

Via email

February 29, 2024

Ms. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20459

Re: Petition for rulemaking regarding traceability of shares

Dear Ms. Countryman:

The Council of Institutional Investors (CII or Council) respectfully asks the Securities and Exchange Commission (SEC or Commission) to initiate a rulemaking to protect investors' rights under Section 11 of the Securities Act of 1933 (Section 11)¹ by endorsing and requiring technological solutions to facilitate the tracing of shares sold into the marketplace by direct listings and traditional initial public offerings (IPOs).

CII is a nonprofit, nonpartisan association of U.S. public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management of approximately \$5 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families, including public pension funds with more than fifteen million participants – true “Main Street” investors through their pension funds. Our associate members include non-U.S. asset owners with about \$4.8 trillion in assets, and a range of asset managers with more than \$55 trillion in assets under management.²

On multiple occasions in the past, the Council has urged the Commission, consistent with our membership-approved policies,³ to use available technology to protect investors through

¹ See Section 11, Securities Act of 1933, available at https://www.law.cornell.edu/wex/section_11.

² Additional information about the Council of Institutional Investors (CII), including its board and members, is available on CII's website at <http://www.cii.org>.

³ CII, Policies on Other Issues, Effective and Efficient Proxy Voting (updated Oct. 24, 2018), https://www.cii.org/policies_other_issues#effective_proxy_voting (“Technology should be used to improve the proxy voting process, including through the adoption of private blockchains operated by trusted third parties that promote each of the above five objectives . . . [timeliness, accessibility, accuracy, certainty and cost-effectiveness] while safeguarding the identities, holdings and voting decisions of individual shareholders.”).

comprehensive reform of the so-called “proxy plumbing”⁴ system.⁵ The Council continues to believe that a comprehensive update of the U.S. proxy system, while continuing to make short-term improvements, would be the best way forward for investor protection.⁶

That said, there is an immediate need to respond to the recent U.S. Supreme Court (Court) decision in *Slack Technologies, LLC v. Pirani* (*Slack*), 143 S. Ct. 542 (2023),⁷ which affirmed, in a suit brought under Section 11, that the shareholder must be able to “trace” his or her shares to a registration statement covering those shares.⁸ The problem is acute, given the ability of investors to purchase shares issued through direct listings, as well as IPOs, thus raising new issues regarding traceability of shares brought to market through one medium rather than the other.⁹

Reasons for initiating a rulemaking proceeding.

Section 11 provides a fundamental protection for investors in new, publicly traded companies because it creates a “virtually absolute” liability for companies, their directors, underwriters, and advisors if there is any misrepresentation or omission of any material information in a registration statement.¹⁰ Section 11 is arguably the single most important investor protection provision in the entirety of the federal securities laws.¹¹

⁴ See Concept Release on the U.S. Proxy System, Exchange Act Release No. 62,495, Investment Advisor Act Release No. 3,052, Investment Company Act Release No. 29,340, 75 Fed. Reg. 42,982 (July 14, 2010), <https://www.federalregister.gov/documents/2010/07/22/2010-17615/concept-release-on-the-us-proxy-system>.

⁵ See, e.g., Letter from Kenneth A. Bertsch, Executive Director, CII et al. to Brent J. Fields, Secretary, Securities and Exchange Commission 3 n.7 (Nov. 3, 2018), <https://www.cii.org/files/20181108%20CII%20Letter%20for%20SEC%20Proxy%20Roundtable.pdf> (“We believe . . . that technological innovation makes it worthwhile now to consider fundamental reform, even while we make continued efforts at short-term improvements to the present system.”).

⁶ See, e.g., Letter from Jeffrey P. Mahoney, General Counsel, CII to Vanessa A. Countryman, Secretary, Securities and Exchange Commission 14 (Aug. 28, 2023), [https://www.cii.org/files/issues_and_advocacy/correspondence/2023/August%2028%202023%20Reg%20Flex%20Letter%20\(final\).pdf](https://www.cii.org/files/issues_and_advocacy/correspondence/2023/August%2028%202023%20Reg%20Flex%20Letter%20(final).pdf) (“[W]e are disappointed that the Commission’s project on “Proxy Process Amendments” continues to remain categorized under “Long-Term Actions” on the Agenda [and] [s]ince the “Universal Proxy” rule has now been successfully implemented, we believe the SEC should prioritize as a next step improving proxy plumbing by addressing end-to-end vote confirmation.”).

