TRACING

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ABSTRACT

Tracing is a method that appears within multiple fields of law. Distinct conceptions of tracing, however, have arisen independently within securities and remedial law. In the securities context plaintiffs must "trace" their securities to a specific offering to pursue certain relief under the Securities Act of 1933. In the remedial context victims who "trace" their misappropriated value into a wrongdoer's hands can claim any derivative value, even if it has appreciated.

This article is the first to compare and then cross-apply tracing within these two contexts. Specifically, this article argues that securities law should adopt a version of the "rules-based tracing" method from remedial law. This method's tracing of exchanged value, instead of purchased securities, will restore broad access to private civil remedies and the optimal level of deterrence for fraudulent public offerings.

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INTRODUCTION

As part of a broader initiative integrating statutory disclosure requirements,[1] the Securities and Exchange Commission (SEC) has proposed an "access equals delivery" model for prospectuses.[2] The model would relieve certain issuers of their existing obligations to print and deliver a final prospectus to investors prior to or contemporaneous with the sale of a security;[3] such issuers merely would have to file the final prospectus with a timely registration statement.[4] This streamlined requirement presumes that investors have access to any filings available on the internet.[5] Accordingly, posting filings on a website would constructively effect delivery.

There are consequences to subsuming delivery obligations within the rubric of presumed access. On the one hand, the "access equals delivery" regime would eliminate simultaneous delivery of the final

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[1] *See, e.g.*, *Securities Offering Reform*, 69 Fed. Reg. 67392, 67393 & n.15 (proposed Nov. 17, 2004) (to be codified at 40 C.F.R. pts. 228, 229, 230, 239, 240, 243, and 274) ("The 1998 proposals [that unsuccessfully attempted to modernize the securities offering process] were a step in an evaluation of the offering process under the Securities Act [of 1933] that began as far back as 1966 . . . .") (referencing *The Regulation of Securities Offerings*, 63 Fed. Reg. 67174 (proposed Dec. 4, 1998), and citing Milton H. Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1342 (1966) ("[I]t is my plea that there now be created a new coordinated disclosure system having as its basis the continuous disclosure system of the 1934 Act and treating the '1933 Act' disclosure needs on this foundation.")).

[2] *See Securities Offering Reform*, 69 Fed. Reg. at 67438-41. The SEC first proposed a version of this model in 2000. *See Use of Electronic Media*, 17 C.F.R. §§ 231, 241, 271 (May 4, 2000); *see also infra* note 5.

[3] These relaxed obligations would be available only to "well-known seasoned issuers," and their majority-owned subsidiaries, that must have at least $700 million of outstanding common equity or $1 billion of registered debt securities. *Securities Offering Reform*, 69 Fed. Reg. at 67396 (A "well-known seasoned issuer" is characterized by "having more regular dialogue with investors and market participants through the press and other media" as well as its communications being "subject to scrutiny by investors, the financial press, and others who evaluate disclosure when it is made.").

[4] *Id.* at 67438-39.

[5] *Id.* at 67438 ("Under an 'access equals delivery' model, investors are presumed to have access to the Internet . . . . The access concept is premised on the information or filings being readily available."). One immediate concern with this presumption is that a sizable segment of the public still do not have access to the internet. *See, e.g.*, Spencer Overton, *The Donor Class: Campaign Finance, Democracy, and Participation*, 153 U. PA. L. REV. 73, 110 (2004) ("Currently, nearly one-quarter of Americans remain 'offline.'"). Indeed, the SEC cited this lack of access as a reason as recently as 2000 for withdrawing an earlier version of "access equals delivery." *See, e.g.*, Michael A. Perino, *Securities Law for the Next Millennium: A Forward-Looking Statement*, 75 ST. JOHN'S L. REV. 1, 5 n.17 (2001) ("The SEC concluded that such an 'access-equals-delivery' model was inappropriate at this time because of concerns that electronic media was not 'universally accessible and accepted' by investors.") (quoting *Use of Electronic Media*, Exchange Act Release No. 42727, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,304, at 83,388, 83,390 (Apr. 28, 2000)). This is not to say that such individuals do not have internet access through public libraries or institutional investment opportunities that do fit the presumption of access. For a more detailed analysis of this presumption of access, see, for example, Anita Indira Anand, *The Efficiency of Direct Public Offerings*, 7 J. SMALL & EMERG. BUS. L. 433, 438-54 (2003).

prospectus and a confirmation of sale,[6] arguably clarifying the function of a confirmation and expediting sales of some securities. On the other hand, delivery of the final prospectus after the sale of a security reassures investors that their purchase is part of a registered transaction in a way that presumed access cannot.[7] Recognizing the value of such reassurance, the SEC has proposed a rule requiring parties effecting sale of a security to send investors a notification, instead of a final prospectus, confirming that the transaction is connected to a registration statement.[8]

Providing reassurance, however, was not the original rationale for the proposed notification provision. In unveiling its "access equals delivery" model the SEC announced: "*[T]o preserve an investor's ability to trace securities to a registered offering*, the proposals include a separate requirement to notify investors that they purchased securities in a registered offering."[9] Inexplicably, the SEC's actual proposal completely omits any such concern over the tracing of securities. This is particularly curious considering that the notification provision has undergone no apparent revision from its inception.[10]

Yet the omission is hardly surprising in that the ability of investors to trace securities has been eroding over time. The Securities Act of 1933 (Securities Act) strives to protect investors by providing private civil remedies that deter fraudulent offerings and sales of securities.[11] To access these remedies, courts require proof that purchased securities were

[6] *Securities Offering Reform*, 69 Fed. Reg. at 67438 ("Because the contract of sale has already occurred, we . . . believe that delivery of a confirmation and the delivery of the final prospectus need not be linked.").

[7] *See, e.g.*, *id.* at 67349 ("[P]rospectus delivery can serve the function of informing investors that they purchased securities in a registered transaction.").

[8] *Id.* Investors still would be able to request a final prospectus, but issuers would not have to deliver it prior to settlement of the purchase. *Id.*; *see also infra* Part I.B.

[9] Press Release, Securities and Exchange Commission, *SEC Proposes Securities Offering Reform, Requires Registration of Hedge Fund Investment Advisers* (Oct. 27, 2004) (emphasis added), *available at* http://www.sec.gov/news/pres/2004-150.htm; *see also* Commission Announcements, SEC News Digest (Oct. 27, 2004) (same), *available at* http://ww.sec.gov/news/digest/dig102704.txt.

[10] Despite the comprehensive and significant nature of the SEC's "access equals delivery" proposal, there was no Concept Release.

[11] *See, e.g.*, Edward N. Gadsby, *Historical Development of the S.E.C.-The Government View*, 28 GEO. WASH. L. REV. 6, 9 (1959) ("The two principal objectives of the 1933 act were, first, to protect investors by requiring adequate and accurate disclosure regarding securities distributed to the public in interstate commerce or by use of the mail, and, second, to outlaw fraud in the sale of all securities whether or not newly issued."); *see also infra* note 85 and accompanying text. This article is concerned only with private civil remedies under the Securities Act because they are exclusively subject to the tracing requirement. Some courts and commentators have pointed plaintiffs unable to satisfy the tracing requirement to Rule 10b-5 under the Securities Exchange Act. *See, e.g.*, Paul C. Curnin & Christine M. Ford, *The Critical Issue of Standing Under Section 11 of the Securities Act of 1933*, 6 FORDHAM J. CORP. & FIN. L. 155, 156 (2001). This is a red herring. Rule 10b-5 imposes a stiffer scienter requirement and targets different defendants than sections 11 or 12(a)(2) of the Securities Act. *Compare* 15 U.S.C. § 78*j et seq.* (2004), *with* 15 U.S.C. §§ 77*k-l et seq.* (2004). Pointing to Rule 10b-5 fails to engage the tracing requirement and its thwarting of access to the Securities Act's private civil remedies.

issued in connection with an oral communication, prospectus, or registration statement containing a material misstatement or omission, that is, plaintiffs must "trace" their securities back to a fraudulent public offering.[12] Courts originally applied this tracing requirement only to section 11 of the Securities Act,[13] which imposes strict liability on offerors and sellers directly involved in a fraudulent registered transaction.[14] Courts have proceeded to extend the tracing requirement to section 12(a)(2) of the Securities Act,[15] which imposes a negligence standard on offerors and sellers that prepare oral communications or prospectuses in a fraudulent registered transaction.[16] Utilizing an aggressive interpretation of the Supreme Court's heavily criticized decision in *Gustafson v. Alloyd Co.*,[17] courts subsequently have applied the tracing requirement to limit section 12(a)(2)'s recissionary remedy to only public offerings.[18] As aptly summarized by Hillary Sale, the net effect of these judicial interpretations is that the Securities Act's private civil remedies have been "Disappearing Without A Trace."[19]

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[12] Tracing of securities is alternatively framed as a question of "standing." *See, e.g.*, Demaria v. Anderson, 318 F.3d 170, 178 (2d Cir. 2003) ("Aftermarket purchasers who can trace their shares to an allegedly misleading registration statement have standing to sue under . . . the 1933 Act."); Curnin & Ford, *supra* note 11, at 156 ("[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 otherwise 'traceable' to the offering."). This conflates distinct terms. Tracing concerns the factual viability of certain causes of action under the Securities Act, whereas standing concerns the procedural propriety of certain shareholders bringing a cause of action under the Securities Act. Accordingly, a plaintiff may raise the question of standing at any point in litigation, whereas tracing is a merits issue that must await trial. *See, e.g.*, *In re* Lilco Sec. Litig., 111 F.R.D. 663, 671 (E.D.N.Y. 1986) ("[T]racing is a question of fact reserved for trial."). Certainly standing is a threshold requirement in that prospective plaintiffs that lack standing will not be subject to the tracing requirement; this perhaps explains why tracing is often collapsed into an inquiry about standing. Plaintiffs with standing, however, still might not be able to satisfy the tracing requirement. *See infra* notes 232-235 and accompanying text.

Moreover, reframing tracing as a question of standing invokes a vast body of literature fraught with problems of no immediate relevance here. *See, e.g.*, Nancy C. Staudt, *Modeling Standing*, 79 N.Y.U. L. REV. 612, 613-14 (2004) ("[V]irtually every published article on the topic seems to argue that the law of standing is at best confusing and at worst a serious impediment to fair and just outcomes. The doctrine, it is charged, is 'permeated with sophistry,' a 'tool to further [judges'] ideological agendas,' wildly vacillating,' and 'a large-scale conceptual mistake.") (quoting 4 KENNETH CULP DAVIS, ADMINISTRATIVE LAW TREATISE § 24:35, at 342 (2d ed. 1983)). As this article demonstrates, tracing within securities law is actually a misnomer for a distinct process known as "following," a purely mechanical exercise of locating misappropriated property. *See infra* Part II.B. Accordingly, this article does not use the term "standing."

[13] *See, e.g.*, Barnes v. Osofsky, 373 F.2d 269 (2d Cir. 1967); *see also infra* Part I.C.

[14] 15 U.S.C. § 77*k* (2004); *see also infra* Part I.A.

[15] *See, e.g.*, In re Crazy Eddie Sec. Litig., 792 F. Supp. 197 (E.D.N.Y. 1992); *see also infra* Part I.C.

[16] 15 U.S.C. § 77*l*(2) (2004); *see also infra* Part I.A.

[17] 513 U.S. 561 (1995); *see also infra* note 118.

[18] Regrettably, Congress has codified *Gustafson* through the Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995).

[19] Hillary A. Sale, *Disappearing Without A Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act*, 75 WASH. L. REV. 429 (2000).

This disappearance is the by-product of securities history and practice. During the late 1960s the system for processing securities trades completely collapsed during the "Paper Crunch."[20] In what the SEC described as "the most prolonged and severe crisis in the securities industry in forty years,"[21] brokerage firms had become inundated with paper stock certificates that had to be altered, recorded, and then physically delivered to issuers for each and every trade.[22] Congress responded by directing the SEC to implement an electronically-based "book-entry system," which now registers securities in the name of a third party nominee, or a "street name."[23] The use of street names has erased from securities any vestige that they belong to a specific purchaser or come from a particular offering. Combined with the creation of centralized repositories,[24] the book-entry system has transformed securities into fungible instruments.[25]

An unintended casualty of this transformation has been the capacity of all securityholders to satisfy the tracing requirement. Securityholders must trace *all* of their purchases to a specific fraudulent offering. This is because courts consistently have found anything less to be wanting,[26] even a showing that 97% of all securities were from a fraudulent offering.[27] When there is only one offering of securities, a simple inference connects all purchases to any fraud.[28] But when there are multiple offerings,[29] the tracing requirement "draws arbitrary distinctions

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[20] *See infra* Part I.B.

[21] STUDY OF SAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS: REPORT AND RECOMMENDATIONS OF THE SECURITIES AND EXCHANGE COMMISSION (PURSUANT TO SECTION 11(h) OF THE SECURITIES INVESTOR PROTECTION ACT OF 1970) 1, H.R. Doc. No. 92-231, 92d Cong., 1st Sess. 35 (1971) [hereinafter SEC, UNSAFE AND UNSOUND PRACTICES]. *See also infra* notes 86-91 and accompanying text.

[22] *See infra* notes 92-96 and accompanying text.

[23] *See, e.g.*, Egon Guttman, *Toward the Uncertificated Security: A Congressional Lead for States to Follow*, 37 WASH. & LEE L. REV. 717, 718 (1980) ("Recordation of securities in the name of a registered broker/dealer or in that of a national bank or their respective nominees is called registration in 'street name.'"). *See also Prefatory Note*, UCC Rev. Art. 8, at 4 (2000) ("[O]ne entity-Cede & Co.-is listed as the shareholder of record of somewhere in the range of sixty to eighty percent of the outstanding shares of all publicly traded companies.").

[24] The Depository Trust Company (DTC) is the nation's largest repository for publicly traded securities. *See, e.g.*, *Prefatory Note*, *supra* note 23, at 4 ("Essentially all of the trading in publicly held companies is executed through the broker-dealers who are participants in DTC . . . ."). *See also infra* notes 103, 108, and accompanying text.

[25] ***See*** *infra* note 111 and accompanying text.

[26] *See, e.g.*, Krim v. pcOrder.com, 210 F.R.D. 581, 586 (W.D. Tex. 2002) ("[D]amages [must] actually [be] issued pursuant to a defective statement, not just that it might have been, probably was, or most likely was, issued pursuant to a defective statement.").

[27] *See* In re Quarterdeck Office Sys. Sec. Litig., No. CV 92-3970, 1993 WL 623310, at *2-3 (C.D. Cal. Sept. 30, 1993).

[28] In re: Initial Public Offering Sec. Litig., Nos. 21 MC 92, 01 Civ. 3857, 01 Civ. 8408, 01 Civ. 7048, 01 Civ. 9417, 01 Civ. 6001, 01 Civ. 0242, 2004 WL 2297401, at *38 (S.D.N.Y. Oct. 13, 2004).

[29] This includes shelf-registered securities, although there is arguably a decreased need to protect participants in such offerings. *See, e.g.*, Barbara Ann Banoff, *Regulatory*

between plaintiffs based on the remote genesis of their shares."[30] Only parties that purchase securities before they flow through the book-entry system have any assurance of tracing successfully; this is a "narrow class of persons,"[31] which includes "institutional investors, members of Congress, and those with connections to underwriters."[32] Everyone else who purchases securities in the aftermarket must try to trace fungible securities registered in street name back to a specific fraudulent offering.[33] As one court has conceded:

> The modern practice of electronic delivery and clearing of securities trades, 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.[34]

Indeed, a commentator recently found only five instances where securityholders were even "possibly able to meet the direct-tracing requirement."[35]

The reason is that tracing creates a perverse incentive to conduct multiple offerings. Provided only one of the offerings does not involve fraud, aftermarket purchasers have little, if any, chance of tracing fungible securities successfully. In this way conducting multiple offerings can utilize the tracing requirement to evade or undo liability under sections 11 or 12(a)(2) of the Securities Act. As Melvyn Weiss, a prominent shareholder advocate, "bitterly" has accused one court:

> Weiss: "[Y]ou are giving them an incentive to avoid section 11 liability."
>
> Court: "What do I do about the case law, which according to the defense, whether it's one percent or less than one percent [of non-fraudulent securities], once that problem occurs, the cases, they . . . uniformly say it's over."[36]

The court proceeded to say just that, finding the securities untraceable while discreetly noting that "it is not the domain of this Court to

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Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415, 70 VA. L. REV. 135, 176-84 (1984).

[30] *In re: IPO*, 2004 WL 2297401, at *37.

[31] Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786 (2d Cir. 1951); *see also* Barnes v. Osofsky, 373 F.2d 269, 273 (2d Cir. 1967).

[32] Sale, *supra* note 19, at 441. This class includes persons fortunate enough to receive "spun" stock. *See generally* Sean J. Griffith, *Spinning and Underpricing: A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings*, 69 BROOK. L. REV. 583 (2004); Therese H. Maynard, *Spinning in a Hot IPO--Breach of Fiduciary Duty or Business as Usual?*, 43 WM. & MARY L. REV. 2023 (2002). *See also infra* note 122 and accompanying text.

[33] *See infra* notes 123-124 and accompanying text.

