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Slack v. Pirani: Will the Section 11 tracing requirement lead to more direct listings?

Introduction

Direct listings gained traction as an innovative approach to go public after Spotify went public through a direct listing on the NYSE in 2018.[1] There have since been 13 additional direct listings to date, including Slack Technologies (Slack) going public on the NYSE on June 20, 2019.[2]

In September 2019, following a stock price decline, Pirani filed a suit against Slack claiming damages under Sections 11 and 12. In September 2021, the Ninth Circuit ruled that liability extends to direct listing shares, contrary to Slack's arguments that the plaintiff could not trace shares to a registration statement.[3] Last week, the Supreme Court ruled that "the better reading of §11 requires a plaintiff to plead and prove that he purchased shares traceable to the allegedly defective registration statement."[4]

Unlike a traditional IPO, in which all shares offered to the public are registered, the registration statement in direct listings may cover only a subset of existing shares. Therefore, shares subsequently traded on an exchange might be traceable to either registered or unregistered shares sold by an insider.[5] Under the modern shareholding system in which shares are held in a fungible pool in "street name" (i.e., brokerage name) at the Depository Trust Corporation

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1 Spotify Technology S.A., Form 424B4, Apr. 4, 2018.

2 Slack Technologies, Inc., Form 424B4, Jun. 20, 2019.

3 Slack Technologies, LLC, v. Pirani, 598 U.S. (2023).The Ninth Circuit's decision also ruled that Pirani's Section 12 claims could proceed "follow[ing] from" its Section 11 analysis.

4 Slack Technologies, LLC, v. Pirani, 598 U.S. (2023). The Court also vacated the Ninth Circuit's judgment on Pirani's Section 12 claims for reconsideration in light of its opinions regarding Section 11, cautioning that Section 11 and Section 12 "contain distinct language that warrants careful consideration."

5 "In the case of a traditional IPO, tracing is easily established by anyone who purchased stock before non-IPO shares enter the market. But tracing is difficult (if not impossible) to establish in "mixed market" situations—such as after the expiration of an IPO lockup period or secondary offerings—where registered and unregistered shares are commingled in the market." See "Complex and Novel Section 11 Liability Issues of Direct Listings" available at https://www.lw.com/admin/upload/SiteAttachments/CC01022020XXXXXLATHAM.pdf.

(DTC), it may be difficult for plaintiffs to trace their own shares to confirm that they are indeed registered.

It remains to be seen how the lower courts will evaluate traceability in the *Slack* matter on reconsideration of the question. Plaintiffs themselves may not have evidence of whether they purchased registered or unregistered shares. However, discovery might establish which shareholders sold and which purchased in a way that allows tracing. For future cases, new systems, such as the Consolidated Audit Trail, might enable secondary market purchasers to trace their shares through identification of counterparties in successive transactions leading back to the original pool of registered shares.[6] If such systems overcome the traceability question, then Section 11 litigation risk may still be a concern for future direct listings.

Damages issues

Even if investors can trace their shares to a registration statement, **as we have discussed elsewhere in an earlier article,** Section 11 damages follow a statutory formula that may pose additional problems in the context of a direct listing.[7] Specifically, damages are capped by restricting the purchase price of a security to the price at which the security was offered to the public. Traditional IPOs have clear offer prices, i.e., the price paid by investors participating in the offering. In contrast, there is no such clear offer price in a direct listing.

