Katten
KattenMuchinRosenman LLP

Litigation Advisory

March 22, 2018

Blockchain Technology May Enable Tracing in Securities Act Litigation

For more information, please contact the following members of Katten's **Litigation** practice.

Bruce G. Vanyo
+1.310.788.4401
bruce@kattenlaw.com

Jonathan Rotenberg
+1.212.940.6405
jonathan.rotenberg@kattenlaw.com

Blockchain technology is creating an ecosystem designed to accommodate peer-to-peer transactions without a trusted administrator or intermediary.[1] On a blockchain platform, direct transactions are underpinned by the blockchain's establishment of an incontrovertible chain of custody over the item being transferred: be it a car, real estate or a piece of fruit.[2]

Legislators have begun to facilitate the implementation of this new technology. One significant such example is Delaware's recent enactment of Senate Bill 69, which amended Delaware's General Corporate Law (DGCL) §§ 219 and 224, *inter alia*, to permit corporations registered in the state to issue and trade shares on a "distributed electronic network," i.e., a blockchain platform.[3] As one observer noted:

> [t]his is likely to pave the way for the entire life cycle of a share—the issuance, custodianship, trading, shareholder communication and redemption—to be enacted on a blockchain . . . With a blockchain system, investors and issuers can interact directly with each other, in theory cutting out brokers, custodians and clearing houses, thus reducing transaction costs . . . Legal ownership would be restored to investors and companies, and would be more transparent.[4]

While maintaining shareholder lists and corporate documents on a blockchain platform will undoubtedly yield certain efficiencies for companies, issuers that opt to implement blockchain in this area should be aware that they run the risk of exposing themselves to increased potential liability under the Securities Act of 1933 (the Securities Act or the Act). This is because blockchain has the potential to make what is currently practically impossible—tracing the beneficial ownership of the stock of a multiple offering issuer—possible, thereby undermining what has developed into a significant defense to private claims brought under the Act.[5]

---

1 Richie Etwaru, *Blockchain: Massively Simplified*, TEDx Talks (March 28, 2017), https://www.youtube.com/watch?v=k53LUZxUF50 (last visited January 8, 2018).

2 *See id.*

3 Del. Gen. Assembly, Senate Bill 69, https://legis.delaware.gov/BillDetail/25730 (last visited Jan. 8, 2018). The definition of "stock ledger" was amended to provide that such records may be "administered by or on behalf of the corporation," DGCL § 219(c), and a corporation's records are now expressly permitted to be "kept on, or by means of . . . 1 or more electronic networks or databases (including 1 or more *distributed electronic networks or databases*)," DGCL § 224 (emphasis added).

4 Noelle Acheson, *Equity Markets on a Blockchain: Delaware's Potential Impact*, CoinDesk (July 10, 2017, 10:00 UTC), https://www.coindesk.com/equity-markets-blockchain-delawares-potential-impact/ (last visited Jan. 8, 2018).

5 In contrast, the more general securities fraud provision found in Section 10(b) of the Securities Exchange Act of 1934 is not limited to material misstatements and omissions in a registration statement or prospectus and does not have a tracing requirement.

A Brief History of Tracing

Section 11 of the Securities Act provides a cause of action for any person acquiring a security issued *pursuant* to a materially false registration statement, unless the purchaser knew about the false statement at the time of acquisition.[6] Similarly, Section 12(a)(2) provides a cause of action for any person who purchases a security *pursuant* to a prospectus that includes "an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading."[7]

Inherent in these provisions is the limitation that, for a claim to exist, the security must have been issued in connection with a negligently prepared registration statement or prospectus. Thus, unless the stockholder can establish a direct chain of title or "trace" her shares of stock to the misleading offering document, the stockholder cannot maintain a claim under these provisions.

When an issuer has made only a single offering, the process is straightforward; all shares in the secondary market can generally be traced to the registration statement and prospectus. But how does a stockholder trace her shares to a specific registration statement or prospectus when the issuer has made multiple offerings?

Perhaps in Wall Street's early years, when purchases and sales of stock were recorded in a physical ledger, tracing in such situations was possible. Today, however, it is not. As Bloomberg described the current state of affairs: "if you own stock, what you really have is an entry in your broker's database, and your broker in turn has an entry in [Depository Trust Company's or "DTC's"] database, and DTC . . . has an entry in the company's database of shareholders of record."[8]

This lack of a direct association between a beneficial owner and a share of stock has created an impenetrable barrier to tracing. As one oft-cited judicial opinion on the subject described:

> The modern practice of electronic delivery and clearing of securities trades, in which all deposited shares of the same issue are held together in fungible bulk, makes it ***virtually impossible*** to trace shares to a registration statement once additional unregistered shares have entered the market. Even where the open market is predominantly or overwhelmingly composed of registered shares, plaintiffs are not entitled to a presumption of traceability.[9]

In other words, the manner in which stock transactions are currently cleared, settled and recorded makes it impossible to trace a single share of stock once the issuer makes a second offering or other shares enter the market through, for example, the exercise of options or the lapse of share restrictions. As a result, broad swaths of stockholders are effectively barred from maintaining claims under Section 11 or Section 12(a)(2).