[34] *In re: IPO*, 2004 WL 2297401, at *38 (emphasis added).

[35] Sale, *supra* note 19, at 463.

[36] *In re: IPO*, 2004 WL 2297401, at *38 n.402. The court more tactfully observed that Weiss had "noted bitterly the possible unfairness of this standard." *Id.*

abrogate" the tracing requirement.[37] The intent of Congress, however, could not be any clearer: to deter fraudulent offerings through the Securities Act's private civil remedies.[38] This is where the true abrogation has occurred. By strictly applying the tracing requirement, courts have thwarted equal and meaningful access to sections 11 and 12(a)(2), and undermined their deterrence effect.

Ironically, the tracing requirement is unsatisfactory regardless of one's view towards these provisions. Scholars that favor expanded access to private civil remedies have observed that "[w]hat began . . . as a shield to prevent non-Offering Shareholders from proceeding with section 11 claims has become a sword in the hands of defendants . . . ."[39] Yet practitioners that support restricted access to these remedies have contended that the "confusion and uncertainty engendered by a broad interpretation of 'tracing' is an anathema to a coherent and predictable federal securities regulatory scheme."[40]

Securities law, however, misunderstands what remedial law already knows. Tracing originated as a remedial method.[41] Though its definition is far from settled,[42] tracing refers to a process of determining when, "for certain legal purposes, one asset stands in the place of another."[43] Tracing in this context enables a victim to seek a claim forcing a wrongdoer to disgorge all proceeds derived from misappropriated value;[44] tracing thus embodies the ancient maxim *omnia praesumuntur contract apoliatorem*, or everything is presumed against a thief.[45] In the parlance of criminal procedure tracing regards the wrongdoer's value as ill-gotten fruit from a poisonous tree.

The justification for remedial tracing lies at the core of restitution. In a conventional sense restitution provides relief from unjust enrichment, when a party has received a legally unjustifiable benefit at another party's expense.[46] There is also a literal sense known as "specific

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[37] *Id.*

[38] *See infra* note 85 and accompanying text.

[39] Sale, *supra* note 19, at 463-64.

[40] Curnin & Ford, *supra* note 11, at 203.

[41] *See infra* Part II.A.

[42] *See infra* Parts II.A-B.

[43] LIONEL D. SMITH, THE LAW OF TRACING 3 (1997). Dale Oesterle defines tracing conventionally as a "restitutionary right to claim specific property . . . that arises from a property interest of the claimant in other property that another has misappropriated." Dale A. Oesterle, *Deficiencies of the Restitutionary Right to Trace Misappropriated Property in Equity and in UCC § 9-306*, 68 CORNELL L. REV. 172, 173 (1983). This definition is premised on certain distinctions that are rebutted by or subsumed within the notion of rules-based tracing that I use here, *see infra* Part II.B., and that is a form of corrective justice, *see generally* Hanoch Dagan, *The Distributive Foundation of Corrective Justice*, 98 MICH. L. REV. 138 (1999); Lionel Smith, *Restitution: The Heart of Corrective Justice*, 79 TEX. L. REV. 2115 (2001).

[44] Remedial tracing typically focuses on assets or property, in the way courts focus on tracing securities. I embrace a conception of tracing that instead focuses on value, a more principled basis for establishing legal claims. *See infra* Parts II.B. & III.A.

[45] PETER BIRKS, AN INTRODUCTION TO THE LAW OF RESTITUTION 368 (1989).

[46] *See, e.g.*, RESTATEMENT OF THE LAW OF RESTITUTION: QUASI CONTRACTS AND CONSTRUCTIVE TRUSTS § 1, at 12 (1937) ("A person who has been unjustly enriched at

restitution," which involves "restoration in something lost or taken away."[47] These dual senses of restitution are captured in a theory known as "rules-based tracing,"[48] which draws a parallel distinction between tracing and "following." The latter is an exercise that attempts to identify and locate only the value of what has been *misappropriated* from a party;[49] although the exercise is exclusively factual, and so does not generate any legal liability, successful following enables a party to seek a specific restitution claim. In contrast tracing is a process that attempts to determine whether certain value a wrongdoer possesses is a *substitute* for original value misappropriated from a party;[50] although the process also does not generate any legal liability, successful tracing enables a party to seek an unjust enrichment claim. In this way tracing represents a powerful tool to impose on the wrongdoer the costs of misappropriation, and reallocate its benefits to the victim *ex post*. Dale Oesterle has observed that "the primary limitation on the scope of the right to trace is the ignorance of lawyers as to its availability."[51]

Securities law suffers from not only an ignorance, but also an impoverished conception, of tracing proper. At best, the current tracing requirement is simply a form of rules-based following.[52] Courts predicate access to private civil relief under the Securities Act upon a showing that plaintiffs can identify and locate their purchased security within a specific fraudulent offering. But while the security is the object of this exercise, this is not what the Securities Act's remedial provisions actually restore, which is monetary relief.[53] The current tracing requirement, then, is not even a form of specific restitution. Nor is the requirement a form of unjust enrichment. Requiring securityholders to demonstrate a link between their purchase and a specific fraudulent offering involves no component of inequitable gain or loss, much less any disgorgement of substituted value. On the contrary, most securityholders cannot satisfy the current tracing requirement precisely because their purchase is commingled with other like securities registered in street name from multiple offerings.[54] Securities law, therefore, applies a conception of tracing that ironically frustrates, rather than relieves, victims of fraudulent offerings.

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the expense of another is required to make restitution to the other.") [hereinafter RESTATEMENT OF RESTITUTION]; *id.* at 1 ("The Restatement of this Subject deals with situations in which one person is accountable to another on the ground that otherwise he would unjustly benefit or the other would unjustly suffer loss.") (General Scope Note).

[47] Douglas Laycock, *The Scope and Significance of Restitution*, 67 TEX. L. REV. 1277, 1279 (1989); *see also* RESTATEMENT (SECOND) OF THE LAW OF CONTRACTS § 372 (1981) (providing for specific restitution at law and in equity) [hereinafter RESTATEMENT OF CONTRACTS]; RESTATEMENT OF RESTITUTION, *supra* note 46, § 4, cmt. c (providing for specific restitution at law); *infra* Part II.A.

[48] *See infra* Part II.B.

[49] *See infra* notes 182, 186, and accompanying text.

[50] *See infra* notes 187-188 and accompanying text.

[51] Oesterle, *supra* note 43, at 180.

[52] *See infra* Part III.A.

[53] *See* 15 U.S.C. §§ 77*k*(e), 77*l*(2) (2004).

[54] *See infra* Part III.B.

This article proposes a novel way to reconceptualize tracing of securities culled from its remedial relative, rules-based tracing. Part I examines tracing within securities law. Specifically, Part I demonstrates how the book-entry system has combined with the judicially-created tracing requirement to restrict access to private civil remedies under the Securities Act and undermine its ability to deter fraud. Part II shifts to tracing within remedial law. Specifically, Part II analyzes inadequacies with various approaches to tracing assets and property, and delineates how rules-based tracing's focus on value can resolve the problems presented by commingled fungible assets. Part III then reconciles securities and remedial tracing. The critical move is to reorient securities law towards substituted value, the money exchanged for securities.[55] This method of tracing can solve the problems presented by multiple offerings with the aid of a simple designation system. At the point of purchase securityholders need only select an offering that will be used for making claims under section 11 or 12(a)(2). Permitting these selections is consistent with the Securities Act's antifraud provisions and with the recently proposed "access equals disclosure" model. Most importantly, by tracing money instead of securities, courts can restore all securityholders' access to private civil remedies and optimal deterrence against fraudulent offerings.

METHODOLOGY

This article is an application of "intradisciplinarity,"[56] a method that "transfers theories, practices, and technologies across legal domains."[57] Intradisciplinarity recognizes that the law is conventionally organized around certain categorical distinctions, such as the theoretical divide between the private and public,[58] or the curricular compartmentalizing of civil procedure, contracts, criminal law, property, and torts.[59] A by-product of these distinctions is that legal doctrines can arise in different domains of the law and develop in dissimilar or inconsistent ways.

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[55] *Cf.* ALL THE PRESIDENT'S MEN (Warner Bros. 1976) ("I have to do this my way. You tell me what you know, and I'll confirm. I'll keep you in the right direction if I can, but that's all. Just . . . follow the money.") (Hal Holbrook aka Deep Throat).

[56] Anupam Chander, *Minorities, Shareholders and Otherwise*, 113 YALE L.J. 119, 152 (2003).

[57] *Id.* Anupam Chander perspicuously observes that "intradisciplinarity seems especially appropriate to law, a discipline that relies on analogical reasoning." *Id.* I agree with his implicit point that intradisciplinarity is neither necessarily nor advisedly restricted to law.

[58] *See, e.g.*, Symposium, *Public/Private Distinction*, 130 U. PA. L. REV. 1289 (1982); Joan Williams, *The Development of the Public/Private Distinction in American Law*, 64 TEX. L. REV. 225 (1985).

[59] *See, e.g.*, David Rosenberg, *The Path Not Taken*, 110 HARV. L. REV. 1044, 1045 (1997) (noting, "in reciprocal disdain, torts courses ignore the policy objectives of adjacent fields like contracts, civil procedure, criminal law, and property," a "path of increasing social irrelevance and irresponsibility" that departs from Oliver Wendell Holmes's prescription of the "rational study of law").

Intradisciplinarity critically examines these dissimilarities and inconsistencies. The method juxtaposes and compares concurrent conceptions of a legal doctrine or method, eliciting structural and substantive parallels. These parallels then serve as a basis for cross-fertilization, utilizing one domain's conception to inform our understanding and application of another. In this way intradisciplinarity facilitates dialogue between legal domains, and thereby challenges the artificiality of certain categorical barriers within the law.

Intradisciplinarity has a distinguished lineage.[60] The method has connected seemingly disparate domains such as contract and tort law,[61] tort and criminal law,[62] criminal and corporate law,[63] as well as corporate and evidentiary law.[64] And a recent movement revitalizing the method appears to be afoot in corporate circles.[65] Cynics might dismiss the

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[60] Within legal discourse the method can be traced back to Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972), which furnished a principled way to integrate property and tort law. Commentators have extended the method to areas such as criminal and contract law. *See infra* notes 62-63 and accompanying text. And intradisciplinarity is naturally suited for quasi-meta-subjects, such as constitutional, intellectual property, and international law, that encompass a broad range of legal fields. *See, e.g.*, BRUCE ACKERMAN, PRIVATE PROPERTY AND THE CONSTITUTION (1977); F. Scott Kieff & Troy A. Paredes, *The Basics Matter: At the Periphery of Intellectual Property*, 73 GEO. WASH. L. REV. 174 (2004) (distilling principles of antitrust, contract, and property law within the framework of intellectual property law); Anne-Marie Slaughter et al., *International Law and International Relations Theory: A New Generation of Interdisciplinary Scholarship*, 92 AM. J. INT'L L. 367, 372 (1998) (observing a "lively intradisciplinary debate" within international law about the relationship between comparative politics and constitutional law). I see no reason why intradisciplinarity cannot be extended to meta-subjects, such as civil and criminal procedure, conflicts of law, evidence, and, obviously, remedies. *See, e.g.*, David A. Sklansky & Stephen C. Yeazell, *Comparative Law Without Leaving Home: What Civil Procedure Can Teach Criminal Procedure, and Vice Versa*, 94 GEO. L.J. (forthcoming 2006), *available at* http://www.ssrn.com/abstract=706601.

[61] *See, e.g.*, P.S. ATIYAH, ACCIDENTS, COMPENSATION AND THE LAW (3d ed. 1980) (connecting compensation systems within criminal, insurance, labor, and tort law); GRANT GILMORE, DEATH OF CONTRACT (1976) (arguing that contracts law is being reabsorbed into the mainstream of tort law). *But see, e.g.*, Jeffrey O'Connell, *The Interlocking Death and Rebirth of Contract and Tort*, 75 MICH. L. REV. 659 (1977) (suggesting a way to segregate problems associated with characterizing problems as one of contract or torts).

[62] *See, e.g.*, Symposium, *The Intersection of Tort and Criminal Law*, 76 B.U. L. REV. 1 (1996). *See also* Richard A. Epstein, *Crime and Tort: Old Wine in New Bottles*, *in* ASSESSING THE CRIMINAL: RESTITUTION, RETRIBUTION, AND THE LEGAL PROCESS 231 (Randy E. Barnett & John Hagel III eds., 1977).

[63] *See, e.g.*, LEO KATZ, ILL-GOTTEN GAINS: EVASION, BLACKMAIL, FRAUD, AND KINDRED PUZZLES OF THE LAW (1996); James Boyle, *A Theory of Law and Information: Copyright, Spleens, Blackmail, and Insider Trading*, 80 CAL. L. REV. 1413 (1992); Arthur L. Goodhard, *Blackmail and Consideration in Contracts*, 44 L.Q. REV. 436 (1928).

[64] *See, e.g.*, Peter B. Oh, *Gatekeeping*, 29 J. CORP. L. 735 (2004) (reconciling corporate and evidentiary gatekeeping).

[65] *See generally* Chander, *supra* note 56 (reconciling the notion of "minorities" within constitutional and corporate law); Stephen Choi & Jill Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269 (2003) (grafting the notion of vouchers from school and campaign finance schemes to certain private intermediaries); Lawrence A. Cunningham, *The Appeal and Limits of*

method as a simple pursuit of consistent approaches among legal domains.[66] With all due respect to Ralph Waldo Emerson,[67] this article endeavors to demonstrate that intradisciplinarity is not foolishly concerned with its own shadow, but instead has much to do with tracing in particular and corporate law in general.

I. TRACING SECURITIES

The express purpose of the Securities Act is to protect investors. In this vein sections 11 and 12(a)(2) of the Securities Act provide private civil remedies for material misstatements or omissions in connection with a public offering of securities. Access to these remedies, however, was compromised by the infamous Paper Crunch of the late 1960s, in which the system for processing securities trades first collapsed and then overhauled itself; the resulting book-entry system created a centralized system where fungible securities are now registered in the name of a third party intermediary, and not the actual purchaser.

Severing this link between purchasers and securities has inadvertently transformed the judicially-created tracing requirement. Courts require plaintiffs seeking relief under sections 11 and 12(a)(2) of the Securities to prove that their purchased securities actually were part of a fraudulent public offering. Tracing securities is thus an evidentiary standard, requiring securityholders to prove factual causation between the alleged fraud in a specific offering and a purchase of securities.

Not all securityholders are alike, however, in the eyes of securities tracing. When there are multiple offerings, courts apply a conception of tracing that can be satisfied by only a select group of purchasers with

Internal Controls to Fight Fraud, Terrorism, Other Ills, 29 J. CORP. L. 267 (2004) drawing parallels between Sarbanes-Oxley Act of 2001 as a response to recent financial scandals, and USA PATRIOT Act of 2001, as a response to the terrorist attacks of September 11, 2001); Thomas W. Joo, *Race, Contract, Property, and the Role of Metaphor in Corporations Law*, 35 U.C. DAVIS L. REV. 779 (2002) (examining within corporate law the contractarian metaphor, based on consent and enforceability, and the property metaphor, based on rights and duties); Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. CORP. L. 565 (2003) (comparing corporate and trust instruments in relation to capital markets).

[66] This objection is formally expressed by the Fallacy of the Transplanted Category. *See* Moffatt Hancock, *Fallacy of the Transplanted Category*, 37 CAN. B. REV. 535, 547 (1959) ("When a legal category . . . is imported into a different context where a different legal result (involving different legal policies) is in issue, the transplanted category may well suggest a result which frustrates the relevant policies which should control the determination of the new issue."). *Cf.* Adam J. Hirsch, *Inheritance and Inconsistency*, 57 OHIO ST. L.J. 1057, 1058 (1996) (examining the problem of structural inconsistency, "[t]he theoretical antithesis of . . . the so-called fallacy of the transplanted category").

[67] *See* Ralph Waldo Emerson, *Self-Reliance*, *in* ESSAYS AND ENGLISH TRAITS 66 (C.W. Eliot ed., 1909) ("A foolish consistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines. With consistency a great soul has simply nothing to do. He may as well concern himself with his shadow on the wall."). *But cf.* Christoph Engel, *Inconsistency in the Law: In Search of a Balanced Norm* (Dec. 2004) (contending that consistency in legal rules has limited consequential value), *available at* http://ssrn.com/abstract=628387.

direct access to a fraudulent offering. Because of the book-entry system, aftermarket purchasers receive fungible securities registered in street name, and cannot trace them reliably back to a specific offering. As a result, the judicial tracing requirement currently operates to eviscerate private civil remedies for a broad set of securityholders, and thereby undercut the Securities Act's ability to deter fraudulent public offerings.

This Part establishes the troubled application of tracing within the securities context. Opponents and proponents of securities tracing both ground their arguments in the Securities Act' intent and provisions. Accordingly, the first step is to examine the statutory relief afforded by sections 11 and 12(a)(2). This statutory background provides a reference point by which to contrast the realities of the book-entry system. The second step is to understand that system's mechanics in relation to the old system responsible for the Paper Crunch. Establishing the gap between these statutory remedies and practical procedures for offered securities creates a context for understanding this conception of tracing. This in turn sets up the remedial, and ultimately the intradisciplinary, conception of tracing.