⁷ *Slack Technologies, LLC v. Pirani*, No. 22–200, slip op. at 1 (U.S. June 1, 2023), available at https://www.supremecourt.gov/opinions/22pdf/22-200_097c.pdf.

⁸ See *Slack Technologies, LLC v. Pirani* at 3.

⁹ See, e.g., Will a Recent U.S. Supreme Court Decision Encourage More Companies to Go Public Through a Direct Listing? Implications of *Slack Technologies v. Pirani*, Fenwick (June 12, 2023), <https://www.fenwick.com/insights/publications/will-a-recent-u-s-supreme-court-decision-encourage-more-companies-to-go-public-through-a-direct-listing-a-summary-of-the-implications-of-slack-technologies-v-pirani> (“As a result of this decision, plaintiffs will have a difficult time successfully pleading and proving Section 11 claims against companies that pursue a direct listing over a traditional IPO, thus making the direct listing structure potentially more attractive than a traditional IPO.”).

¹⁰ *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983), available at <https://www.law.cornell.edu/supremecourt/text/459/375>.

¹¹ See Andrew F. Tuch & Joel Seligman, The Further Erosion of Investor Protection: Expanded Exemptions, SPAC Mergers, and Direct Listings, 108 Iowa L. Rev. 303, 305 (2022), available at <https://ilr.law.uiowa.edu/print/volume->

Investors seeking to pursue remedies under Section 11 must establish that they purchased shares pursuant to a registration statement, thus demonstrating that their shares are “traceable” to that statement. Until recently, traceability was not an issue, given that underwriters generally imposed a lockup period for insiders and early investors after a registration statement became effective. Such a lockup period prevented insiders and early investors from selling unregistered shares acquired before the public offering.

With the advent of direct listings, it became possible for unregistered shares to be sold alongside shares issued pursuant to a registration statement, thus complicating questions of traceability for Section 11 plaintiffs. Last June in *Slack* the Court found that, notwithstanding these multiple sources of shares being sold to the public, a Section 11 plaintiff must nonetheless establish that his or her shares were purchased pursuant to a registration statement and not through a direct listing of unregistered shares.¹²

We believe the *Slack* decision underscores the need for the Commission to take prompt action related to our long-standing request to protect investors’ rights under Section 11.¹³ One potential response was suggested by a working group of academics, former SEC officials and legal scholars who proposed that the Commission amend SEC Rule 144¹⁴ to limit sales of unregistered securities for a certain period of time after the effectiveness of a registration statement (WG Petition).¹⁵ The working group proposed this approach as a way to potentially balance the interests of insiders and early investors in being able to sell unregistered shares against the

[108-issue-1/the-further-erosion-of-investor-protection-expanded-exemptions-spac-mergers-and-direct-listings](#) (“Section 11 was instrumental in restoring confidence in U.S. capital markets in the wake of the Great Depression and has helped them become the world’s deepest and most liquid”); *see generally* The Further Erosion of Investor Protection with Andrew Tuch, Voice Corp. Governance (Dec. 2022), <https://podcasts.apple.com/us/podcast/the-voice-of-corporate-governance/id1433954314> (discussing the history and importance of Section 11 of the Securities Act of 1933 to investors and the capital markets, including its importance to investors in the context of direct listings and initial public offerings).

¹² *See Slack Technologies, LLC v. Pirani* at 3 (“The Court concludes that the better reading of §11 requires a plaintiff to plead and prove that he purchased shares traceable to the allegedly defective registration statement . . .”).

¹³ *See, e.g.*, Letter from Kenneth A. Bertsch, Executive Director, CII et al. to Brent J. Fields, Secretary, Securities and Exchange Commission at 6 (“While this Roundtable is focused on the proxy process, a system of traceable shares actually addresses broader matters of share custody and transfer [and] [w]e believe traceable shares could substantially improve areas of corporation law that require share identification, including Section 11 claims . . .”).

¹⁴ *See generally*, SEC, Investor Publications, Rule 144 Selling Restrictive and Control Securities (Jan. 2013), <https://www.sec.gov/reportspubs/investor-publications/investorpubrule144> (providing an overview of Rule 144 requirements for “restricted or control securities”).

