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INSIGHT: California Appeals Court Blocks Investor Class Actions Against ETF Issuers

May 18, 2020, 4:00 AM

Morgan Lewis attorneys examine the first significant Securities Act decision out of the California Court of Appeal in 10 years. They say that, by affirming traditional standing requirements, the court makes it effectively impossible to pursue class action relief on behalf of investors in most exchanged traded funds (EFTs) under the Securities Act.

Soon after the U.S. Supreme Court ruled in *Cyan* that actions brought in state court under Securities Act of 1933 are *not* removable to federal court, plaintiffs began flooding state courts across the country with Securities Act claims that had been primarily within the purview of federal courts.

While some issuers are pushing back on this trend with forum selection provisions, particularly following the Delaware Supreme Court decision in *Salzberg v. Sciabacucchi* , for the time being, Securities Act class actions filed in state courts still exceed those in federal courts. Consequently, state court judges, particularly those in California and New York, have been thrust to the forefront of resolving controversial questions under the Securities Act.

Indeed, earlier this year, the California Court of Appeal, First Appellate District, issued its first significant Securities Act decision in more than 10 years: *Jensen v. iShares Trust* . In *Jensen*, the plaintiffs pursued a novel legal theory that would have effectively circumvented standing requirements of Sections 11 and 12 in cases brought by investors in ETFs. With assets exceeding $5 trillion, ETFs comprise an increasingly important component of the equity markets.

While the court shot down the plaintiffs' attempts to expand liability under the Securities Act, plaintiffs are not giving up without a fight, and have recently filed a petition for review by the California Supreme Court.

In *Jensen*, a putative class of investors who bought stock index ETFs sought to hold the issuer of the ETFs liable under the Securities Act after their positions were sold at a substantial loss due to automated sell orders they placed (called "stop-loss orders").

On Aug. 24, 2015, the market experienced a brief "flash crash" during which major indices suddenly swooned and shares of certain equity index ETFs briefly traded 35% or more below the indicative values of their underlying assets, triggering the stop-loss orders. The plaintiffs alleged that the offering materials for the ETFs had not adequately warned them about the risks of flash-crashes and stop-loss orders, thereby violating Sections 11 and 12(a)(2).

Defendant iShares Trust (iShares), which issued the ETFs, was registered with the Securities and Exchange Commission as an open-ended investment company under the Investment Act of 1940 (ICA). In contrast to traditional stocks, ETF shares are continuously offered and redeemed in block transactions with broker-dealers (called Authorized Participants), and sold pursuant to an initial registration statement which is then periodically updated through later amendments. Ownership of ETF shares is typically recorded and transferred through an electronic book-entry system, which ordinarily provides no way to link any particular share back to the registration statement or amendment under which it was issued.

Because of this unique creation mechanism, as discussed further below, few (if any) investors can meet traditional standing requirements of Sections 11 and 12(a)(2). Largely for this reason, class actions against ETF issuers under the Securities Act have been virtually non-existent. In *Jensen*, however, the plaintiffs sought to establish a workaround by arguing that the strict standing requirements of Section 11 and 12(a)(2) are effectively waived for ETFs due to certain provisions in the ICA.

The plaintiffs brought this test case in Superior Court of San Francisco before Judge Curtis E.A. Karnow. The trial court dismissed the Section 12(a)(2) claim on the pleadings. In an unusual twist, Karnow then conducted a one-day bench trial, ultimately finding that plaintiffs could not establish standing under Section 11.

Court Affirms Dismissal of Section 11 Claims for Failing to Meet 'Tracing' Requirement

The plaintiffs argued on appeal that provisions of the ICA modify the traditional "tracing" requirement to establish standing under Section 11.

For context, Section 11 provides potentially broad relief to investors when there are materially false or misleading statements in offering materials, making it an attractive vehicle for litigation by securities plaintiffs and plaintiffs' counsel. For example, in contrast to Section 10(b) of the Exchange Act of 1934, Section 11 does not require that plaintiff prove that the alleged misstatement was made with scienter, *i.e.*, with knowledge or reckless intent, or that any investor relied upon the alleged misstatement. While the liability requirements for Section 11 may be looser, the standing requirements are stricter in that Section 11 protection is only available only to aggrieved investors who can "trace" their shares to the allegedly defective registration statement. *See, e.g.*, *In re Century Aluminum Co. Securities Litigation*, 729 F.3d 1104, 1106 (9th Cir. 2013); *Hertzberg v. Dignity Partners Inc.*, 191 F.3d 1076, 1080 (9th Cir. 1999).