A. *The Securities Act of 1933*

In the shadow of the "Black Days,"[68] and the ensuing Great Depression, Congress enacted the Securities Act.[69] Otherwise known as the "Truth in Securities" Act,[70] this "remarkable piece of legislation"[71]

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[68] *See, e.g.*, Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 408 n.97 (1990) ("[T]here was hardly an American who was not aware of its occurrence and who did not date hard times from, and associate his distress with, the black days of October 1929") (citing DAVID SAUL LEVIN, REGULATING THE SECURITIES INDUSTRY 59 (1969) (Ph.D. dissertation, Columbia University)).

[69] 15 U.S.C. § 77k *et seq.* (2003); *see also* Gadsby, *supra* note 11, at 9 ("The Securities Act of 1933 . . . became effective on July 7, 1933, a date roughly corresponding to the low point in the stock market and in our general economy."); James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959) ("The [Securities] [A]ct naturally had its beginnings in the high financing of the Twenties that was followed by the market crash of 1929."). This is not to suggest that Black Monday caused the Great Depression or that either event singularly prompted Congress to adopt the Securities Act. *See, e.g.*, JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET--A HISTORY OF THE SECURITIES EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 33, 39 (1982) ("[M]uch more than the depression or the preceding market crash, it was the Pecora hearings [examining banking institutions and personalities] that influenced the character of the 1933 Securities Act and of the Securities and Exchange Commission later created to enforce it."); *see also* Bevis Longstreth, *The SEC After Fifty Years: An Assessment of Its Past and Future*, 83 COLUM. L. REV. 1593, 1594 (1983) ("[T]he picture that emerges [from Seligman's account] is one of considerate controversy and political horse trading."). According to the Securities Act's legislative history, "[t]he general belief among legislators was that many underwriters and dealers in securities had not been operating in a fair, honest, and prudent manner." Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Act of 1934*, 49 OHIO ST. L.J. 329, 334-35 (1988).

[70] *See, e.g.*, William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 171 (1933) ("All the [Securities] Act pretends to do is to require

has the express purpose of "provid[ing] full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof . . . ."[72] According to then-President Franklin Roosevelt, the Securities Act "adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller."[73] Specifically, through registration requirements, the Securities Act strives to provide investors with adequate disclosures and thereby guard against fraudulent offers and sales of all securities.[74]

The Securities Act provides two private civil remedies for fraud connected with an offer of securities.[75] Section 11 imposes strict liability on persons directly[76] involved in an offering whose registration statement

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the 'truth about securities' at the time of issue, and to impose a penalty for failure to tell the truth. Once it is told, the matter is left to the investor.").

[71] Cohen, *supra* note 1, at 1344; *but cf.* Adolph A. Berle, *High Finance: Master or Servant*, 23 YALE REV. 20, 42 (1933) (describing the Securities Act as "spectacular," and yet also "salutary," in its failure "to solve the problem of who is entitled to the increment of value arising from organization, or the increment of power arising from control"); Amy L. Goodman, *It's Past Time To Rethink the Securities Act of 1933*, 14 INSIGHTS 2, 2 (2000) ("[B]efore the registration statement is filed, no 'offers to sell may be made' and prior to the SEC declaring the registration statement to be effective (the waiting period), no written offers may be made. The end result is that in many ways the Securities Act is an antidisclosure statute.").

[72] 15 U.S.C. § 77a (2004); *see also* S. REP. NO. 47, 73d Cong. 1st Sess. 1 (1933), *reprinted in* 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 item 17, at 1 (comp. by Jack S. Ellenberg & Ellen P. Mahar 1973) ("The basic policy is that of informing the investors of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation.") [hereinafter LEGISLATIVE HISTORY]. The Securities Act further provides that the SEC, whenever "required to determine whether an action is necessary or appropriate in the public interest," "shall also consider, in addition to the protection of investors, whether action will promote efficiency, competition, and capital formation." 15 U.S.C. § 77b(b).

[73] H.R. REP. NO. 85, 73d Cong., 1st Sess. 2 (1933), *reprinted in* 2 LEGISLATIVE HISTORY, *supra* note 72, item 18, at 2 (Statement of President Franklin D. Roosevelt); *see also* Keller & Gehlmann, *supra* note 49, at 338 ("The aim [of President Roosevelt's call for federal securities legislation] was to be 'full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.'").

[74] *See, e.g.*, Gadsby, *supra* note 11, at 9 ("The two principal objectives of the 1933 act were, first, to protect investors by requiring adequate and accurate disclosure regarding securities distributed to the public in interstate commerce or by use of the mail, and, second, to outlaw fraud in the sale of all securities whether or not newly issued."); Therese H. Maynard, *Liability Under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Postdistribution Markets*, 32 WM. & MARY L. REV. 847, 871 (1991) ("Adoption of the 1933 Act served a two-fold purpose. First, Congress intended to provide prospective investors with full disclosure through the section 5 registration obligation. . . . Second, Congress intended to outlaw fraud in connection with the offer and sale of any security, whether registered or unregistered.").

[75] This article does not address remedies under sections 15 and 17(a) of the Securities Act as they are not subject to the tracing requirement.

[76] Five classes of defendants can be held liable under section 11: (1) the issuer; (2) its current directors or partners; (3) its future directors or partners who have consented to being named in the registration statement; (4) experts who have consented to being named as having prepared or certified the registration statement; and (5) underwriters.

misstates or omits material facts.[77] As reliance is generally presumed,[78] a *prima facie* case requires only proof of a material misstatement or omission.[79] In comparison section 12(a)(2) imposes essentially a

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See 15 U.S.C. § 77*k*(a)(1)-(5) (2004). There have been unsuccessful attempts to attach section 11 liability to a sixth class of defendants, institutional investors. *See, e.g.*, Jennifer O'Hare, *Institutional Investors, Registration Rights, and the Specter of Liability Under Section 11 of the Securities Act of 1933*, 1996 WIS. L. REV. 217, 222 ("The argument that institutional investors are subject to liability under Section 11 has so far been rejected by the courts.") (citing cases). For the issuer, liability "is virtually absolute, even for innocent misstatements." Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1982). For other classes of defendants, there is a due diligence defense. *See* 15 U.S.C. § 77*k*(b) (2004).

[77] Section 11 relevantly 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 . . . .

15 U.S.C. § 77*k*(a) (2004); *see also* Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 LAW & CONTEMP. PROBS. 45, 45 (2000) ("[S]trict liability . . . and the failure of 'due diligence' liability . . . [have made] Section 11 the 'bête noire,' in Louis Loss's words, of the legislative scheme.") (quoting LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4246 (3d ed. 1991)).

[78] *See* 15 U.S.C. § 77*k*(a) (2004). Reliance is presumed for one year after the post-effective date. *Id.* Of course, this is a variation of the "fraud on the market" theory first established in *Basic, Inc. v. Levinson*, 485 U.S. 224, 241-42 (1988), and its underlying Efficient Capital Markets Hypothesis (ECMH), seminally formulated in Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970), and famously applied to law in Reinier H. Kraakman & Ronald J. Gilson, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984). Among the more serious challenges to the EMCH have come from legal decision theory, otherwise known as behavioral law and economics. *See, e.g.*, Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias* (Oct. 2003) (incorporating insights from legal decision theory into their MOME thesis), *available at* http://ssrn.com/abstract=462786; Lynn Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance* (Dec. 2003) (exploring financial literature on asset pricing, arbitrage, and behavioral phenomena that suggests alternative ways to analyze market behavior), *available at* http://ssrn.com/abstract=470161.

There are, however, extensive concerns about legal decision theory and its critique of the EMCH. For instance, Greg Mitchell has argued that:

> [A] great deal of psychological research . . . brings into question the claims of the legal decision theorists regarding the fallibility of judgment and decision making in experimental settings and qualifies the generalizations that can be safely drawn from this research.

Gregory Mitchell, *Taking Behavioralism Too Seriously? The Unwarranted Pessimism of the New Behavioral Analysis of Law*, 43 WM. & MARY L. REV. 1907, 1936 (2002); *see also* Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. ECON. PERSP. 59, 80 (2003) ("I suspect that the end result [of the behavioral theory influx] will not be an abandonment of the belief of many in the profession that the stock market is remarkably efficient in its utilization of information."). *But cf., e.g.*, Jeffrey L. Rachlinski, *The "New" Law and Psychology: A Reply to Critics, Skeptics, and Cautious Supporters*, 85 CORNELL L. REV. 739 (2000).

[79] Section 11 limits total liability to the aggregate offering price. *See* 15 U.S.C. § 77*k*(g) (2004). Section 11 damages are calculated by a complex formula that subtracts from the purchase price of a security (a) its sale price, if sold prior to the lawsuit, or (b)

negligence standard upon offerors or sellers[80] of securities that sign or prepare prospectuses or oral communications in connection with an offering of securities.[81] Although reliance is also presumed,[82] a *prima facie* case under section 12(a)(2) requires a three-fold showing: (1) the prospectus or oral communication misstates or omits a material fact, (2) the registered securityholder must not have known of the fraud at the time of purchase, and (3) privity exists between the registered security and the seller defendant.[83] Moreover, unlike their section 11 counterparts, section 12(a)(2) defendants have a defense that they did not and reasonably could not know of the material misstatement or omission.[84] Both of these private civil remedies, however, represent a

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its "true" value at the time the lawsuit commences, if retained throughout the lawsuit. *See id.* at § 77*k*(e). If a section 11 plaintiff sells the relevant security after commencing the lawsuit, but before judgment, courts will deduct the sales price only if it is less than the true value; accordingly, "[t]he formula set forth in section 11(e) presents the plaintiff who has not yet sold his or her securities with a strategic decision: whether or not to sell." 1 THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION § 7.5[2], at 368 (2d ed. 1990). If a section 11 plaintiff retains the relevant security throughout the lawsuit, subsequent price increases or decreases are irrelevant. *See, e.g.*, Sale, *supra* note 19, at 437 ("This formula provides the shareholders who do not sell before suit with a potential windfall if their securities appreciate after the filing date, but offers no protection if the price declines after the judgment.").

[80] The level of active participation necessary to qualify a party as a "seller" under section 12(a)(2) is a contentious subject. *See, e.g.*, Joseph E. Reece, *Would Someone Please Tell Me the Definition of the Term 'Seller': The Confusion Surrounding Section 12(2) of the Securities Act of 1933*, 14 DEL. J. CORP. L. 35 (1989) (recommending consistency as between the definitions of "seller" in sections 12(a)(1) and 12(a)(2)). Due to the privity requirement, there is only class of section 12(a)(2) defendants. *See infra* note 83.

[81] Section 12(a)(2) relevantly provides:

> Any person who . . . offers or sells a security . . . by means of a prospectus or oral communication, which 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 (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable . . . to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security . . . .

15 U.S.C. § 77*l*(2) (2004); *cf.* LOSS & SELIGMAN, *supra* note 77, at 982 (opining that "it is best not to attempt a paraphrase" of section 12(a)(2) as it is "not too happily drafted").

[82] *See, e.g.*, Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682, 689 (3d Cir. 1991); Smole v. Deloitte, Haskins & Sells, 921 F.2d 959, 965 (9th Cir. 1990); Sanders v. John Nuveen & Co., Inc., 619, F.2d 1222, 1226 (7th Cir. 1980); Wigand v. Flo-Tek, Inc., 609 F.2d 1028, 1034 (2d Cir. 1980); Alton Box Bd. Co. v. Goldman, Sachs, & Co., 560 F.2d 916, 923 (8th Cir. 1977).

[83] *See* 15 U.S.C. § 77*l*(2) (2004). Section 12(a)(2) damages are based on the purchase price of the security, if sold prior to the lawsuit, or limited to rescission of the purchase of the security, if retained throughout the lawsuit. *See, e.g.*, LOSS & SELIGMAN, *supra* note 77, at 983 ("Rescission and § 12(2) are substantially the same in that both require the buyer to prove a 'misrepresentation' of fact.'").

[84] *See* 15 U.S.C. § 77*l*(2) (2004). *See also generally* Therese H. Maynard, *The Affirmative Defense of Reasonable Care Under Section 12(2) of the Securities Act of*

deterrence-based approach to preventing fraudulent offerings of securities.[85]

B. *The Book-Entry System*

Three decades after the enactment of the Securities Act, brokers and dealers found themselves in the "Paper Crunch."[86] By the late 1960's, the daily trading volume had increased to approximately thirteen million within a system designed to process only three million.[87] As a result,

> The back offices of many a broker-dealer resembled a trackless forest. . . . Stock certificates and related documents were piled "halfway to the ceiling" in some offices; clerical personnel were working overtime, six and seven days a week, with some firms using a second or even a third shift to process each day's transaction. Hours of trading on the exchange and over the counter

1933, 69 NOTRE DAME L. REV. 57 (1993). This "reasonable care" standard is different than section 11's "due diligence" language. *Compare* 15 U.S.C. § 77*k*(b) *with* 15 U.S.C. § 77*l*(2).

[85] *See, e.g.*, *Concerning Litigation Under TI-IF, Federal Securities laws, Before the House Subcomm. on Telecommunications and Finance of the Comm. On Energy and Commerce*, Fed. News Serv. (July 22, 1994) (referencing "the importance of private actions under the federal securities law" to provide "deterrence against securities law violations") (Testimony of Arthur Levitt, Chairman, U.S. Sec. and Exch. Comm'n). *See also* Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 613 (1985) ("True, people sometimes say that the function of securities law is 'the protection of investors' or 'compensation for wrongs,' but these are just restatements of the objective of efficient operation of the markets."); Theresa A. Gabaldon, *Causation, Courts, and Congress: A Study of Contradiction in the Federal Securities Laws*, 31 B.C. L. REV. 1027, 1060 (1990) ("[D]eterrence is the logical, and acknowledged, congressional goal; its method of accomplishment is imposition of a penalty that sometimes theoretically will equal but sometimes will exceed the defendant's gain from any misrepresentation."). *Cf.* A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 945 (1999) ("Deterrence plays an important role in reducing [the principal social costs produced by fraud on the market]. Compensation, by contrast, does little reduce the costs of fraud on the market.").

[86] SEC, UNSAFE AND UNSOUND PRACTICES, *supra* note 21, at 28.

[87] *Id.* As a reference point, on January 2, 1934, only 1.27 million shares were traded on the New York Stock Exchange. *NYSE Statistics Archive*, *available at* http://www.nyse.com/marketinfo/p1020656068262.html?displayPage=%2Fmarketinfo%2F1022221393893.htm (last visited Feb. 15, 2005). The increase in trading volume that induced the Paper Crunch is attributable to the rise of over-the-counter markets and large financial institutions. *See, e.g.*, Robert B. Ahdieh, *Law's Signal: A Cueing Theory of Law in Market Transition*, 77 S. CAL. L. REV. 215, 274 (2004) ("Over-the-counter . . . began to acquire substantial and growing market share. By the late 1950s, large financial institutions were actively trading large blocks of equity securities. Over the next decade, this trend would produce a quadrupling of equity share volume."). "Today, the system can easily handle trading volume on routine days of hundreds of millions of shares." Prefatory Note, *supra* note 23, at 4. The all-time record for shares traded in one day on the New York Stock Exchange is 2.81 billion shares on July 24, 2002. *NYSE Statistics Archive*, *available at* http://www.nyse.com/marketinfo/p1020656068262.html?displayPage=%2Fmarketinfo%2F1022221393893.htm (last visited Feb. 15, 2005).

> were curtailed to give back offices additional time after the closing bell.[88]

For instance, from June 12 to December 31, 1968, the New York Stock Exchange suspended all trading on Wednesdays to allow brokerage firms time to process trades.[89] By late 1969 stock prices began to decline, and a concomitant reduction in trading volume contributed to the liquidation of over 160 brokerage firms, impacting thousands of their customers.[90] According to Joel Seligman, the Paper Crunch "was the most serious failure of securities industry self-regulation in the Commission's history," a complete "collapse of industry regulatory controls . . . ."[91]

The object of ensuing reform efforts was the very system for processing securities. Until 1970 clearing and settlement of trades involved the physical movement of paper stock certificates.[92] These unique certificates, issued by a corporation, evidenced their holder's ownership and its accompanying rights.[93] To effect a trade, brokers and dealers wrote the transferee's name on the back of the certificate and then delivered the actual certificate to the issuer, who then recorded on its books the change in ownership.[94] Even in light of the technological

[88] SEC, UNSAFE AND UNSOUND PRACTICES, *supra* note 21, at 13; *see also Clearance and Settlement of Securities Transactions: Hearings on S.3412, S.3297 and S.2551 Before the Subcomm. On Securities of the Senate Comm. On Banking, Housing and Urban Affairs*, 92d Cong., 2d Sess. 95-96 (1972) (reporting that, in December, 1968, member firms of the New York Stock Exchange had failed to deliver $4.4. billion and to receive $4.7 million in securities to brokers or dealers within the customary five business day settlement period) (Statement of William J. Carey, Chairman of the Securities and Exchange Commission). *But cf.* Jeanne L. Schroeder, *Is Article 8 Finally Ready This Time?*, 1994 COLUM. BUS. L. REV. 291, 312 n.42 (contending drafters of 1997 amendments to Article 8 of the UCC "thought that the 'paper crunch' was a problem of too many pieces of paper" and "did not consider that the colloquial phrase 'paper work' is shorthand for any form of clerical work, regardless of the presence or absence of physical pieces of paper.").