The lack of a clear offer price is not unique to direct listings. Special purpose acquisition companies (SPACs), for example, issue units combining a share of stock with warrants at a public offer price for each unit (typically a public offer price of $10). Some time after a SPAC IPO, the stock and warrants are typically allowed to trade separately. If an investor purchases only the stock and wishes to bring a Section 11 claim, there is no specific offer price for the stock itself- the public offer price reflects value of the combined units of both stock and warrants.[8] Likewise, Section 11 claims are sometimes brought with respect to securities offered in a merger transaction, where selling shareholders receive some basket of different forms of consideration (e.g., cash, preferred shares, and/or stock). In such cases, there is typically no offer price specifically for the stock consideration.[9] The impact of lack of a public

[6] Among other things, the Consolidated Audit Trail provides for reporting of both sides of a trade event. See, for example, SIFMA and Deloitte, “Firm’s Guide to the Consolidated Audit Trail (CAT)”, August 20, 2019, available at https://www.sifma.org/wp-content/uploads/2019/07/SIFMA-Firms-CAT-Guide.pdf . The possibility of tracing through the Consolidated Audit Trail was mentioned during Slack oral arguments: “[L]aw and business professors' brief also suggests that a recent regulatory change after this case, the creation of the consolidated audit trail, may facilitate tracing in the future” Slack Technologies, LLC, v. Pirani Oral Arguments; April 17, 2023; p. 31; available at https://www.supremecourt.gov/oral_arguments/argument_transcripts/2022/22-200_5367.pdf

[7] See Aaron Dolgoff and Julian DiPersio. “Section 11 Damages Computation for Direct Listings.” CRA Insights, May 10, 2022. https://media.crai.com/wp-content/uploads/2022/05/10095059/CRA-Insights-Section-11-Damages-Computation-for-Direct-Listings.pdf. In that article, we discussed various approaches plaintiffs might use in place of a clear offer price, including ignoring the offer price limitation, using the registration statements “maximum offering price” disclosure, the reference prices disclosed prior to the direct listing, first day trading prices (either opening price or closing price), or transaction price in the company stock prior to its direct listing.

[8] This issue would be relevant only for Section 11 claims brought with respect to the SPAC IPO. Typical securities litigation claims related to SPACs focus on the “de-SPAC” transaction (i.e., merger of the SPAC with the target company), rather than the earlier issuance of units by the SPAC sponsor.

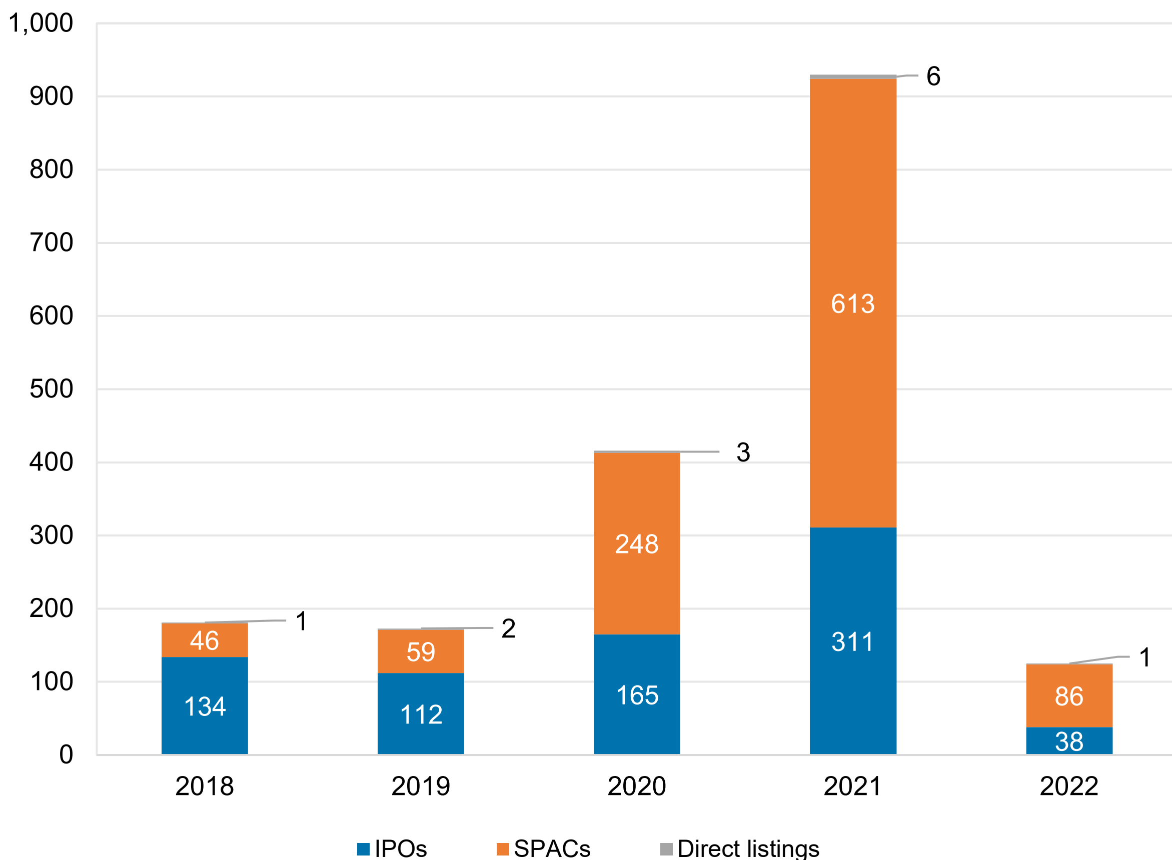
[9] For a discussion of Section 11 damages in such situations see Melanie E. Walker, Nicholas K. Tygesson, and Aaron Dolgoff, “Section 11 Damages and Stock-for-Stock Acquisitions: Legal and Economic Considerations,” Bloomberg Law, 2019.

