demands certainty and predictability”).

<sup>210</sup> Professors Grundfest and Perino report that “87.6% of the securities class actions filed from April 1988 through September 1996 ended in a settlement, with the large majority of the remainder resolved by dispositive motions or voluntary dismissal. Very few class action securities fraud cases go to trial.” Joseph A. Grundfest and Michael A. Perino, *Securities Litigation Reform: The First Year’s Experience* (Feb. 27, 1997) (available at <<http://securities.stanford.edu>>). One study found that, out of 952 securities class actions filed between 1988 and 1996, only 13 (0.9%) were actually tried. Vincent E. O’Brien, D.B.A., *A Study of Class Action Securities Fraud Cases 1988-1996* (1997) (available at <<http://lecg.com/study2.htm>>).

have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment, The very pendency of the lawsuit may frustrate or delay the business activity of the defendant which is totally unrelated to the lawsuit.<sup>211</sup>

The difficulties encountered by issuers facing baseless securities fraud lawsuits with an unduly expanded plaintiff classes harm investors who ultimately suffer the consequences of an unnecessarily inflated settlement.<sup>212</sup> The propensity for vexatious litigation in this area of the law, without regard to the merits, strongly favors the imposition of clear rules governing standing.<sup>213</sup>

The Supreme Court repeatedly has counseled against unduly expansive plaintiff classes in securities litigation.<sup>214</sup> In delineating the principles of standing governing claims under Section 10(b) and Rule 10b-5 in *Blue Chip Stamps*, the Supreme Court explained:

Obviously there is no general legal principle that courts in fashioning substantive law should do so in a manner which makes it easier, rather than more difficult, for a defendant to obtain a summary judgment. But in this type of litigation, where the mere existence of an unresolved lawsuit has settlement value to the plaintiff not only because of the possibility that he may prevail on the merits, an entirely legitimate concept of settlement value, but because of the threat of extensive discovery and disruption of normal business activities which may accompany a lawsuit which is groundless in any event, but cannot be proved so before trial, such a factor is not to be totally dismissed. The *Birnbaum* rule<sup>215</sup>

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<sup>211</sup> *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740 (1975).

<sup>212</sup> *Blue Chip Stamps*, 421 U.S. at 739 (“unduly expansive imposition of civil liability ‘will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers’”) (quoting *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring)). The Court revisited this concept in *Ernst & Ernst*, 425 U.S. at 185 n.33, quoting then-Chief Judge Cardozo for the proposition that “‘a liability in an indeterminate amount for an indeterminate time to an indeterminate class . . . [is] so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes [business] to these consequences.’” (quoting *Ultramares Corp. v. Touche*, 174 N.E. 441, 444 (N.Y. 1931)).

<sup>213</sup> *Blue Chip Stamps*, 421 U.S. at 742-43.

<sup>214</sup> See *Ernst & Ernst*, 425 U.S. at 185 n.33.

<sup>215</sup> In *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), the Court of Appeals for the Second Circuit held that the plaintiff class for the purposes of Section 10(b) and Rule 10b-5 was limited to actual purchasers and sellers of securities. This principle of standing under Section 10(b) became known as the “*Birnbaum* rule.” See *Blue Chip Stamps*, 421 U.S. at 731 (endorsing the *Birnbaum* rule).

undoubtedly excludes plaintiffs who have in fact been damaged by violations of Rule 10b-5, and to that extent it is undesirable. But it also separates in a readily demonstrable manner the group of plaintiffs who actually purchased or actually sold, and whose version of the facts is therefore more likely to be believed by the trier of fact, from the vastly larger world of potential plaintiffs who might successfully allege a claim but could seldom succeed in proving it. And this fact is one of its advantages.<sup>216</sup>

This same reasoning applies to Section 11 and compels its limitation to initial purchasers. Allowing a claim to stand on the mere allegation of traceability without ascribing a substantive meaning to the term contravenes the rationale underlying the *Blue Chip Stamps* decision. In rejecting an expansive reading of Section 11, the *Barnes* court indicated that it would be an abuse of judicial discretion “to allow recovery by persons not legally entitled thereto.”<sup>217</sup> Conversely, there is no abuse of discretion when courts “limit[] participation to those who might have recovered had the suits been fought and won.”<sup>218</sup>

These same considerations prompted the enactment of Federal Rule of Civil Procedure 23(f) which provides a vehicle for a party to obtain an interlocutory appellate review of a class certification decision.<sup>219</sup> The enactment of Rule 23(f) has particular import in the field of securities litigation where class actions predominate.<sup>220</sup> The United States Court of Appeals for the Seventh Circuit, in *Blair v. Equifax*,<sup>221</sup> first addressed circumstances meriting interlocutory review. Among the factors courts should consider in determining the propriety of interlocutory review is that a grant of class status can exert pressures on defendants to settle even where the plaintiffs’ probability of success on the merits is remote.<sup>222</sup> Referring specifically to securities class actions, the Seventh Circuit observed that the “interaction of procedure with the merits justifies an earlier appellate look.”<sup>223</sup> This acknowledgment of settlement pressures peculiar to

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<sup>216</sup> *Blue Chip Stamps*. 421 U.S. at 742-43.

<sup>217</sup> *Barnes v. Osofsky*, 373 F.2d 269, 271 (2d Cir. 1967).

<sup>218</sup> *Id.*

<sup>219</sup> See Advisory Committee Notes, Fed.R.Civ.P. 23(f) (“An order granting certification . . . may force a defendant to settle rather than incur the costs of defending a class action and run the risk of potentially ruinous liability.”).

<sup>220</sup> See Tamara Loomis, *Securities Reform: What Went Wrong?* NYLJ (Oct. 26, 2000) (reporting an increase in securities class action filings between 1995 and 1999); *Securities Fraud Litigation Sets Record in 1998* <<http://www.securities.stanford.edu/news/990125/pressrel.html>> (“[A]t least 235 companies were named as defendants in federal class action securities fraud lawsuits in 1998 . . . [which] indicates a litigation rate of close to ‘one-a-day’ for every trading day that the stock market is open.”).

<sup>221</sup> 181 F.3d 832 (7th Cir. 1999).

<sup>222</sup> *Id.* at 834.

<sup>223</sup> *Id.*

the area of securities litigation illustrates the need for clarity and workable standards on threshold questions such as standing.

**I. Conclusion**

Eradication of the “tracing” concept from Section 11 jurisprudence would reflect the proper interpretation of the statutory language and legislative intent, and provide clarity in this important area of the law. Courts must clearly and concretely define who has standing under Section 11.

The language of the statute, legislative history, persuasive caselaw, and market realities demonstrate that one rule makes sense: only purchasers in the actual initial distribution of securities itself have standing to maintain a claim under Section 11. Such a rule would further Congressional intent as reflected in the 1933 Act and resolve the current discordance between Sections 11 and 12. Moreover, because Section 10(b) and Rule 10b-5 provide the aftermarket purchaser with an appropriate cause of action that would adequately compensate them for their losses, plaintiffs would not be deprived of a remedy for securities fraud. The issue of standing can be addressed through allegations regarding when, from whom, and the price at which a security was purchased. The logic and ease of application of this approach would not only facilitate the development of the law in this area, but provide business people with clear rules by which they can structure and manage complicated transactions.