[89] Jeanne L. Schroeder & David Gray Carlson, *Security Interests Under Article 8 of the Uniform Commercial Code*, 12 CARDOZO L. REV. 557, 562 n.13 (1990).

[90] *See, e.g.*, SEC, UNSAFE AND UNSOUND PRACTICES, *supra* note 21, at 14; S. REP. NO. 92-1009, 92d Cong., 2d Sess., at 1 (1971); H.R. REP. NO. 92-1519, at 9-10 (1972).

[91] SELIGMAN, *supra* note 49, at 450.

[92] *See* Charles W. Mooney, Jr., *Beyond Negotiability: A New Model for Transfers and Pledge of Interests in Securities Controlled by Intermediaries*, 12 CARDOZO L. REV. 307, 316-17 (1990) (defining "clearing" as "the process whereby the trades are compared, matched, and confirmed" and "settling" as "the process whereby parties to trades fulfill their obligations thereunder-generally a 'delivery' of the securities by the seller and payment of the agreed price by the buyer").

[93] *See, e.g.*, *Prefatory Note*, *supra* note 23, at 2-3 ("Ownership of securities was traditionally evidenced by possession of the certificates . . . ."). Some states, however, do not require corporations to issue stock certificates to shareholders. *See, e.g.*, Cal. Corp. Code § 12401(a) (2003). *See also* REV. MODEL BUS. CORP. ACT § 6.26(a) (3d ed. 2004) ("Unless the articles of incorporation or bylaws provide otherwise, the board of directors of a corporation may authorize the issue of some or all of the shares of any or all of its classes or series without certificates.").

[94] *See, e.g.*, Suellen M. Wolfe, *Escheat and the Concept of Apportionment: A Bright Line Test to Slice a Shadow*, 27 ARIZ. ST. L.J. 173 (1995) ("Prior to 1970 . . . [t]he owner would endorse the physical certificate to the name of the assignee on the back of the certificate . . . . If the parties used the services of a broker, the seller would transfer the certificate to his brokerage firm.").

limitations at that time,[95] the process was expensive in its consumption of time and susceptibility to error.[96]

Congress responded by enacting the Securities Investor Protection Act of 1970 (SIPA).[97] Specifically, SIPA directed the SEC to "facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities."[98] By the end of 1971 the SEC reported the creation of a "nationwide net-by-net clearance and settlement system for over the counter securities which promises to minimize substantially the handling of certificates and speed up the entire transaction process with regard to those securities for the bulk of the certificate handling problems."[99] This in turn lead to the eventual introduction of a national book-entry system.[100]

As with its accounting counterpart,[101] the book-entry system involves a combination of physical and non-physical securities.[102] Corporations

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[95] *See generally* Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747 (1985).

[96] *See, e.g.*, *Prefatory Note*, *supra* note 23, at 3 ("Transfer of securities in the traditional certificate-based system was a complicated, labor-intensive process."). According to the SEC's assessment of the Paper Crunch, "the primary cause of the industry's problems was its inability to accurately, promptly and inexpensively record and process the substantially increased trading volume of the late 1960's." SEC, UNSAFE AND UNSOUND PRACTICES, *supra* note 21, at 28; *see also* Guttman, *supra* note 23, at 718 n.8 (citing causes of failure for 64 securities firms liquidated under SIPA, with "poor books and records" being the most prevalent reason in 44 cases).

[97] 15 U.S.C. §§ 78aaa-78lll (2004). According to Thomas Joo,

> although SIPA was designed to protect broker-dealers by promoting investor confidence, the loss of investor confidence was not the cause of the failures that inspired SIPA. Rather, the reverse was the case: Congress feared the failures attributed to the back office crisis were causing a loss of confidence.

Thomas W. Joo, *Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure*, 72 S. CAL. L. REV. 1071, 1082 (1999).

[98] 15 U.S.C. § 78*q*-1(a)(2) (1976); *see also In re* Nat'l Sec. Clearing Corp. for Registration as a Clearing Agency, SEC Sec. Exch. Act Rel. No. 34-13,163 (Jan. 13, 1977), *codified at* 42 Fed. Reg. 396 (delineating, in response to the congressional directive, characteristics for a national clearing and settlement system).

[99] SEC, UNSAFE AND UNSOUND PRACTICES, *supra* note 21, at 34.

[100] The U.S. Treasury and Federal Reserve actually began to implement a book-entry system before the Paper Crunch's onset in 1966, albeit only for Treasury securities. *See* Kenneth D. Garbade, *Origins of the Federal Reserve Book-Entry System*, FRBNY ECON. POL'Y REV. 7-10 (forthcoming 2004), *available at* http://www.ny.frb.org/research/epr/forthcoming/garbade.pdf. *See also generally* Hamilton F. Potter, Jr. & David L. McLean, *Introduction to Book Entry Transfer of Securities*, 28 BUS. L. REV. 209 (1972).

[101] *See, e.g.*, Wolfe, *supra* note 94, at 185 ("The book entry system operates like the accounting system of the same name.").

[102] The UCC briefly contemplated a purely uncertificated system, in which, "instead of surrendering an indorsed certificate for registration of transfer, an instruction would be sent to the issuer directing it to register the transfer." *Prefatory Note*, *supra* note 23, at 3. This system, however, never completely materialized. *See, e.g.*, Schroeder & Carlson, *supra* note 89, at 559-60. What actually emerged was the indirect holding system, in which "the issuer's records do not show the identity of all of the beneficial owners. Instead, a large portion of the outstanding securities of any given issue are recorded on the issuer's records as belonging to a depository." *Prefatory Note*, *supra* note 23, at 6.

still issue physical stock certificates, but they now typically are placed in the control of a depository,[103] and registered in the name of a third party, or a "street name."[104] Clearing and settling occurs in three phases.[105] Customers first instruct their brokers to buy or sell the relevant securities. Brokers then send that instruction to the clearing corporation. Finally, the clearing corporation proceeds to compare the reported information, debit or credit the appropriate trading account, and issue a report to the brokers indicating their net obligation to deliver or receive securities.[106]

The book-entry system's efficiency is attributable principally to a streamlining of the brokerage function. Pre-SIPA, brokers were responsible for processing the legal sale and physical transfer of paper stock certificates.[107] The book-entry system eliminated the need for physical transfer by bifurcating the process of legal sale. Brokers remain responsible for negotiating and settling trades, but their clearance is now the responsibility of an independent intermediary, usually Depository Trust & Clearing Corporation (DTCC).[108] This intermediary serves as

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This article focuses only on the indirect holding system and its complicating effect on the tracing requirement.

[103] In 1968, to track the transfer and volume of shares among its member broker-dealers, the New York Stock Exchange established the Central Certificate Service (CCS). *See DTCC: Evolution of DTC and NSCC*, http://www.dtcc.com/AboutUs/history.htm (last visited Feb. 15, 2005). In 1973 Depository Trust Company (DTC) was established to "immobilize securities for broker-dealers and banks, complete the book-entry delivery of those securities, and handle the myriad operational tasks required to provide centralized, automated processing." *Id.* DTC has subsumed CCS and is now the nation's largest securities repository; at the end of 2003, DTC had decreased its paper stock holdings to 4.6 million, approximately 20 million less than over a decade ago. *See* The Depository Trust & Clearing Corporation, *2003 Annual Report: Leading the Transformation*, at 28 (2004), *available at* http://www.dtcc.com/AboutUs/annual.htm. Along with the National Securities Clearing Corporation, DTC is a wholly owned subsidiary of The Depository Trust & Clearing Corporation. *See About DTCC*, http://www.dtcc.com/AboutUs/index.htm (last visited Feb. 15, 2005); *see also infra* note 108.

[104] *See, e.g.*, Chaim J. Fortgang & Thomas Moers Mayer, *Developments in Trading Claims: Participations and Disputed Claims*, 15 CARDOZO L. REV. 733, 747 (1993) ("Most securities are not held 'of record' by their true owners."). Most securities are registered in the name of Cede & Company, a partnership whose "sole function . . . is to maintain registered ownership of securities deposited with DTC." Mooney, *supra* note 92, at 319 n.34; *see also* Joo, *supra* note 97, at 1073 n.3 ("Stock held in street name can represent as much as 80% of a public company's outstanding shares.").

[105] *But cf.* SEC, SAFE AND UNSOUND PRACTICES, *supra* note 21, at 1 ("Clearance, settlement, depository and transfer functions form part of a continuous process.").

[106] Guttman, *supra* note 23, at 724-26.

[107] *See supra* notes 92-96 and accompanying text.

[108] Created in 1999, DTCC is owned by banks, brokers and dealers, mutual fund firms, and its two preferred shareholders, the National Association of Securities Dealers and New York Stock Exchange. *See About DTCC*, http://www.dtcc.com/AboutUs/index.htm (last visited Feb. 15, 2005); *see also* James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?*, 80 WASH. U. L.Q. 855, 868 n.69 (2002) (describing DTC as "an entity that owes much of its existence to the efficiency of not depending upon individual owners to physically deliver share certificates to an intermediary each time the securities are sold"). Before DTCC, DTC was responsible for clearing functions. *See supra* note 103.

the repository for stock certificates, thereby diminishing paper-based traffic and its corresponding costs.[109]

This innovation to the clearing and settlement process, however, is not without consequences. Brokers no longer act as intermediaries between an issuer and a securityholder. Instead there is a series of interlocking contracts:

> [I]ndividual beneficial owners of securities have no direct contractual relationships with the depository--rather, individuals have contractual relationships with their brokers, which in turn have contractual relationships with the depository or, as is often the case, relationships with another intermediary . . . which in turn is in privity with the depository.[110]

A path, therefore, does exists from a securityholder to the depository, but there is no real connection between the depository and the issuer. Thus there is no longer a path between the issuer and a securityholder. Further, the book-entry system centralizes custody of securities by altering their very nature: securities are now fungible financial instruments.[111] The use of a common nominee means that there is no real difference between any of the securities held by the depository; one security is as tradable as another.[112] To be sure, this is what ensures that the book-entry system will not suffer from another Paper Crunch. And that catastrophic collapse militates against revisiting any sort of processing system that depends on paper stock certificates. Nevertheless, the book-entry system has severed the securityholder's relationships to a particular security and to its issuer.

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[109] Computerizing the clearance process undeniably has reduced the need for paper stock certificates. *See, e.g.*, Mooney, *supra* note 92, at 320 n.37 ("The principal savings from eliminating certificates would relate to DTC[C]'s costs of physical storage, retrieval, deposit and withdrawal of certificates for participants' customers."). This technological innovation, however, is distinct from and arguably less significant than the structural innovation of a centralized custodian of either paper or uncertificated securities. *See, e.g.*, *id.* at 320 ("Even without actually eliminating paper certificates, the successful development by DTC[C] of the 'book entry only' (BEO) system for securities issuance and transfer has resulted in substantial savings for securities issuers.").

[110] Joo, *supra* note 97, at 1073 n.3. Privity here is distinct from what is required by section 12(a)(2). *See supra* note 83 and accompanying text.

[111] *See, e.g.*, Mooney, *supra* note 92, at 319-20 n.34 ("Were the securities not part of a fungible bulk, much of the benefit of the intermediary control phenomenon would evaporate.").

[112] *See, e.g.*, *id.* at 310 ("The property interest received by a purchase on the books of its securities intermediary bears little resemblance to the property interest resulting from a physical delivery of a certificated security or registration on the books of an issuer."). *But cf., e.g.*, Guttman, *supra* note 23, at 719 ("The system which is evolving is one applicable to the securities industry as such and does not affect the individual investor, unless the investor insists on becoming a registered owner of his shares or desires to hold the certificate himself . . . .").

C. *Doctrinal Methods*

The severance has cast doubt over which shareholders may have access to private civil remedies under the Securities Act for fraudulent offerings. Neither section 11 nor 12(a)(2) provides an explicit answer. Section 11 merely states that "[i]n case any part of the registration statement" contains such misstatements or omissions, "any person acquiring *such security* . . . may, either at law or in equity, sue . . . ."[113] Similarly, section 12(a)(2) provides that "[a]ny person who . . . offers or sells a security . . . shall be liable . . . to the person purchasing *such security* from him, who may sue either at law or equity in any court of competent jurisdiction . . . ."[114] Absent from these provisions is any sense of what "such security" one must purchase to be entitled to relief.[115] Is a remedy under the Securities Act available to a person who purchases any security similar to that issued in a particular offering? Or must a person purchase a security actually issued in the relevant offering to be eligible for relief?

The judicial answer comes in the form of a tracing requirement. Since 1967,[116] courts have interpreted section 11 "as applying only to purchasers who can trace the lineage of their shares to the new offering . . .";[117] and, building on the troubling decision in *Gustafson v. Alloyd Co.*,[118] courts subsequently have interpreted section 12(a)(2) as requiring

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[113] 15 U.S.C. § 77*k*(a) (2004) (emphasis added); *see also* Barnes v. Osofsky, 373 F.2d 269, 271 (2d Cir. 1967) ("The key phrase is 'any person acquiring such security'; the difficulty, presented when as here the registration is of shares in addition to those already being traded, is that 'such' has no referent.").

[114] 15 U.S.C. § 77*l*(2) (2004) (emphasis added).

[115] This is distinct from the grand question of what actually constitutes a "security." *See, e.g.*, LOSS & SELIGMAN, *supra* note 77, 923-1138.19.

[116] This slightly precedes the enactment of SIPA, which introduced the book-entry system. *See supra* notes 97-98 and accompanying text.

[117] *Barnes*, 373 F.2d at 271; *see also* Curnin & Ford, *supra* note 11, at 165 n.60 (citing cases); Sale, *supra* note 19, at 453 n.163 (citing cases). Interestingly, the shareholder plaintiffs in *Barnes* were the ones who characterized this interpretation of section 11 as "tracing." *Id.*

[118] 513 U.S. 561 (1995). The *Gustafson* Court held that a private stock placement agreement did not constitute a "prospectus," and thus was not sufficiently connected with an initial offering to be actionable under section 12(a)(2). *Id.* at 583. Prior to *Gustafson* a virtual consensus existed among courts and commentators that section 12(a)(2) permitted claims concerning secondary and private purchases of securities. Justice Ginsburg's dissent in *Gustafson* observed that:

> Commentators writing shortly after passage of the Act understood § 12(2) to cover resales and private sales, as well as public offerings. Felix Frankfurter, organizer of the team that drafted the statute, firmly stated this view. . . . Most subsequent commentators have agreed that § 12(2), like § 17(a), is not confined to public offerings.

Id. at 601-02 (Ginsburg, J., dissenting) (citations omitted). Not surprisingly, the Court's decision has been the subject of vigorous criticism. *See, e.g.*, Stephen Bainbridge, *Securities Act Section 12(2): After the* Gustafson *Debacle*, 50 BUS. LAW. 1231, 1270 (1995) ("[T]he majority opinion is at best bizarre and borders on the irresponsibly unintelligible.").

plaintiffs to "trace" their securities to an initial public offering.[119] In essence tracing withholds access to private civil relief unless plaintiffs can prove that they purchased a security from a specific public offering involving a material misstatement or omission.[120]

The requirement can be understood by its impact on three primary classes of securityholders, defined by their proximity to a public offering.[121] The first class comprises securityholders that have unmediated access to a public offering (Class I), a limited group that includes institutional investors and underwriters as well as their spinning partners.[122] The second class comprises securityholders that have access the public offering only through a secondary market (Class II), otherwise known as the "aftermarket."[123] Finally, the third class comprises securityholders that have no access to a public offering (Class III), but instead purchase similar types of securities in a different offering.[124]

These classes have varying access to private civil remedies under the Securities Act depending on the tracing method a court may apply. Direct Tracing, "the easiest method to understand and prove,"[125] is

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[119] *See, e.g.*, Shapiro v. UJB Fin. Corp. 964 F.2d 272, 287 (3d Cir. 1992) ("If defendants were eventually to prove that the shares came from the secondary market, § 12(2) would not apply, and judgment would be entered for them."); *see also supra* notes 118 and accompanying text. Interestingly, only the Third and Eleventh Circuits have made an explicit appellate reference to the tracing requirement under section 12(a)(2). *See, e.g.*, First Union Disc. Brokerage Servs., Inc. v. Milos, 997 F.2d 835 (11th Cir. 1993) ("[W]e are persuaded by the Third Circuit's reasoning and hold that section 12(2) of the 1933 Act does not apply to aftermarket transactions.") (citations omitted); *see also* Sale, *supra* note 19, at 454 nn.164-67 (citing district court cases). Other courts instead tend to discuss tracing under section 12(a)(2) in the guise of either the privity requirement, *see supra* note 83 and accompanying text, or aftermarket purchases, *see infra* notes 123-124 and accompanying text.

[120] Sale, *supra* note 19, at 441 ("Courts use the term 'tracing' to refer to the judicially created requirement that to access sections 11 and 12(a)(2) shareholders must plead and prove that they bought shares issued either 'in' the public offering for which the registration statement or prospectus was issued, or 'pursuant to' that offering.") (citing Feiner v. SS&C Techs., Inc., 47 F. Supp. 2d 250, 252 (D. Conn. 1999)).