offer price on companies' decisions to go public via IPO or direct listing is unclear in these situations.

The future of direct listings in light of updated regulations

After a surge in 2020 and 2021, IPO activity decreased substantially in 2022 as shown in Figure 1 below. A disproportionate share of the surge related to SPAC IPOs, and the cooling of the SPAC market contributed to the overall decline in new public listings. Direct listings were used by only a few companies in this period. However, if market conditions improve, companies deciding to go public can choose one of these alternatives or other approaches such as merging with an already public company. Aside from how the *Slack* decision might affect issuers' decisions to go public via direct listing, recent regulatory changes may also impact the frequency of direct listings, as discussed below.

Figure 1: Number of IPOs, SPACs, and direct listings by year[10]



It is too early to tell if, or to what extent, the *Slack* decision will make direct listings more attractive to companies seeking to go public. To date, direct listings have been rare compared to traditional IPOs. We previously discussed 12 stocks which became publicly traded through

[10] Source: Jay R. Ritter, "Initial Public Offerings: Updated Statistics," (May 22, 2023), https://site.warrington.ufl.edu/ritter/files/IPO-Statistics.pdf.

direct listings through September 2021.[11] Since September 2021, there have been only two other direct listings: Bright Green on the Nasdaq in May 2022 and Cool Company on the NYSE in March 2023.

Direct listings appear to have been a favorable option for companies that had well-established brand recognition (requiring no investor roadshows), did not have immediate need for additional capital, and could potentially gain significant value by following a direct listing approach as opposed to a traditional IPO (avoiding the underwriting discount of a traditional IPO and maximizing price received from public offering by capturing the typical first day large price increases after traditional IPOs).[12] Traditional IPOs, though more costly, allow for marketing the company to investors, underwriting backstops, and raising new capital. Though the market for SPACs has cooled significantly, the availability of SPAC mergers as an alternative route to going public also may have limited interest in direct listings.[13]

One regulatory change that may increase interest in direct listings is the SEC approval of capital raising through direct listing for the NYSE in December 2020 and for the Nasdaq in May 2021.[14] Previously, price limit restrictions may have restricted interest in raising new capital through direct listings. However, such restrictions were eased in December 2022,[15] which might lead to increased capital raising through direct listings in the future.