While this “tracing” requirement is often uncontested in situations where there is only one registration statement, tracing can spell the death-knell for securities where there are multiple registration statements, meaning that it may be impossible for any individual investor to trace whether its shares were issued pursuant to registration statement at issue.

These tracing challenges are compounded in the case of ETFs, where initial registration statements are often supplemented by follow-on amendments. Because new ETF shares are continually created (and redeemed) each trading day and then released to the secondary market, where they are held by brokerage firms in a fungible mass in book entry form, it is usually impossible for investors to trace the ETF shares they hold to the registration statement or amendment that originally authorized their sale. Consequently, ETF investors cannot ordinarily meet the “tracing” requirement of Section 11.

Seeking to skirt this requirement, the plaintiffs in *Jensen* argued that Congress intended to do away with standing requirements for ETFs registered under the ICA. The plaintiffs’ argument rested on Section 24(e) of the ICA, which provides that: “the effective date of the latest amendment filed shall be deemed the effective date of the registration statement with respect to securities sold after such amendment shall have become effective.” According to the plaintiffs, Section 24(e) provides that all purchases of ETFs are deemed to be traceable to the latest-filed amendment to the registration statement.

The Court of Appeal disagreed, holding that Section 24(e) did not alter the normal tracing requirement under Section 11. Instead, Section 24(e) made a “clarification that a section 11 claim may be based upon false or misleading statements in the most recent amendment despite section 11 itself referring only to registration statements.”

While acknowledging the reality that ETF purchasers may never be able to establish “tracing” under Section 11, the Court of Appeal correctly noted that such concerns should be addressed to Congress and not to courts applying Section 11.

Court Affirms Dismissal of Section 12(a)(2) Claim for Failing to Meet ‘Statutory Seller’ Requirement

The *Jensen* plaintiffs also urged the appellate court to adopt novel legal interpretations to allow purchasers of ETFs to bring claims under Section 12(a)(2).

Like Section 11, Section 12(a)(2) is regularly employed in securities litigation, as it allows aggrieved investors to seek rescission for purchases made pursuant to defective offering materials. Even more so than Section 11, however, Section 12(a)(2) claims are subject to strict standing requirements that limit relief to those investors who purchased their securities “by means of a prospectus,” rather than simply requiring that the investors be able to “trace” to the defective prospectus. *Gustafson v. Alloyd Co. Inc*. 513 U.S. 561, 564 (1995).

Moreover, Section 12(a)(2) only permits a plaintiff to bring claims against the counter-party who was its immediate seller (or "statutory seller") under *Pinter v. Dahl*, 486 U.S. 622, 642, 647 (1988).

Once again, the *Jensen* plaintiffs argued that the ICA altered these requirements. Under the plaintiffs' theory, because iShares was required to deliver a prospectus to ETF purchasers, that opens up Section 12(a)(2) claims to any and all investors who purchased the ETFs. Likewise, the plaintiffs argued that anyone who participated in general marketing efforts for the ETFs should be subject to Section 12(a)(2) claims as "statutory sellers"—a theory designed to target ETF Authorized Participants, though none were sued in this case.

Once again, the Court of Appeal disagreed. While acknowledging that there is less than uniform agreement among federal courts regarding these interpretative questions under Section 12(a)(2), the Court of Appeal followed the majority of federal courts and limited Section 12(a)(2) claims to "statutory sellers" who directly communicated with the plaintiffs and affirmed the trial court's dismissal of the plaintiffs' claims under Section 12(a)(2).

In reaching these conclusions, the Court of Appeal surveyed a broad swath of federal case law interpreting Sections 11 and 12(a)(2), providing much-needed guidance to state trial courts that are increasingly being called upon manage class actions under the Securities Act.

As it currently stands, the standards set forth by the California Court of Appeal make it effectively impossible to pursue class actions relief on behalf of investors in ETFs under the Securities Act as to most ETFs, which have multiple registration statements, except in unusual cases. We will have to wait to see whether this is the last word or if plaintiffs can convince the California Supreme Court to revisit these issues on review.

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