[121] *See supra* note 30.

[122] *See, e.g.*, In re: Initial Public Offering Sec. Litig., Nos. 21 MC 92, 01 Civ. 3857, 01 Civ. 8408, 01 Civ. 7048, 01 Civ. 9417, 01 Civ. 6001, 01 Civ. 0242, 2004 WL 2297401, at *37-*39 (S.D.N.Y. Oct. 13, 2004) (citing cases). *See also* Hillary A. Sale, *Gatekeepers, Disclosure, and Issuer Choice*, 81 WASH. U. L.Q. 403, 415 (2003) ("Members of Congress have benefited from investment bank largesse. Some members benefited from spinning, receiving IPO shares at the offering price that they were allowed to flip in the market at easy profits."). *See also supra* note 32.

[123] *See, e.g.*, *In re: IPO*, 2004 WL 2297401, at *37-*39 (citing cases). Small and individual investors are usually Class II securityholders as they "can rarely get in on . . . hot initial public offerings (IPOs) because IPOs are largely private club[s] that the average investor [i]sn't invited to join." Sale, *supra* note 19, at 441 (citations and quotation marks omitted).

[124] *See, e.g.*, *id.* at 443.

[125] Kirkwood v. Taylor, 590 F. Supp. 1375, 1378 (D. Minn. 1984), *aff'd*, 760 F.2d 272 (8th Cir. 1985) (unpublished table decision). Notably, the Supreme Court has rejected the need for Direct Tracing in the context of 18 U.S.C. § 666 (2004), which governs theft or bribery in connection with programs receiving federal funds. *See, e.g.*, Salinas v. United States, 522 U.S. 52 (1997). *See also* United States v. Cabrera, 328 F.3d 506, 509-10 (9th Cir. 2003) (noting that "circuits have since split on whether to require a

correspondingly also the most accepted.[126] Courts assess a plaintiff's ability to trace their purchased securities directly back to a specific offering by examining multiple factors:

> [A]n 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, language regarding the prospectus on the customer's confirmation slip, and special coding of the transaction by the brokerage firm.[127]

Satisfying these factors is relatively easy for Class I securityholders, as they have an opportunity to purchase a security prior to its entrance into the aftermarket.

Class II and III securityholders, however, face a significant practical problem. Courtesy of the book-entry system, these two classes of securityholders are simply beneficial owners, and not record holders, of publicly offered securities.[128] And, because of centralized repositories, these securities are fungible.[129] This is unproblematic when an issuer has conducted only one offering, as its connection to all of the securities purchased is inferentially clear.[130] But issuers can, and often do, conduct multiple offerings.[131] In such circumstances courts have held that "a plaintiff is entitled to a presumption that she has satisfied the tracing requirement . . . only if *every* such offering was defective."[132] Accordingly, whenever one among multiple offerings is non-fraudulent, Class II and III securityholders cannot trace their aftermarket purchases.

The Fungible Mass Tracing method attempts to address this problem. Statistical probability determines whether a particular security is part of a specific public offering. Courts calculate this probability by simply dividing the number of shares issued in the disputed public offering by the number of total shares issued in all public offerings. In the case of one offering the probability would be 100% that the plaintiffs purchased securities in connection with material misstatements or omissions. In the case of multiple offerings the probability must be "some particular

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federal nexus [between theft or bribery and expenditure of federal funds], with [the Second and Third Circuits] requiring one and [the Sixth and Seventh Circuits] holding that none is required").

[126] *See, e.g.*, *In re: IPO*, 2004 WL 2297401, at *37-*39 (citing cases).

[127] *Kirkwood*, 590 F. Supp. at 1378 (citation omitted).

[128] *See supra* notes 104, 110-112, and accompanying text.

[129] *See supra* notes 111-112 and accompanying text.

[130] *See, e.g.*, *In re: IPO*, 2004 WL 2297401, at *38 ("Tracing may be established . . . through proof that the owner bought her shares in a market containing *only* shares issued pursuant to an allegedly defective registration statement.") (emphasis added).

[131] *See supra* note 29 and accompanying text.

[132] *In re: IPO*, 2004 WL 2297401, at *39 (emphasis added).

number" that constitutes a preponderance of the evidence,[133] roughly quantified by some courts and commentators as greater than 50%.[134]

Courts, however, generally have rejected the Fungible Mass method within the securities context. First, the method establishes only that certain securities "might," and not actually, have been issued in a specific fraudulent offering; this is an inferential leap in causation that courts have refused to make.[135] Second, the method provides remedies to an overinclusive class of securityholders; provided the requisite probability obtains, even plaintiffs with non-fraudulent securities could trace successfully.[136]

A more reliable and less inclusive method is Contrabroker Tracing. Under this method securityholders need to demonstrate a chain of purchase from a broker to another broker or underwriter that directly participated in the disputed offering.[137] Proof of an underwriter's involvement, however, does not dispositively connect a security with the offering; underwriters can be market-makers that facilitate over-the-counter trading by buying and selling securities that may not be from the relevant offering.[138] Moreover, the method is still overinclusive; provided the contrabroking link exists, any securities purchased from that broker or underwriter would enable any plaintiff to satisfy the tracing requirement.[139]

Similar to the Contrabroker method's focus on underwriters, the Heritage method looks to the stock certificates for a causal link. The method, the "most complex" one recognized by courts,[140] follows the path of stock certificates that bear unique code numbers from brokers to purchasers. Not all stock certificates, however, bear unique code numbers.[141] Moreover, stock certificates reflect the increments

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[133] *Kirkwood*, 590 F. Supp. at 1379; *see also infra* notes 242-243 and accompanying text.

[134] *See, e.g.*, In re Elscint, Ltd. Sec. Litig., 674 F. Supp. 374, 380 (D. Mass 1987). *See also infra* note 244 and accompanying text.

[135] *See, e.g.*, *In re: IPO*, 2004 WL 2297401, at *38-*39 (citing cases).

[136] *See, e.g.*, *Kirkwood*, 590 F. Supp. at 1380 ("Even if the court somehow limited the class of plaintiffs to those who held shares on or after the offering date, all persons who held stock in street on and after the offering date could claim a proportional interest in the shares. The issuer could find itself liable for far more than the number of shares issued in the challenged offering.").

[137] *See, e.g.*, *Kirkwood*, 590 F. Supp. at 1381. No plaintiff has convinced a court to apply this method, and so it is not discussed extensively here.

[138] *See, e.g.*, Mark A. Allebach, *Small Business, Equity Financing, and the Internet: The Evolution of a Solution?*, 4 VA. J. L. & TECH. 3, 63 (1999) ("In a standard offering, the underwriter may function as a market maker for the stock, facilitating secondary trading.").

[139] *Kirkwood*, 590 F. Supp. at 1381 ("Obviously at some point plaintiffs' assumption must be false; otherwise anyone who ever purchased from a participant in the underwriting after the offering date could claim he or she bought 'new' stock under this contrabroker theory.").

[140] *Id.* at 1382. As with the Contrabroker method, no plaintiff has convinced a court to apply the Heritage method, and so it is not discussed extensively here.

[141] *See, e.g.*, Sale, *supra* note 19, at 452 n. 153 ("Today . . . the usual practice is to hold shares in street names. As a result, this [heritage] method is unlikely to prove fruitful for modern shareholders."). A simple solution might be to require all brokers or

purchased, and not the specific offering involved.[142] Accordingly, the Heritage method provides perhaps the most speculative evidence of causation between a securityholder's purchase and an issuer's misstatements or omissions.

All of these tracing methods, however, suffer from the same glaring problem. Whenever there are multiple offerings, the tracing requirement arbitrarily segregates according to the securityholder class.[143] Only Class I securityholders have any reliable access to private civil remedies under the Securities Act. Class II and III securityholders, however, must overcome all the difficulties associated with the use of fungible securities registered in street name. Accomplishing this feat, as courts have acknowledged, is "virtually impossible."[144] Indeed, all of these possible tracing methods are effectively an attempt to assist Class II and III securityholders in this regard. But because this is a substantial group of securityholders, the stringent application of the tracing requirement inadvertently confers a benefit on defendants involved in multiple offerings. As long as one of them involves non-fraudulent securities, these defendants can eliminate or reduce their liability under sections 11 and 12(a)(2) of the Securities Act.[145] The net effect, then, is that the tracing requirement represents a way to avoid private civil remedies, and thereby severely compromises their deterrence effect.

II. REMEDIAL TRACING

Part I established deficiencies within securities law's tracing requirement. These deficiencies prompt one to look beyond the securities context and examine conceptions of tracing in other areas of the law. This examination begins, and ends, with remedial law, the original source of tracing.

Remedial tracing is a venerable product of civil law. The method's heritage is manifest in an ongoing controversy over distinct conceptions of tracing in equity and at common law. The justification for all conceptions of tracing, however, lies in restitution. Conventional restitution seeks to redress unjust enrichment by disgorging benefits

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centralized holding companies to keep records of which security is sold or purchased. This is akin to the more conceptually sound designation system that I propose. *See infra* Part III.C.

[142] *Kirkwood*, 590 F. Supp. at 1381.

[143] *See, e.g.*, Barnes v. v. Osofsky, 373 F.2d 269, 272-73 (2d Cir. 1967) ("[T]his construction [of the tracing requirement] gives . . . a rather accidental impact as between one open-market purchaser of a stock already being traded and another."); Klein v. Computer Devices, Inc., 591 F. Supp. 270, 273 n.7 (S.D.N.Y. 1984) ("If the purchaser bought identical securities already being traded on the open market, he must look elsewhere for relief.").

[144] In re: Initial Public Offering Sec. Litig., Nos. 21 MC 92, 01 Civ. 3857, 01 Civ. 8408, 01 Civ. 7048, 01 Civ. 9417, 01 Civ. 6001, 01 Civ. 0242, 2004 WL 2297401, at *38 (S.D.N.Y. Oct. 13, 2004); *see also id.* at *38 n.402 ("The advent of fungible bulk storage has made plaintiffs' tracing requirement a stringent one indeed . . . . ").

[145] *See supra* note 36 and accompanying text; *infra* Part III.B.

inequitably gained at another's expense, while specific restitution seeks to restore misappropriated value to its original owner.

Rules-based tracing reconciles both forms of restitution. Unlike other competing conceptions, rules-based tracing does not focus on assets or property, but rather the *value* inherent in things. The first step is to determine whether misappropriated value has traveled into a wrongdoer's hands; this is part of an exercise known as "following," which is a factual inquiry that enables one ultimately to claim specific restitution. Tracing, however, involves a substitution of value. The second step, then, is to determine whether certain value in a wrongdoer's possession is derived from misappropriated value, and thus subject to a claim of unjust enrichment.

Rules-based tracing also fares well with the classic problem of commingled funds. The difficulty lies in the fact that such funds are fungible instruments, as in the case of a bank account. Courts have devised a myriad of rules for tracing through bank accounts where there has been a deposit or withdrawal of the wrongdoer's own funds. These rules, which focus on assets or property, are not necessarily inconsistent with a focus on value. But rules-based tracing does present a more principled approach to bank accounts, by understanding them as a simple exchange in value.

This Part completes the foundation necessary to set up the ultimate intradisciplinary comparison between tracing within the securities and remedial contexts. Although mindful of corollary securities notions, the analysis here is not explicitly comparative. Rather, the analysis provides a parallel account of rules-based tracing that ultimately suggests how it may be applied to fungible securities.

A. *Equitable and Legal Formulations*

The origins of tracing date back to early eighteenth century civil jurisprudence.[146] English courts introduced the method as a way to protect the ownership rights of beneficiaries in *res* from errant trustees.[147] Specifically, the doctrine entitled beneficiaries to claim the proceeds of

[146] *See, e.g.*, Kendar v. Milward, 23 Eng. Rep. 882 (1702); Halcott v. Markant, 24 Eng. Rep. 81 (1701). For early American applications and analyses of remedial tracing, see Schuyler v. Littlefield, 232 U.S. 707 (1914); National Bank v. Ins. Co., 104 U.S. 54 (1881); James Barr Ames, *Following Misappropriated Property Into Its Product*, 19 HARV. L. REV. 511 (1906); Samuel Williston, *The Right to Follow Trust Property When Confused With Other Property*, 2 HARV. L. REV. 28 (1888). Among the doctrine's glorious applications involved Charles K. Ponzi's pyramid scheme at the turn of the twentieth century. *See* In re Ponzi, 268 F. 997 (D. Mass 1920); Lowell v. Brown, 280 F. 193 (D. Mass 1922); Cunningham v. Brown, 265 U.S. 1 (1924). In adjudicating claims against Ponzi's estate Chief Justice William Taft opined that various creditors "must trace the money, and therein they have failed." *Cunningham*, 265 U.S. at 11.

[147] Oesterle, *supra* note 43, at 186, 187 (noting that the birth of tracing "was understandable: to provide relief against errant trustees, English equity courts granted beneficiaries a proprietary right to follow misappropriated property into its product" and that this right "was a fictional extension of the beneficiary's fluid equitable ownership interest in the trust res"). Oesterle provides a rich, historical account of remedial tracing. *See id.* at 186-95.

misappropriated *res* that a predatory trustee already had converted into a different form. As one court explained,

> [i]t makes no difference in reason or law into what other form different from the original, the change may have been made . . . for the product of or substitute for the original thing still follows the nature of the thing itself, as long as it can be ascertained to be such . . . .[148]

Such indifference to the proceeds' ultimate form is possible because tracing focuses on what lies in the custody of the wrongdoer, rather than the whereabouts of the misappropriated *res*. This focus is premised on a judicial assumption that the transfer of misappropriated *res* was valid.[149]

Characteristic of its vintage, tracing has concurrent equitable and legal roots.[150] Equity conferred a proprietary right upon the original owner of misappropriated *res* to its proceeds; this conferral was predicated on the wrongdoer assuming the role of a trustee that had breached its fiduciary duty towards its principal, the original owner.[151] In contrast, the common law did not recognize the trust,[152] and instead

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[148] Taylor v. Plumer, 105 Eng. Rep. 721, 726 (1815); *see also* In re Hallet's Estate, 13 Ch. D. 696, 708-09 (1879) ("There is no distinction. . . between a rightful and wrongful disposition of the property, so far as regards the right of the beneficial owner to *follow* the proceeds.") (emphasis added). *But see infra* Part II.B.

[149] *See, e.g.*, Oesterle, *supra* note 43, at 188 ("[A]t the plaintiff's election a court would presume conclusively that the errant trustee had acted with proper authority when the exchange was made. This simple fiction of regularity was the seed of all current tracing doctrine.") (citing cases).

[150] *See, e.g.*, Paul Matthews, *The Legal and Moral Limits of Common Law Tracing*, *in* LAUNDERING AND TRACING 23, 31-32 (Peter H. Birks ed., 1995) ("There are two different sets of rules of tracing: those for tracing at *common* law, and those for tracing in Equity. . . .") (emphasis in original). Matthews maintains that this distinction makes sense even in light of the merger of law and equity within the United States:

> [I]f tracing has different rules at law and in equity, that is because the rules were evolved to deal with different situations, and still do so. . . . It *may* be pedagogically and analytically sensible to put both systems together (without changing any rules) and to treat the composite whole as 'the rules of tracing', although, given the importance of history in understanding English law, I am inclined to think that this would obscure rather more than it would illuminate.

Id. at 32 (emphasis in original); *see also* N.E. PALMER, BAILMENT 290 (2d ed. 1991) ("This view that the common law doctrine of tracing has been fused with its equitable counterpart has rightly been described as an expression of hope rather than a statement of reality and weakens the expression of view accordingly."); *infra* note 152.

[151] *See, e.g.*, ROY M. GOODE, COMMERCIAL LAW § 11(ii), 52-53 (3d ed. 2004).

[152] Considerable controversy exists within the civil law over whether common law tracing requires a fiduciary relationship between the original owner of property and its converter. *See, e.g.*, Michael Scott, *The Right to "Trace" at Common Law*, 7 U.W. AUS. L. REV. 463, 479 (1966) ("At common law . . . no fiduciary relationship needs to be postulated . . . . It should not be necessary at this date to argue this last point; and within the limits of this article it is scarcely possible, without wading into [a] morass of academic controversy . . . ."). Lionel Smith disagrees:

> It is sometimes said that a prerequisite to tracing in a court of equity is the establishment of a fiduciary relationship. If this were true, the consequences would be startling. . . . It is to be hoped that courts will heed the weight of academic commentary and discard the notion that a fiduciary relation is a prerequisite to tracing in equity.

regarded the wrongdoer as a bailee whose sale of misappropriated goods conferred the original owner with legal title to their proceeds.[153]

Although the differences are hardly trivial,[154] these conceptions of tracing do share a common principle. As Lionel Smith has noted, equitable and legal tracing both "subordinate the interests of wrongdoers in the same way" and also are "willing to treat non-wrongdoers equally."[155] When presented with a choice between these parties, tracing harnesses the powerful intuition that the law should relegate the wrongdoer's interests beneath those of the victim and any third party.[156] And, by extension, even when the wrongdoer misappropriates and then converts something into greater value, tracing can award that entire value to the victim.[157]

The rationale for tracing is rooted within restitution itself. The law of restitution, which concerns "benefit-based liability or benefit-based

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SMITH, *supra* note 43, at 120, 130 (citations omitted)). There is even dispute over the significance of tracing at common law. *Compare, e.g.*, Scott, *supra*, at 466 (referencing "the very pertinent fact that the great majority of 'tracing' cases are cases arising out of common law relationships"), *with* SIR ROBERT GOFF & GARETH JONES, THE LAW OF RESTITUTION 48 (2d ed. 1978) ("In restitution the common law of tracing has been in practice of little importance. . . . [E]quity has successfully intervened to enable claimants to trace money and negotiable instruments, particularly when money has become mixed with other money in a bank account."). This fiduciary requirement historically has not held true in American courts. *See* Oesterle, *supra* note 43, at 187 ("For years American courts could afford to be lax on the matter because they do not require a fiduciary relationship for tracing relief in equity."). In any event the intradisciplinary conception of tracing proposed here revolves around the Securities Act, which awards monetary relief. *See infra* Part III.B.