On the other hand, both the NYSE and Nasdaq require firms to have an underwriter for direct listings with a capital raise,[16] which will perform a similar role as in the IPO process. Underwriters are expected to ensure the accuracy of registration statements through their due diligence. This might expose underwriters to reputation risks, which in turn could lead them to increase the cost of a direct listing with a capital raise.

Traditionally, IPOs are followed by an increase in share prices compared to their public offering prices. One of the benefits of a direct listing approach is to create a market-based pricing mechanism that allows companies to raise more capital due to higher prices and insiders to realize a higher selling price.[17] Prior to December 2022, both the NYSE and Nasdaq permitted a direct listing only if the price determined at the opening auction fell within

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[11] See Aaron Dolgoff and Julian DiPersio. “Section 11 Damages Computation for Direct Listings.” CRA Insights, May 10, 2022. https://media.crai.com/wp-content/uploads/2022/05/10095059/CRA-Insights-Section-11-Damages-Computation-for-Direct-Listings.pdf.

[12] Huang, Rongbing, and Donghang Zhang. “Initial Public Offerings: Motives, Mechanisms, and Pricing.” Mechanisms, and Pricing (February 5, 2022) (2022), p. 22.

[13] On the other hand, research has found that SPAC mergers typically involve smaller, younger and riskier firms than traditional IPOs, so it is unlikely that SPAC merger opportunities placed a significant constraint on interest in direct listings. See, for example, Bai, Jessica, Angela Ma, and Miles Zheng. "Segmented going-public markets and the demand for SPACs." Available at SSRN 3746490 (2021).

[14] Securities and Exchange Commission, Exchange Act Release No. 34-90768 (Dec. 22, 2020) and Securities and Exchange Commission, Exchange Act Release No. 34-91947 (May 19, 2021)

[15] Securities and Exchange Commission, Exchange Act Release No. 34-96443 (Dec. 2, 2022).

[16] The Exchange states that an underwriter plays an important role in a traditional IPO and, therefore, proposes to require that a company listing securities on Nasdaq in connection with a Direct Listing with a Capital Raise must retain an underwriter with respect to the primary sales of shares by the company and identify the underwriter in its effective registration statement. See Securities and Exchange Commission, Exchange Act Release No. 34-96443 (Dec. 2, 2022).

[17] Huang, Rongbing, and Donghang Zhang. “Initial Public Offerings: Motives, Mechanisms, and Pricing.” Mechanisms, and Pricing (February 5, 2022) (2022), p. 18.

the price range included in the effective registration statement.[18] In case of a high demand from investors, a direct listing could fail due to a market price above the limits, eliminating one of the potential benefits of the direct listing approach. However, new regulations allow opening auction prices to be up to 20% below and up to 80% above the disclosed price range,[19] and provide more flexibility to companies.

Conclusion

In the context of a company seeking to go public, there is a trade-off between opting for a traditional IPO or a direct listing approach. All else equal, the *Slack* opinion is likely to make direct listings more attractive to issuers to the extent Section 11 liabilities are more difficult to establish under the tracing requirement. It is unclear, however, whether plaintiffs will be able to overcome the traceability requirement in the future, or if other factors, such as statutory caps on damages will play a role in future Section 11 claims associated with direct listings. Additionally, other recent developments, such as the ability to raise capital and pricing flexibility, enhance the advantages of direct listings. However, the requirement of a mandatory underwriter limits the positive impact of such regulatory changes by increasing costs of issuers.

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[18] Price range is also regulated by SEC. See Securities and Exchange Commission, Exchange Act Release No. 34-96443 (Dec. 22, 2020).

[19] Ropes & Gray, "SEC Approves NYSE's Proposal to Facilitate Primary Direct Listings by Modifying Pricing Limitations; Follows Approval of Nasdaq Proposal," Dec. 19, 2022, https://www.ropesgray.com/en/newsroom/alerts/2022/december/sec-approves-nyses-proposal-to-facilitate-primary-direct-listings-by-modifying-pricing-limitations.