How Blockchain May Impact the Tracing Paradigm

The application of blockchain technology to stock ledgers could result, over the ensuing years, in the gradual movement away from the masses of fungible stock held by investors indirectly through the DTC, which makes tracing currently impossible, to a system in which stock transactions for each individual share of stock are recorded in a blockchain ledger. While this shift is in its naissance, to the extent that blockchain ledgers are implemented by the DTC or issuers themselves to record the chain of custody of individual shares of stock, it would likely undermine tracing as an obstacle to Securities Act claims and expose issuers to increased liability under the Act.[10]

---

6 *DeMaria v. Andersen*, 318 F.3d 170, 175-76 (2d Cir. 2003) (discussing 15 U.S.C. § 77k(a)); *see also, e.g., Plichta v. SunPower Corp.*, 790 F. Supp. 2d 1012, 1022-23 (N.D. Cal. 2011); *Caiafa v. Sea Containers Ltd.*, 525 F. Supp. 2d 398, 407 (S.D.N.Y. 2007).

7 15 U.S.C. § 77l(a)(2); *see also, e.g., Welgus v. Trinet Grp., Inc.*, No. 15-cv-03625-BLF, 2017 WL 6466264, at *26 (N.D. Cal. Dec. 18, 2017); *In re Magnum Hunter Res. Corp. Sec. Litig.*, 26 F. Supp. 3d 278, 303 (S.D.N.Y. 2014), aff'd, 616 F. App'x 442 (2d Cir. 2015).

8 Matt Levine, *Dole Food Had Too Many Shares*, Bloomberg (Feb. 17, 2017, 10:00 a.m.), https://www.bloomberg.com/view/articles/2017-02-17/dole-food-had-too-many-shares (last visited Jan. 8, 2018).

9 *In re Initial Pub. Offering Sec. Litig.*, 227 F.R.D. 65, 118 (S.D.N.Y. 2004), *vacated and remanded on other grounds sub nom. In re Initial Pub. Offerings Sec. Litig.*, 471 F.3d 24 (2d Cir. 2006) (emphasis added).

10 Of course, plaintiffs will still be required to adequately plead that they purchased shares in the relevant offering, and questions regarding the propriety of class certification will remain to be developed in this new regime. *See, e.g., In re Initial Pub. Offerings Sec. Litig.*, 471 F.3d 24, 31 (2d Cir. 2006), *decision clarified on denial of reh'g sub nom. In re Initial Pub. Offering Sec. Litig.*, 483 F.3d 70 (2d Cir. 2007) (reversing district court's grant of class certification).

For example, imagine if an issuer made an initial offering of its stock in September 2016 (the IPO) and a secondary offering in February 2017 (the SPO). A putative class action is filed in June 2017 alleging that the registration statement and prospectus for the IPO (but not the SPO) contained materially misleading statements. Under the current regime, in such an action, only those stockholders who could prove that they purchased their stock prior to the SPO could trace their stock to the IPO and maintain a claim under Section 11 or Section 12(a)(2). Any stockholders who purchased shares after the SPO would have difficulty maintaining such claims because it would be impossible for them to prove that their shares were issued in the IPO. Theoretically, if all of the IPO shares were traded in the secondary market after the SPO, the inability of any stockholders to trace those shares would reduce the issuer's liability to $0.

In a blockchain regime things might look vastly different. From its issuance, a share of stock would have an encrypted record of it ownership history. Using this record, stockholders who purchased shares in a peer-to-peer enabled aftermarket subsequent to the SPO would be able to tell whether those shares originated in the IPO or the SPO. The chain of custody would be impeccable, assuming the blockchain performed as anticipated. Tracing, now virtually impossible, might be accomplished by the click of a button or the scan of a bar code on a stock certificate. In such a scenario, all of the owners of IPO shares could potentially have the ability to maintain Securities Act claims even if they purchased their shares after the SPO. The issuer's potentially liability would be greatly increased.

In conclusion, while issuers may have robust business reasons for integrating blockchain technology into their processes, at least with respect to the securities laws issuers should consult with counsel and consider how the adoption of blockchain technology in this context might ultimately increase their exposure to claims brought under the Securities Act, especially if the issuer plans on making an offering in the near future.