[153] *See, e.g.*, PALMER, *supra* note 150, at 288 ("At common law, [a proprietary claim] entails that the claimant should have an immediate right to possession of the goods as against the defendant.").

[154] *See, e.g.*, GOODE, *supra* note 151, § 11(ii), at 52-53 (comparing historical conceptions of tracing in equity and law); Scott, *supra* note 152, at 479 (observing that common law and equitable tracing differ in that "(a) the consequent right of action at common law is not in personam, but in equity in rem, and (b) the common law right of action can thus survive the loss or destruction of the res, while the equitable right of action depends upon its continued possession by the defendant").

[155] SMITH, *supra* note 43, at 278. This is in contrast to the proprietary rights rationale that other commentators frequently cite in support of tracing. *See, e.g.*, PALMER, *supra* note 150, at 287-88 ("There are a number of reasons why a person may wish to employ the proprietary remedy of tracing . . . . The most obvious reason is that a person who has the right to trace will take priority over other creditors in the case of an insolvency. . . .").

[156] *See, e.g.*, Oesterle, *supra* note 43, at 176-77 ("[T]he basic tracing paradigm has substantial intuitive appeal. Notions of vindicating title, of deterring misappropriation, of disgorging unlawfully acquired profits . . . all seem to coalesce in support of the result."); *see also supra* note 45.

[157] *See, e.g.*, *id.* at 176 ("In sum, courts find it more desirable to give the victim a windfall . . . than to allow the wrongdoer to keep any profit."). The most extreme version of this principle is the "swollen assets" theory courts applied to bankruptcy cases during the Great Depression. Upon a mere showing of an equitable wrong, courts would award prioritized claims to certain victims over other third party creditors when the funds had become commingled in an insolvent bank; most civil and common law courts reject this theory. *See, e.g.*, *id.* at 189 n.33. *But see, e.g.*, 2 DAN B. DOBBS, DOBBS LAW OF REMEDIES: DAMAGES-EQUITY-RESTITUTION § 6.1(3), at 14 (1993) ("There is some authority taking a more liberal view [of the swollen assets theory]. . . .") (citing cases).

recovery,"[158] encompasses two distinct principles.[159] First, "specific restitution" provides relief in the form of restoration of the actual misappropriated asset or property to its original owner.[160] Second, unjust enrichment provides various forms of relief to victims at whose expense another party has obtained legally unjustifiable gains.[161]

Conventional conceptions of tracing can involve either of these restitutionary principles. On one level tracing can provide specific restitution to victims that identify misappropriated assets or property within the hands of a defendant or a third party.[162] On another level tracing can redress unjust enrichment when there has been a substitution or commingling of the victim's misappropriated assets or property with

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[158] HANOCH DAGAN, THE LAW AND ETHICS OF RESTITUTION 1 (2004).

[159] This distinction is the subject of intense controversy. *See, e.g.*, Colleen P. Murphy, *Misclassifying Monetary Restitution*, 55 SMU L. REV. 1577, 1581-98 (2002). Both the *Restatement of the Law of Restitution* and a significant group of civil and common law scholars equate restitution with unjust enrichment. *See, e.g.*, RESTATEMENT OF RESTITUTION, *supra* note 46, § 1; 1 DOBBS, *supra* note 157, § 1.1, at 6 ("[R]estitution today is a general term for diverse kinds of recoveries aimed at preventing unjust enrichment of the defendant and measured by the defendant's gains . . . ."); Andrew Kull, *Restitution's Outlaws*, 78 CHI-KENT L. REV. 17, 17 (2003) ("The modern consensus puts unjust enrichment at the heart of liability in restitution, so the question, simply put, is whether restitution properly includes anything else."). Other scholars believe unjust enrichment is but a subdivision of restitution. *See, e.g.*, SMITH, *supra* note 43, at 294 ("The goal of restitution is to reverse the transfer of wealth from the plaintiff to the defendant."); Laycock, *supra* note 47, at 1279 ("'Restitution' means recovery based on and measured by unjust enrichment. It also means restoration in kind of a specific thing. Both usages are part of any complete definition of restitution."). *But cf., e.g.*, Oesterle, *supra* note 43, at 176 n.9 ("Restitution is most commonly understood . . . as a grab bag of judge-made rules developed originally in both the early Anglo-American law and equity courts."). I take no position on the distinction, but use it only to clarify a subsequent distinction between claiming, following, and tracing. *See infra* Part II.B.

[160] Laycock, *supra* note 47, at 1279-80 ("[R]estitution continues to include remedies that restore to plaintiff the specific thing he lost or that undo disrupted transactions and restores both parties to their original positions in kind."); *see also* RESTATEMENT OF CONTRACTS, *supra* note 45, § 372(1) ("Specific restitution will be granted to a party who is entitled to restitution."); RESTATEMENT OF RESTITUTION, *supra* note 46, § 4, cmt. c ("Specific restitution in actions at law"). Laycock believes there is a third sense of restitution, compensatory damages, *id.* at 1282, which is not discussed as the Securities Act's remedies are based on a deterrence theory, *see supra* note 85 and accompanying text. *See also* Murphy, *supra* note 159, at 1586 (asserting that prominent restitutionary theorists "would agree that 'restitution' must be distinguished from 'compensation,' a remedy measured by the plaintiff's loss").

[161] *See, e.g.*, GOFF & JONES, *supra* note 152, at 11 ("There are many circumstances in which a defendant may find himself in possession of a benefit which, in justice, he should restore to the plaintiff. . . . 'Unjust Enrichment' is, simply, the name which is commonly given to the principle of justice which the law recognises [sic] and gives effect to in a wide variety of claims of this kind."); Andrew Kull, *Rationalizing Restitution*, 83 CAL. L. REV. 1191, 1193 (1995) ("Restitution, meaning the law of unjust enrichment . . . [bases liability on the principle] that the defendant has been enriched without legal justification at the expense of the plaintiff; it is not that the defendant has necessarily done anything wrong."); Nicholas J. McBride & Paul McGrath, *The Nature of Restitution*, 15 OXFORD J. LEGAL STUD. 33 (1995) (contending that restitution entails only a common law duty borne by the defendant to correct unjust enrichment).

[162] *See infra* note 183 and accompanying text.

those of a defendant or third party.[163] Under either principle conventional tracing thus represents a powerful re-allocative tool. The method enables courts to impose the full costs of misappropriation on a wrongdoer, while shifting all of the benefits to a victim *ex post*.

B. *Rules-Based Tracing*

Like the myriad of forms that misappropriated assets or property can assume, the doctrine of tracing has mutated over time. According to Lionel Smith, "[t]he complexity of tracing has been exacerbated by a history of inexact use of language, and a consequent failure to distinguish it from related matters."[164] Courts and commentators have referred to tracing within and across legal contexts as "claiming,"[165] "identifying,"[166] "following,"[167] "standing,"[168] and "transactional links."[169] This semantic confusion only complicates the substantive controversy over equitable versus legal conceptions of tracing,[170] and its basis in restitution as either restoration or unjust enrichment.[171]

A way out of this morass is to have a principled understanding of tracing, or what Lionel Smith calls "rules-based tracing."[172] This conception presents tracing as a process by which courts apply legal

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[163] *See infra* Part II.C. *See also* Oesterle, *supra* note 43, at 175-76 (observing that some theorists "argue that tracing is restitutionary in that the doctrine is premised on the principle of unjust enrichment – the conceptual thread that is said to unite all restitutionary doctrines."). Oesterle, however, contends that "[t]he principle of unjust enrichment cannot be defensibly invoked to justify most of the numerous applications of tracing" because the doctrine is actually "a complicated façade for a rough doctrine of causation." *Id.* at 190.

[164] SMITH, *supra* note 43, at 3.

[165] *See, e.g.*, GOFF & JONES, *supra* note 152, at 46-63.

[166] *See, e.g.*, BIRKS, *supra* note 45, at 358 ("The exercise of identifying the surviving enrichment is called tracing."); David Hayton, *Equity's Identification Rules*, *in* BIRKS, *supra* note 150, 1, 1 ("[T]he equitable rules where new assets have been acquired in place of the original trust property . . . endeavour [sic] to identify the value of the original property in new assets so as to ascertain the value surviving in the defendant's hands."); Scott, *supra* note 152, at 478 ("[T]he word 'trace' is commonly used . . . as meaning no more than 'identify.'").

[167] *See, e.g.*, Roy M. Goode, *The Right to Trace and Its Impact in Commercial Transactions-I*, 92 L. Q. REV. 361, 369 (1976) ("[T]he right to follow denotes a right to trace the asset into a changed form . . . ."); Williston, *supra* note 146, at 30 (referencing the "right the *cestui que trust* always has, even though he may also be able to follow his money into a certain investment"). *See also supra* note 148.

[168] *See supra* note 12.

[169] *See, e.g.*, Oesterle, *supra* note 43, at 174 ("The plaintiff bears the burden of proving any transactional link between the misappropriated property and the property found in the defendant's hands."). *But cf.* Simon Evans, *Rethinking Tracing and the Law of Restitution*, 115 L. Q. REV. 469 (1999) (challenging the need for tracing to involve a transactional link between the initial and surviving enrichment).

[170] *See supra* notes 150-154 and accompanying text.

[171] *See supra* notes 159-161 and accompanying text.

[172] This is in contrast to the rights-based conception of tracing advanced by many commentators. *See, e.g.*, Oesterle, *supra* note 43, at 173 (defining tracing as a "restitutionary right to claim specific property . . . that arises from a property interest of the claimant in other property that another has misappropriated"). *See also supra* note 155.

rules that determine whether certain value in a wrongdoer's hands is derivative of misappropriated value, and thus subject to a justifiable legal claim.[173] Significantly, unlike competing conceptions, rules-based tracing focuses on *value*, rather than specific assets or property. This is because tracing fundamentally concerns situations where a substitution of misappropriated assets or property for other assets or property has occurred:

> The only connection which the plaintiff has to the new thing is that it was acquired with the original thing. . . . What is traced, then, is the value inherent in things. It is *value*, not property or assets, which can be identified in different forms after each substitution. The grammatical object of 'to trace' is 'value.'[174]

This is because no other component of tracing purely captures the illicitness that the process seeks to remedy. Certainly, there is no principled basis in focusing on the actual exchange between the wrongdoer and an innocent third party, as that act can be legal.[175] And there is no principled basis in focusing on the specific path of the property or assets, either of the misappropriated or substituted sort. On the one hand, the path of the misappropriated property or assets simply diverts the inquiry to an innocent third party that is equal to the victim in the eyes of tracing.[176] On the other hand, the path of substituted property or assets does lead to the wrongdoer, but without any evidence of the actual wrongdoing.[177]

Value properly orients the tracing inquiry. Fundamentally, value is what the wrongdoer has misappropriated from the victim. Value is also a sufficiently abstract notion to accommodate the shift to substituted

[173] *See* GOODE, *supra* note 151, § 11(ii), at 53 ("[T]racing is . . . merely a legal mechanism to establish that a benefit received by the defendant can be identified as resulting from a diminution in the plaintiff's assets."); SMITH, *supra* note 43, at 6 ("Tracing identifies a new thing as the potential subject matter of a claim, on the basis that it is the substitute for an original thing which was itself the subject matter of a claim.").

[174] *Id.* at 15 (emphasis in original).

[175] *See supra* note 149 and accompanying text. Moreover, the form of the exchange need not be the same for tracing to apply. *See, e.g.*, GOODE, *supra* note 151, § 11(ii), at 53 ("[A]n improper transfer of value by novation is just as traceable as a transfer of value by assignment.").

[176] *See supra* note 155 and accompanying text.

[177] The substituted property's path may not even end up involving the wrongdoer, as tracing still applies when the substituted property is in the custody of an intermediary or a fourth party. Moreover, value can encompass scenarios in which both the wrongdoer possesses both misappropriated and substituted property; one such instance involves a company that redeems outstanding debt through the issuance of stock or proceeds from lower cost debt. *See, e.g.*, Morgan Stanley & Co., Inc. v. Archer Daniels Midland Co., 570 F. Supp. 1529 (S.D.N.Y. 1983) (denying injunctive relief against such redemption even in light of a prohibitory clause in an indenture). Borrowing companies can avoid this question altogether simply by entering into an interest rate swap agreement while issuing debt. I thank Lawrence A. Cunningham for this point.

property that the victim seeks to claim.[178] As one commentator has observed, the notion of value eliminates the "need to show any physical correlation between the asset the plaintiff lost and the asset the defendant received."[179] Equally important, value "inheres in rights, where they are rights in tangible things or not" and thus "simply reifies that which inheres in an asset . . . ."[180] In this way value also serves as a principled basis for the victim's claim.[181]

Reconceptualizing the method in this way clarifies two analytically distinct processes that are often conflated with tracing itself.[182] The first process is what Professor Smith denotes "following." This is an entirely factual and mechanical exercise of locating the misappropriated value that originally belonged to the victim; following "is not a claim or a right in itself. . . . By itself, it does not make anyone liable."[183] Liability is the domain of the second process, what Professor Smith denotes "claiming." This is a justificatory exercise of determining whether liability attaches; claiming affords the victim rights to value, of either the *misappropriated* or *substituted* sort.[184]

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[178] *See* SMITH, *supra* note 43, at 119 ("[Value] is the only constant that exists before, through and after the substitution through which we trace. It exists in a different form after the substitution, and that is what can justify a claim to the new asset."). Another way to conceptualize value is as a category enabling different assets or property to become fungible. *See, e.g.*, Goode, *supra* note 166, at 383 ("Fungibles are tangible assets of which one unit is, in terms of an obligation owed by one party to another, indistinguishable from any other unit . . . ."). This is not to say that the exchange between the wrongdoer and an innocent third party consists of equivalent value. *See id.* at 157 ("The concept of 'tracing value' does not imply or entail that the traceable proceeds of an asset must have a market value equivalent to the market value of that asset."). Because the wrongdoer knowingly provides misappropriated value, that may be or command less than what a legally acquired value would on the market. *See, e.g.*, Richard A. Posner, *An Economic Theory of the Criminal Law*, 85 COLUM. L. REV. 1193, 1196 (1985) ("Since I am unwilling (because unable--but it does not matter why) to pay [the original owner's] price for [the misappropriated value], it follows that the [misappropriated value] would be less valuable in an economic sense in my hands than in his.").

[179] GOODE, *supra* note 151, § 11(ii), at 53.

[180] SMITH, *supra* note 43, at 16.

[181] Tracing does not by itself generate liability. *See id.* at 132; *infra* note 183 and accompanying text.

[182] The distinction between following, claiming, and tracing is not merely theoretical. *See, e.g.*, GOODE, *supra* note 151, at § 11 (ii), at 53 ("These concepts have now been endorsed by the highest authority.") (citing Foskett v. McKeown, 1 A.C. 102, 128 (2002)). American courts implicitly make the same distinction. *See, e.g.*, In re United Cigar Stores Co., 70 F.2d 313, 316 (2d Cir. 1934) ("There can be no recovery . . . where all that can be shown is enrichment of the trustee." Misappropriated trust property "must be clearly traced and identified in specific property.").

[183] SMITH, *supra* note 43, at 10. According to Smith,

> [t]he most salient difference between the exercise of tracing and the exercise of following is that the latter can be exclusively factual. Following can involve no more than the proof that a particular thing was in a certain place at a certain time. Tracing, on the other hand, always involves the application of legal rules.

Id. at 11.

[184] *See, e.g.*, GOODE, *supra* note 151, § 11(ii), at 53.

Although they can be stand-alone processes, following and claiming overlap with the tracing process. The first step is to follow the path of the misappropriated value from the victim to the wrongdoer. At that point, the paths diverge.[185] On the one hand, continuing the exercise of following would lead to an innocent third party and an attempt to restore the original value back to the victim, i.e., specific restitution.[186] On the other hand, abandoning the exercise of following would lead to the exercise of claiming that substituted value in the wrongdoer's custody is a legally unjustified benefit at the victim's expense, i.e., unjust enrichment.[187] This latter step completes the tracing exercise, which thus neither follows the misappropriated value to its ultimate resting point nor claims that the substituted value justifiably belongs to the victim.[188] All that concerns tracing is recognizing substituted value.