¹⁵ *See* Letter from Working Group On Investor Protection in Public Offerings to Vanessa A. Countryman, Secretary, U.S. Securities and Exchange Commission 1 (Mar. 9, 2023), [20230309 Modernization Petition \(As Sent\) \(sec.gov\)](#) (“We ask that the SEC amend Rule 144 in light of changes in securities-offering practices and the Supreme Court’s consideration of *Slack v. Pirani*, addressing Section 11 liability in direct listings.”).

interest of public shareholders in having an effective remedy under Section 11. Last October, CII filed comments in general support of that concept.¹⁶

We write today to urge an alternative approach, namely, requiring the use of technology that would facilitate tracing to deal with situations such as occur in Section 11 cases.¹⁷ To put the point in context, there is no shortage of alternatives that the Commission could pursue to reinvigorate Section 11. The issue is not whether, but how to do so.

As an alternative to incorporating some form of the WG Petition, we would respectfully request that the Commission add a project to its rulemaking agenda requiring the use of technology that would facilitate tracing to deal with situations such as occur in Section 11 cases. Two potential approaches have been recently identified by former SEC Chair Jay Clayton and former Commissioner Joseph A. Grundfest.¹⁸ In a brief filed as *amici curiae* in the *Slack* case they stated that the Commission could:

1. Require that registered and exempt shares offered in a direct listing trade with differentiated tickers, at least until expiration of the relevant Section 11 statute of limitations;¹⁹ or
2. Migrate the entire clearance and settlement system to a distributed ledger system or to other mechanisms to allow the tracing of individual shares as individual shares, and not as fractional interests in larger commingled electronic book entry accounts.²⁰

We note that the second more ambitious approach is aligned with the recommendation CII submitted to the SEC in connection with its 2018 Roundtable on the Proxy Process.²¹

¹⁶ See Letter from Jeffrey P. Mahoney, General Council, CII to Ms. Vanessa A. Countryman, Secretary, Securities & Exchange Commission 1 (Oct. 5, 2023), https://www.cii.org/Files/issues_and_advocacy/correspondence/2023/10-05-2023_CII_Letter_to_SEC.pdf (“the Council supports the adoption of a rule in this area”).

¹⁷ See, e.g., U.S. Supreme Court Rejects Ninth Circuit Expansion of Section 11 Standing, Wilson Sonsini (June 3, 2023), <https://www.wsg.com/en/insights/us-supreme-court-rejects-ninth-circuit-expansion-of-section-11-standing.html> (Noting that for “traditional IPOs, the existence of tradeable pre-IPO shares not subject to the IPO registration statement or a lock-up agreement will limit Section 11 liability to those shares actually purchased from the underwriters and therefore traceable to the IPO registration statement.”).

¹⁸ See Brief for amici curiae Jay Clayton and Joseph A. Grundfest in *Slack Technologies, LLC v. Pirani*, U.S. (2023) (No. 22-200) at 31-34, available at https://www.supremecourt.gov/DocketPDF/22/22-200/253996/20230203160500846_Brief%20of%20Amici%20Curiae%20The%20Honorable%20Jay%20Clayton%20and%20The%20Honorable%20Joseph%20A.%20Grundfest%20in%20Support%20of%20Petitioners.pdf.

¹⁹ *Id.* at 31 (“First, the SEC can require that registered and exempt shares offered in a direct listing trade with differentiated tickers, at least until expiration of the relevant Section 11 statute of limitations.”).

²⁰ *Id.* at 33 (“Most ambitiously, as many commenters have observed, the SEC could migrate the entire clearance and settlement system to a distributed ledger system or to other mechanisms that would allow the tracing of individual shares as individual shares, and not as fractional interests in larger commingled electronic book entry accounts.”).

²¹ See Letter from Kenneth A. Bertsch, Executive Director, CII et al. to Brent J. Fields, Secretary, Securities and Exchange Commission at 3 (“We believe that technological change creates the potential to construct a better system of share ownership and clearing that is based on traceable shares.”).

A third potential approach for our proposed rulemaking was described in a recent study by Professors John C. Coffee, Jr., and Joshua Mitts (“C&M Study”).²² The C&M Study advocates various steps using modern computing power to trace the purchase of shares to an allegedly misleading registration statement. As they point out, broker-dealers, exchanges and the Financial Industry Regulatory Authority (FINRA) must all maintain detailed, timestamped transactional records, which show when securities in one account are transferred to another account.²³