C. *Doctrinal Methods*

The litmus test for any conception of remedial tracing is the problem of commingled funds. As one commentator has observed, "[i]t was at one time thought that once money had reached the hands of a banker or broker, it was absolutely merged, not traceable, and so not recoverable, whatever might be the claimant's rights against the customer."[189] Unlike the basic tracing scenario involving an exchange of value between a wrongdoer and a third party, commingled funds introduce another wrinkle. Commingling enables the wrongdoer to substitute fungible value,[190] or more cynically, to launder money.[191]

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[185] *See, e.g.*, SMITH, *supra* note 43, at 8 ("Sometimes a plaintiff will want to conduct both exercises, tracing and following. . . . Both exercises cannot . . . be conducted in relation to the same transaction, except of course as alternatives, because they are mutually inconsistent.").

[186] *See supra* note 160 and accompanying text.

[187] *See supra* note 161 and accompanying text.

[188] *But see, e.g.*, 2 DOBBS, *supra* note 157, § 6.1(3), at 11 ("The purpose of constructive trust, equitable lien and even subrogation, is to require restitution to prevent unjust enrichment.").

[189] MARK HAPGOOD, PAGET'S LAW OF BANKING 177 (10th ed. 1989). Indeed, many civil law commentators maintain that

> [t]he common law will not trace through a mixed fund. . . . In other words, at common law, the question whether anything survives in your hands becomes a question whether there is anything which you hold as the result of one or more clean substitutions, without adding outside funds to those originally received.

BIRKS, *supra* note 45, at 359. *But see, e.g.*, SMITH, *supra* note 43, at 162-74, 174 (challenging this view, as part of a broader conception of tracing that does not abide by the distinction between equity and law, because "[t]he rules of tracing tell us when an asset counts as the substitute for or proceeds of another asset"); *see also supra* notes 150-154 and accompanying text.

[190] *See, e.g.*, SMITH, *supra* note 43, at 161-62 ("This situation has multiple inputs, and multiple outputs as well. It is impossible definitively to ascribe the value being traced to either of the outputs."). The wrongdoer need not be entitled to the additional source of value, as it may come from another illicit transaction.

[191] *See generally* Stephen Moriarty, *Tracing, Mixing and Laundering*, *in* BIRKS, *supra* note 150, at 73.

Courts have devised a myriad of rules for tracing commingled funds. The elementary case involves a bank account that contains a fixed amount of the wrongdoer's own value and the misappropriated value. In this case the victim can claim the full amount of the traceable misappropriated value,[192] even if the wrongdoer deposits additional value into the commingled fund.[193]

The intermediate case involves a commingled bank account from which the wrongdoer has withdrawn value. The dominant approach is to employ a *pari passu* rule.[194] Courts award the victim a proportionate interest in the wrongdoer's bank account at the time it becomes commingled with the misappropriated value. When the wrongdoer only withdraws funds from the bank account, the victim maintains a claim to a proportionate interest in the remaining traceable value.[195] When, however, the wrongdoer has withdrawn and also deposited value within the bank account, courts use what is known as the Lowest Intermediate

[192] *See, e.g.*, 2 DOBBS, *supra* note 157, § 6.1(4), at 16 ("In the simplest situation . . . [t]he plaintiff is entitled to a lien on the commingled fund in the amount of his own monies traced to it."); HAPGOOD, *supra* note 189, at 178 ("[S]o long as money is traceable either in specie or in its proceeds or investment, equity will follow and lay hold of it, under what is known as a tracing order . . . ."). The wrongdoer bears the burden of proving that certain commingled value does not belong to the victim; interestingly, this permits a startling possibility in which the victim could claim all of the value in a commingled fund when the wrongdoer fails to meet the applicable burden. *See id.* at § 6.1(4), at 16 n.3 (citing Hamilton-Brown Shoe Co. v. Wolf Bros. & Co., 240 U.S. 251 (1916); Republic Supply Co. of Calif. v. Richfield Oil Co. of Calif., 79 F.2d 375 (9th Cir. 1935)). This would seem to be an impermissible extraction of the claiming process within rules-based tracing. *See supra* note 187 and accompanying text. In any event, this scenario is not possible under the Securities Act, which caps the amount recoverable by a securityholder to the amount of the offering price and, in the case of section 11, the total award to the aggregate offering yield. *See infra* note 79 and accompanying text.

[193] *See, e.g.*, RESTATEMENT OF RESTITUTION, *supra* note 46, § 215, at 869 cmt. c ("Although subsequent additions of cash from other sources increase the amount of the fund on which the claimant has a lien, they do not increase the amount he is entitled to receive from the fund."). *See also* 2 DOBBS, *supra* note 157, § 6.1(4), at 16 n.2 ("If the fund has grown by the deposit of unidentified funds, there seems no reason to give the plaintiff a proportionate share of the fund."). This is distinct from the situation where the value within the commingled fund appreciates. *See infra* notes 199-200 and accompanying text.

[194] *In re Diplock*, 1 Ch. 465 (1948), is the first notable case in which courts applied this rule. An alternate rule used within civil jurisdictions is known as "First In, First Out," which deems the source of the first deposit into an active commingled account as the source of the first withdrawal. *See, e.g.*, Clayton's Case, 1 Mer. 572 (1816). Because of the difficulty associated with proving the source of the first deposit, some courts proceeded to deem the first withdrawal to be presumptively from the wrongdoer's value, regardless of the order of deposits. *See, e.g.*, Hallet's Case, 13 Ch.D. 696 (1879). *But see, e.g.*, GOFF & JONES, *supra* note 152, at 59.

[195] *See, e.g.*, RESTATEMENT OF RESTITUTION, *supra* note 46, §§ 211, 212. *See also* BIRKS, *supra* note 45, at 363 ("[T]he fund which is held by the defendant is regarded at the moment of the mixing as containing both the plaintiff's money and his own and then as depreciating in the same proportions as it was originally constituted."). *But see* 1 GEORGE PALMER, LAW OF RESTITUTION §§ 2.16, 2.17 (1978) (questioning the mechanics of *pari passu* when the withdrawals are untraceable).

Balance rule;[196] because there are multiple possible sources of value,[197] the victim can claim only up to the lowest balance between the time of the wrongdoer's deposit and tracing.[198]

The difficult case involves a commingled bank account that has appreciated in value. In this case the value may have increased through any number of ways, such as investment or interest. Some contend that the victim should be entitled to no more than the traceable misappropriated value.[199] Others instead advocate a *pari passu* approach, whereby the victim is entitled to claim a proportionate interest in the appreciated commingled value.[200]

None of these rules, however, represents a principled approach to commingled funds as rules-based tracing does. According to Dan Dobbs, "every one of the methods for tracing commingled funds can present a problem on some set of facts."[201] The problem is that these existing methods focus on assets or property in support of a legal claim. In contrast rules-based tracing focuses on value and does not include the analytically distinct exercise of claiming.[202] Under this conception, "[a] mixed substitution creates a mixture of value."[203] Rules-based tracing merely seeks to determine whether commingled funds are a substitution, and thus a mixture, of value; this process "does not entail that the plaintiff has any rights in the traceable proceeds."[204] Commingling perforce involves fungible instruments, typically money within a bank account. This fungibility is the linchpin of any situation where misappropriated value is substituted with value from the wrongdoer or some other party. Certainly, fungibility does not entail substitution. But whenever a wrongdoer commingles fungible instruments, they are either the original value that is the object of following or substituted value that

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[196] *See, e.g.*, Connecticut Gen. Life Ins. Co. v. Universal Ins. Co., 838 F.2d 612 (1st Cir. 1988); Re Mahan & Rowsey Inc., 817 F.2d 682 (10th Cir. 1987); United States v. Bacno Cafetero Panama, 797 F.2d 1154 (2d Cir. 1986).

[197] This includes not only value from the wrongdoer and the victim, but also from another victim or an innocent third party. *See, e.g.*, SMITH, *supra* note 43, at 201 ("[I]t is impossible to say whether or not [a deposit of value] cam from the plaintiff; the account is an indistinguishable mixture of value; but this impossibility is resolved in her favour [sic] against a wrongdoer.").

[198] *See, e.g.*, 2 DOBBS, *supra* note 157, § 6.1(4), at 22.

[199] *See, e.g.*, BIRKS, *supra* note 45, at 366 (citing dicta within *Re Hallet's Estate*, 13 Ch.D. at 709, that "*a fortiori* that as against an innocent defendant the recipient can only say that there survives, in the appreciated asset, the full value of the enrichment originally received"). Birks rightfully notes, however, that this position "seems inconsistent with the view expressed in relation to purchases from an unmixed fund," where the victim is entitled to all of the wrongdoer's proceeds. *Id.*

[200] *See, e.g.*, 2 DOBBS, *supra* note 157, § 6.1(4), at 16 n.2 ("[T]he plaintiff may have a plausible claim not only for a lien to secure his losses, but for a share of the augmented fund represented by the original ratio of his deposits to those of the defendant's.").

[201] *Id.* at § 6.1(4), at 25.

[202] *See supra* note 188 and accompanying text. This is particularly appropriate within the securities context, where the justification for liability is based on the Securities Act and not the tracing requirement. *See infra* Part III.A.

[203] SMITH, *supra* note 43, at 165.

[204] *Id.* at 166.

is the object of tracing. Because portions of the following exercise are part of tracing,[205] commingled funds are safely deemed traceable. Rules-based tracing, therefore, encounters no peculiar difficulties with commingled funds.

INTRADISCIPLINARY TRACING

The previous Parts have navigated through the technical terrain of securities and remedial law to map their respective conceptions of tracing. Within each domain tracing has received particularized criticism. Explicit comparison between these conceptions, however, allows remedial law to reveal the most serious problem with securities law's conception of tracing: it is not actually tracing. Equally troubling, it is not even a form of following. Securityholders must follow their purchase back to a fraudulent offering, and yet never seek specific restitution of these securities. Moreover, because of the book-entry system, these securities are fungible, and thus substitutable, instruments ill-suited to following.

Rules-based tracing can rehabilitate securities law's tracing requirement. The key is to abandon focus on the securities purchased, and instead trace the value exchanged, that is, the money. This value is substituted via the wrongdoer's commingled bank account. And this value is the benefit that a wrongdoer unjustifiably receives at the securityholder's expense. Rules-based tracing also comports with the Securities Act in that the process directs securityholders to claim the statutory provision of monetary relief.

Rules-based tracing handles multiple offerings with relative ease. This is accomplished by a simple designation system in which securityholders arbitrarily select an offering at the point of purchase. For the purposes of asserting a claim, that selection will determine whether the securityholders exchanged value in connection with a fraudulent offering. Designating offerings in this way will restore access private civil relief to all securityholders, and deter fraud optimally. Further, this approach to tracing is not only compatible with the SEC's "access equals delivery" model, but can further its objectives. This Part's intradisciplinary comparison thus yields a superior conceptual and practical framework for rules-based tracing within securities law.

A. *Re-Tracing*

Remedial tracing has no true counterpart within securities law. The latter's conception of tracing filters access to private civil relief under the Securities Act based on what "such security" a person has purchased.[206] This factual inquiry examines a security only to determine the link

[205] *See infra* note 186 and accompanying text.
[206] *See supra* notes 113-114 and accompanying text.

between a securityholder and a fraudulent offering.[207] To "trace" securities successfully means to conclude that an inferable relationship exists between the fraud and the ultimate purchase.[208]

"Tracing" in securities law entails nothing more. Proof of the causal link neither generates nor justifies any legal liability.[209] The source of liability are sections 11 and 12(a)(2) of the Securities Act,[210] and the justification comes from the Securities Act's express purpose of adequate disclosure and implicit purpose of deterrence.[211] Proof of the causal link does not even resolve the question of legal liability. This is true even with respect to the strict liability provided under section 11 of the Securities Act, which requires proof not only of the fraud but also of the defendant's direct role.[212]

Put differently, the remedial counterpart to this securities doctrine would seem to be following. The "tracing" requirement is simply a mechanical exercise in which courts reconstruct the path of a security from a public offering, through a centralized custodian, to a broker or dealer, and then into the hands of a purchaser.[213] The security is but a proxy for the flow of misstatements or omissions within a public offering.[214] Correspondingly, "tracing" here involves no real substitution of the security.[215] On the contrary, to "trace" successfully requires proof that the security from the disputed public offering has not been substituted in any way;[216] that is, the purchaser must perform the complete following exercise, which is "mutually inconsistent" with tracing.[217] Indeed, the only actual substitution involves the requested relief; both sections 11 and 12(a)(2) do not award relief in the form of the

[207] *See, e.g.*, In re: Initial Public Offering Securities Litig., Nos. 21 MC 92, 01 Civ. 3857, 01 Civ. 8408, 01 Civ. 7048, 01 Civ. 9417, 01 Civ. 6001, 01 Civ. 0242, 2004 WL 2297401, at *38 (S.D.N.Y. Oct. 13, 2004) ("Tracing may be established . . . through proof of a direct chain of title from the original offering to the ultimate owner . . . .").

[208] *See supra* Part I.C. This is entirely distinct from the presumption of reliance. *See supra* notes 78, 82, and accompanying text.

[209] Certainly, failure to establish the requisite causal link precludes access to private civil remedies under the Securities Act. To understand tracing in this way, however, is to commit the mistake of seeing the requirement as one of standing. *See supra* note 12 and accompanying text.

[210] *See supra* notes 76-84 and accompanying text.

[211] *See supra* notes 72-74, 85, and accompanying text.

[212] *See supra* note 76.

[213] *See supra* notes 110, 187-188, and accompanying text.

[214] *See supra* Part I.C.

[215] When there is only one public offering, there is still "substitution" of the security in the limited sense that it is fungible with all other like securities via the book-entry system. One, however, does not purchase a "specific" security in the aftermarket and thus one cannot know even the original thing that is "substituted" through a clearing corporation. Moreover, this notion of substitution is merely one of form, and not of value, and thus not relevant for the purposes of tracing. *See* SMITH, *supra* note 43, at 15; *see also supra* notes 174-181 and accompanying text.

[216]*See supra* notes 26-27 and accompanying text; *supra* Part I.C.

[217] *See supra* note 185.

security, but rather its offering price.[218] Courts, therefore, require purchasers to "follow" securities, and yet "substitute" their claim.

Securities law instead should trace the value exchanged and then substituted. The existing method curiously takes the vantage point of the wrongdoer, and follows its direct connection to a security into the purchaser's hands.[219] This inverts and distorts the proper orientation that rules-based tracing takes, which is the value derived from misappropriation.[220] In the context of securities this value is the purchase money. Rather than focusing on the wrongdoer, this inquiry begins with the object of relief, the securityholder. One need go no further than the Securities Act to see the primacy accorded to protecting the securityholder, and thus why it should be the initial vantage point.[221] And to the extent that courts follow anything, it should not be the security, but the money. Beyond the fact that the statutory relief comes in the form of money,[222] this is the misappropriated value that following should seek to locate and then restore.[223]

But following the securityholder's misappropriated value neither entails a substitution nor generates any liability. Rules-based tracing is a process whereby courts determine whether certain substituted value within the wrongdoer's possession is derivative of the victim's original value, and thus is subject to a legal claim.[224] The misappropriated value - the securityholder's money - almost invariably ends up commingled in the wrongdoer's bank account.[225] In a semantic sense this money has changed into equity for the defendant. In a more substantive sense the original value has merged with other value, either from other innocent parties or the wrongdoer, into a fungible mass available for separate

[218] *See* 15 U.S.C. §§ 77*k*(e), 77*k*(g), 77*l*(2) (2004). This is not to say that the substitution in relief is improper. This, however, merely reinforces the fact that liability, and thus claiming, exclusively come from the Securities Act and its rationales.

[219] *See supra* notes 28-33, 127, and accompanying text.

[220] *See supra* notes 174, 185-187, and accompanying text.

[221] *See supra* notes 72-74 and accompanying text. This is compatible with a deterrence rationale for sections 11 and 12(a)(2), pursuant to which *ex post* awards to aggrieved securityholders are justified in their provision of *ex ante* protection to future securityholders. *See supra* note 85. The wrongdoer is relevant only to the extent that the relief provides incentives to prevent further claims by securityholders.

[222] *See* 15 U.S.C. §§ 77*k*(e), 77*l*(2) (2004).

[223] *See supra* note 183 and accompanying text.

[224] *See supra* note 173 and accompanying text. Like following, however, rules-based tracing does not generate liability, which is the subject of claiming. *See, e.g.*, SMITH, *supra* note 43, at 132.

[225] This could be any one of the many classes of defendants subject to section 11 or 12(a)(2) liability. Conceivably, such defendant might deposit the securityholder's money into a separate account that experiences no other deposits or withdrawals. This, however, would devolve into a following exercise. If there are separate deposits or withdrawals, the same tracing principle would apply. To the extent this does not comport literally with rules-based tracing, courts likely would not exalt form over substance. *See, e.g.*, Barnes' Lessee v. Irwin, 2 U.S. (2 Dall.) 199, 203 (1793) ("The substance, and not the form, ought principally to be regarded.").

transactions; this commingling perforce interchanges value, and thus involves a substitution that can only be traced.[226]

And focusing on the substituted value supplies the particular form of relief provided by the Securities Act. Misappropriating original value constitutes an unjustified benefit that a section 11 or 12(a)(2) defendant obtains at the securityholder's expense; this is a paradigmatic case of unjust enrichment.[227] Indeed, this is what sections 11 and 12(a)(2) contemplate by providing claims "either at law or in equity."[228] Further, the substituted value is the specific object of the securityholder's claim. Sections 11 and 12(a)(2) both award monetary relief based on, respectively, the "amount paid for the security,"[229] and the "consideration paid for such security,"[230] without requiring that this be the purchaser's actual misappropriated value.