They explain that so-called FINRA “Electronic Blue Sheets”²⁴ currently “contain both trading and account holder information,” and thus for any trade executed for a client, the firm maintains electronically a record of the name of the security, the date of the trade, the price of the trade, and with whom the individual client traded.²⁵ These records are kept and stored electronically. In addition, under SEC Rule 613, these records are all contained within the Consolidated Audit Trail (CAT).²⁶ The existence of such data makes it possible to trace transactions using either first-in-first-out (FIFO) or last-in-first-out (LIFO) accounting assumptions for determining the cost of inventory.²⁷ Those accounting assumptions could be adapted to provide for tracing all shares without relying on other methodologies such as probability analysis that some courts view as inadequate.²⁸ As suggested by the C&M Study, this approach could be incorporated into a

²² John C. Coffee, Jr. & Joshua Mitts, *Slack v. Pirani and the Future of Section 11 Claims* (Dec. 1, 2023), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4644888.

²³ *See id.* at 21 n.51 (Indicating that under 17 CFR § 240.17a-3(a)(6) broker-dealers must maintain detailed records on individual orders showing “the time the order was received, the time of entry, the price at which executed, the identity of each associated person, if any, responsible for the account . . . and, to the extent feasible, the time of execution or cancellation.”).

²⁴ *See id.* at 21 & n.52 (referencing Financial Industry Regulatory Authority, *Electronic Sheets (EBS)* (last visited Feb. 23, 2024), available at <https://www.finra.org/filing-reporting/electronic-blue-sheets-ebs#overview>).

²⁵ *Id.* at 21.

²⁶ *See id.*; SEC, Rule 613 (Consolidated Audit Trail) (modified Nov. 14, 2023), <https://www.sec.gov/divisions/marketreg/rule613-info#:~:text=Among%20other%20things%2C%20the%20rule,reported%20to%20a%20central%20repository>.

²⁷ *See* John C. Coffee, Jr. & Joshua Mitts at 22 (“With an accessible (both in terms of record-keeping and computing power) body of transactions, it is possible to trace the chain of title for securities, using standard accounting methods, like first in-first out (“FIFO”) or last in-first out (“LIFO”)”); *see also* Determination of Inventory Costs, FASB, Accounting Standards Codification, 330-10-30-9 (last visited Feb. 29, 2024), <https://asc.fasb.org/330/showallinonepage> (“Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors, such as first-in first-out (FIFO), average, and last-in first-out (LIFO) [and] [t]he major objective in selecting a method should be to choose the one which, under the circumstances, most clearly reflects periodic income.”).

²⁸ *See* John C. Coffee, Jr. & Joshua Mitts at 22 (illustrating the point with the following example: Suppose Broker A received 10 unregistered shares at 9 AM, and then received 10 registered shares at 12 PM. And that Broker A then sold 10 shares to Broker B at 3 PM. Using FIFO, we conclude the 10 unregistered shares were the ones sold to Broker B at 3 PM, since the unregistered shares were the first to enter Broker A’s account. And thus Broker A is left holding 10 registered shares, and Broker B holding 10 unregistered shares. Using LIFO, we conclude that the 10 registered shares were the ones sold to Broker B at 3 pm, since the registered shares were the last to enter Broker’s account. And thus Broker A is left holding 10 unregistered shares, and Broker B holding 10 registered shares).

²⁸ *See* John C. Coffee, Jr. & Joshua Mitts at 22 (illustrating the point with the following example:

Suppose Broker A received 10 unregistered shares at 9 AM, and then received 10 registered shares at 12 PM. And that Broker A then sold 10 shares to Broker B at 3 PM.

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Using LIFO, we conclude that the 10 registered shares were the ones sold to Broker B at 3 pm, since the registered shares were the last to enter Broker’s account. And thus Broker A is left holding 10 unregistered shares, and Broker B holding 10 registered shares).

proposed rule stating that standard FIFO and LIFO accounting assumptions shall satisfy Section 11's tracing requirement. In addition, since the CAT contains customer identifying information, the proposed rule could also make clear to FINRA that these records must be produced to private litigants in the course of Section 11 litigation.

As these three proposed technological solutions illustrate, the Commission has a number of potential options available to update and enhance the protections afforded under Section 11. The Council thus asks the Commission to open a rulemaking that endorses and requires technological solutions that would facilitate the tracing or attribution of individual shares to a registration statement in connection with a direct listing or a traditional IPO.

Thank you for your consideration of this request. Please do not hesitate to contact us if we can provide further information.

Respectfully Submitted,

A handwritten signature in black ink, appearing to read "Jeff Mahoney". The signature is written in a cursive, flowing style.

Jeffrey P. Mahoney
General Counsel