Rules-based tracing of money represents a principled and justified way to restore access to private civil relief under the Securities Act. The first step is to establish the transfer of the securityholder's money to the defendant, as evidenced by a confirmation of sale or some other form of receipt. The next step is to establish the merger or conversion of the securityholder's money by the defendant with other value, as inferred from a deposit into a bank account containing value from either the wrongdoer or another party.[231] Upon completing these steps, the securityholder can seek to invoke unjust enrichment as a basis for a claim under sections 11 or 12(a)(2).

None of this guarantees that a securityholder will obtain relief. Beyond the admittedly lax requirements of the first two steps, a securityholder must satisfy the elements of unjust enrichment to have avail to a claim. A court, therefore, must determine that there has been no breach of an independent duty and that the benefit to the defendant clearly exceeds the losses to the securityholder.[232] Moreover, completing the rules-based tracing exercise only entitles a securityholder access to private civil relief. A securityholder still must establish a *prima facie* case under section 11 or 12(a)(2). For section 11 this involves proof of the defendant's direct role in an offering and its fraudulent character.[233] For section 12(a)(2), in addition to the section 11 elements, there must be privity.[234] Moreover, defendants certainly have an array of defenses.[235]

[226] Accordingly, even if one wanted to follow the original value, completing the exercise would be virtually impossible whenever a commingled bank account is involved.

[227] *See supra* note 161 and accompanying text.

[228] 15 U.S.C. §§ 77*k*(a), 77*l*(2) (2004).

[229] Section 11 provides a formula for deducting from this "amount paid," with a cap based on the offering price. *See supra* note 79. Notably, one of the deductions involves "the *value* thereof as of the time such suit was brought." 15 U.S.C. § 77*k*(e) (emphasis added).

[230] *Id.* at § 77*l*(2).

[231] Additional value from the securityholder would require only a following exercise. *See supra* note 225.

[232] *See, e.g.*, RESTATEMENT OF RESTITUTION, *supra* note 46, § 1.

[233] *See supra* notes 30-34 and accompanying text.

[234] *See supra* note 83 and accompanying text.

[235] *See* 15 U.S.C. §§ 77*k*(b), 77*l*(2).

B. *Tracing Multiple Offerings*

Rules-based tracing of securities provides a significant benefit, however, that the existing requirement cannot. The existence of the book-entry system and its centralized custodial structure effectively necessitates discrimination between various classes of securityholders.[236] Regardless of the method used, only Class I securityholders have any assurance of claiming private civil relief under the Securities Act.[237] Through inferential reasoning, this assurance extends to Class II, and arguably some Class III, securityholders when there is only one offering.[238] This assurance evaporates, however, when there are multiple offerings; at best Class II securityholders have uncertain access to sections 11 and 12(a)(2), and at worst Class III securityholders have no access whatsoever.[239] As a result, there is a considerable incentive to conduct multiple offerings to avoid substantial liability under the Securities Act.

The way to combat this incentive is resort to intradisciplinary tracing. One possibility is the Fungible Mass method derived from the toxic tort context.[240] The method originated as a way to deal with the problem of indeterminate plaintiffs that cannot pinpoint the source of their injury.[241] To solve this problem, courts have permitted the use of statistical evidence to establish that exposure to a particular substance was more probably the specific cause of the injury than other background factors.[242] Adapted to the securities context, courts would apply a preponderance of the evidence standard to all securityholders.[243] Provided there is a greater than fifty percent probability that a given purchase was from an offering involving material misstatements or omissions,[244] the total number of offerings involved would be irrelevant, and any securityholder could satisfy the existing tracing requirement.[245]

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[236] *See supra* Parts I.B-C.

[237] *See supra* notes 31-32, 121, and accompanying text.

[238] *See supra* notes 33-34 and accompanying text.

[239] *See supra* Part I. C.

[240] *See supra* notes 133-136 and accompanying text.

[241] *See* Sale, *supra* note 19, at 486 & n.361 (analyzing causation issues within *In re "Agent Orange" Product Liability Litigation*, 597 F. Supp. 740, 833-35 (E.D.N.Y. 1984), and noting that the problem also plagues insider trading claims within securities law).

[242] *See* Sale, *supra* note 19, at 486-87 ("Many . . . courts have considered this problem in various toxic-substance contexts and have permitted proof of causation through statistically based evidence.") (citing cases).

[243] *See, e.g.*, Kirkwood v. Taylor, 590 F. Supp. 1375, 1378-79 (D. Minn. 1984), *aff'd*, 760 F.2d 272 (8th Cir. 1985) (unpublished table decision).

[244] *Cf.* 4 WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND 358 (photo. reprint 1978) (9th ed. 1783) (quantifying reasonable doubt as tolerating a 10% error rate). This implicates voluminous evidentiary literature concerning proof paradoxes and Bayesian formulations that cannot be addressed reasonably here. *See generally* L. JONATHAN COHEN, THE PROBABLE AND THE PROVABLE (1977) (Proof Paradoxes); Richard O. Lempert, *Modeling Relevance*, 75 MICH. L. REV. 1021 (1977) (Bayesian Formulation). *But see, e.g.*, Lawrence M. Solan, *Refocusing the Burden of Proof in Criminal Cases: Some Doubt about Reasonable Doubt*, 78 TEX. L. REV. 105, 126 (1999)

Hillary Sale has argued forcefully in favor of using this method instead of the prevailing Direct Tracing approach.[246] The Fungible Mass method now enjoys sufficient currency within torts law that allays early judicial apprehension within securities law.[247] Further, the method comports not only with sections 11 and 12(a)(2),[248] but also the Securities Act's express purpose.[249] And, perhaps most significantly, the method provides Class II and III securityholders more assured access to private civil relief.[250]

This access, however, would not always be available. The Fungible Mass method requires statistical proof that a majority of the shares are from a fraudulent offering. The method's flip-side, then, is that securityholders would have no access to relief when a majority of the shares are from a non-fraudulent offering.[251] Accordingly, the method still generates a perverse incentive. Section 11 and 12(a)(2) defendants can use a non-fraudulent offering to eliminate or undo their liability for a previous fraudulent offering.[252] Alternatively, one could preempt any risk of liability by splitting an originally planned offering into two offerings of equal amounts of securities, only one of which involves fraud. The Fungible Mass method thus provides a solution to the tracing requirement, but suffers from the same current evasion strategy.

Rules-based tracing can eliminate this problem. All that would be necessary with multiple offerings is to give securityholders a choice. At the point of purchase a securityholder would designate an offering to be connected with the value provided. That designation would be recorded

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("Our courts do not use jury instructions based on percentages of certainty, and I do not suggest here that they begin doing so.").

[245] *See* Sale, *supra* note 19, at 488 ("[R]egardless of when they bought their shares, all of the shareholders would be Offering Shareholders and should have access to remedies of sections 11 and 12(a)(2).").

[246] *See id.* at 483-93.

[247] *See id.* at 485 ("[A]cceptance of [statistically derived-proof] has gained ascendancy in all types of civil litigation and can be used for proof of traceability here."). This development directly addresses a reason cited by a court that considered, and then rejected, the Fungible Mass method. *See* In re Elscint, Ltd. Sec. Litig., 674 F. Supp. 374, 381 (D. Mass 1987). Sale's proposal thus builds upon a method that courts already have recognized within the securities context. I see no reason, however, why courts should be any more reluctant to embrace another intradisciplinary method that enjoys currency within the remedial context and is actually a theoretically correct conception of tracing.

[248] *See* Sale, *supra* note 19, at 489-93 (establishing the method's compatibility with various restrictive aspects of both provisions, such as the one-year statute of limitations, liability caps, and strike suit guards).

[249] *See id.* at 493 ("[T]he use of statistics . . . would help to force defendants to take seriously their due-diligence responsibilities to deter misstatements and omissions-the reason Congress created such stringent provisions in sections 11 and 12(a)(2) in the first place.").

[250] *See id.* at 488 (" [S]tatistically derived proof solves the problem of shareholders who purchase Offering Shares in the Aftermarket and are, therefore, unable to meet the direct tracing requirement.").

[251] *See id.* at 489 ("[A]ny time the percentage of later Offering Shares exceeds those in the earlier, disputed offering, the plaintiffs will not succeed with their statistically based evidence.").

[252] *See, e.g.*, *supra* note 36.

by the central depository or issuer, contemporaneous with the purchase. The total number of designations possible would be tied to the number of securities offered. Akin to the rule courts currently apply,[253] designations would operate on a "First-Come, First-In" basis; once all securities in a particular offering are designated, that option would disappear and the process would continue until all such designations of offerings were complete.[254] Securityholders would be permitted only to trace, and then claim, value for designated offerings.

Designations would present no logistical problems. The electronic system currently in place for clearing and settling trades easily could handle recordation of designations. Further, this task would be only a slight imposition for brokers or dealers that already must handle transactions. Accordingly, the systemic and transaction costs of implementing this right-based tracing system would be minimal. At the same time, the designations would provide clear evidence, and thus conserve judicial resources that the existing tracing inquiry does, or the Fungible Mass method would, expend.[255]

Further, designations would present no legal difficulties. The fact that securityholders necessarily must choose an offering without knowing *ex ante* which designation will lead to a claim is entirely consistent with sections 11 and 12(a)(2)'s bar on securityholders purchasing while knowing of fraud.[256] And because the number of designations and securities offered are linked, the cap on damages to offering price would ensure that the maximum aggregate liability would comply with the statutory limit.[257]

Moreover, the limit on designations effectively addresses any policy concerns about the accuracy of relief. On the one hand the class of claimants may be overinclusive. Certainly there will be some securityholders that will choose an offering actually unconnected with the exchanged value;[258] and some securityholders will be able to make a claim even though they exchanged value in connection with a non-fraudulent offering.[259] On the other hand the class of claimants may be underinclusive. There will be other securityholders that will not be able to choose the offering actually connected with their exchanged value;

[253] *See supra* note 194 and accompanying text.

[254] As with other methods, this designation scheme would be unnecessary when there is only one offering, as all those securities are already traceable. *See supra* note 130.

[255] *Cf.* Linda J. Candler, *Tracing and Recovering Proceeds of Criminal Fraud Cases: A Comparison of U.S. and U.K. Legislation*, 31 INT'L LAW. 3, 4 (1997) (In numerous cases "tracing the assets and recovering the proceeds of the fraud have proved to be difficult, time-consuming, and expensive.")

[256] *See* 15 U.S.C. §§ 77*k*(a), 77*l*(2) (2004).

[257] *See id.* at §§ 77*k*(e), 77*l*(2).

[258] Courts historically have viewed this concern as one of legal causation. *See, e.g.*, Barnes v. Osofsky, 373 F.2d 269 (2d Cir. 1967). As demonstrated earlier, such a view is premised on a conception of tracing that is actually following. *See supra* notes 213-218 and accompanying text. Rules-based tracing, however, is not concerned with the connection between misappropriated value and a fraudulent offering. *See supra* notes 219-223 and accompanying text.

[259] *See* Sale, *supra* note 19, at 489-91.

and some securityholders will not be able to make a claim even though they exchanged value in connection with a fraudulent offering.[260]

While there is no guarantee that these different groups will be symmetrical, and thus offset each other,[261] the amount of relief certainly will be accurate. From the standpoint of a section 11 or 12(a)(2) defendant the limit on the number of designations ensures that the liability will not exceed the capped offering price.[262] To the extent that sections 11 and 12(a)(2) seek to deter, rather than compensate,[263] these designations would achieve a superior result than any of the existing methods.[264] Indeed, these designations theoretically should produce the optimal amount of desired deterrence contemplated by statute.

At the same time, the designations employ an egalitarian approach to all classes of securityholders. Unlike existing approaches that follow securities, the designation system is based on the value exchanged. This is manifest in how securityholders would select an offering at the time of purchase, which is when an exchange of value occurs. Class I securityholders effectively will experience no difference under this scheme, as they will have the first opportunity to make a designation. And unless Class I securityholders purchase the entire offering, Class II and III securityholders also will have an opportunity to make a designation. This is because the capacity to designate, and thus seek a claim, would turn on not a securityholder's access, but the relationship between the value exchanged and the number of securities offered.[265] Rules-based tracing thus eschews the need to make "arbitrary

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[260] Securityholders can avoid this result by simply purchasing at least two shares and hedging their designations on different offerings. A modest consequence of such rational hedging might be that shares from different offerings will trade at different prices, particularly in response to one offering being barred by the statute of limitations and in situations where the company has a less than pristine reputation. A more cynical consequence might be the emergence of a secondary post-purchase market in which securityholders trade their designations about which offerings might involve material misstatements or omissions. I thank Tung Yin for raising these points.

Both possible consequences present the same basic problem of variances between different designated shares, either for the same company or between separate companies. As a preliminary matter, these variances can be accounted for and justified by the Efficient Capital Markets Hypothesis. *See supra* note __. Moreover, the market would be limited by the one-year statute of limitations running from the post-effective date. And, in any event, these secondary claims likely would not generate any additional liability; because the designation scheme eliminates any uncertainty in claiming, any securityholder that had designated a fraudulent offering likely would assert a claim. Finally, as the aggregate recovery cap limits the number of permissible claims, courts simply could look at the records for securityholders that had made initial designations and prefer their claims.

[261] *But cf.* RESTATEMENT OF RESTITUTION, *supra* note 46, § 1 cmt. d ("Ordinarily the benefit to the one and the loss to the other are co-extensive, and the result . . . [will be] to make restitution to the other for the loss which he has suffered.").

[262] *See id.* at §§ 77*k*(e), 77*l*(2).

[263] *See supra* 85.

[264] As Sale has noted, "[t]he most important argument . . . is that without a new way to prove tracing, the mechanism to enforce the recovery rights of [Class II and III securityholders] is eliminated." Sale, *supra* note 19, at 491.

[265] *See supra* note 253.

distinctions" between securityholders.[266] Instead, the market for purchasing securities would govern the capacity to seek private civil relief under the Securities Act.

C. *Value Equals Access Equals Delivery*

The SEC's "access equals delivery" model is remarkably compatible with the rules-based tracing scheme proposed here. The model strives to streamline the procedures for effecting delivery of a final prospectus without compromising investor confidence about their participation in a registered offering.[267] The additional notification provision cuts against this objective. The provision effectively requires delivery of a notice by a "well-known seasoned issuer" in lieu of the final prospectus delivery requirement that the model seeks to relax.

To be sure, this notification requirement is necessary to protect investors. Notice performs a valuable function in confirming that a purchase was part of a registered transaction. This reassures investors of their access to certain private civil remedies in the event that the offering turns out to be fraudulent.[268] Whether deliberate or not, however, the SEC no longer explicitly bases the need for notice on "an investor's ability to trace securities."[269] Certainly this ability has deteriorated at the hands of the book-entry system and judicial formulations of the "tracing" requirement.[270] As a result, while delivery of a final prospectus can be effected through online access, securityholders no longer have reliable access to private civil remedies under the Securities Act.

Rules-based tracing would obviate the need for a notification requirement. Tellingly, the notification requirement does not revolve around the path of the security, but rather the transactional status of the purchase, that is, the exchange of value.[271] Similarly, designating an offering at the point of purchase enables securityholders to later trace the exchange, and subsequent substitution, of misappropriated value. This scheme thus would reassure all initial participants in a "well-known seasoned issuer's" offering that they will be capable of seeking relief through sections 11 or 12(a)(2).[272] Such reassurance is what the notification requirement presumably seeks to provide.

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[266] In re: Initial Public Offering Sec. Litig., Nos. 21 MC 92, 01 Civ. 3857, 01 Civ. 8408, 01 Civ. 7048, 01 Civ. 9417, 01 Civ. 6001, 01 Civ. 0242, 2004 WL 2297401, at *37 (S.D.N.Y. Oct. 13, 2004).

[267] *See supra* notes 3-5 and accompanying text.

[268] *See supra* note 7 and accompanying text.

[269] *See supra* notes 9-10 and accompanying text.

[270] *See supra* Parts II.B-C. Under the "access equals delivery" model securityholders still would receive a confirmation of sale and subsequently could request a copy of the final prospectus. *See Securities Offering Reform*, 69 Fed. Reg. at 67439. Because issuers eligible for the "access equals delivery" model must be relatively established and reliable, *see id.*, there is a limited need for reassurance that rules-based tracing can satisfy. For other issuers rules-based tracing would not supplant existing final prospectus and notification requirements.

[271] *See supra* notes 224-226 and accompanying text.

[272] *See supra* notes 254-264 and accompanying text.

CONCLUSION

Tracing is a method that appears within multiple fields of law. Courts frequently trace in agency,[273] antitrust,[274] bankruptcy,[275] commercial,[276] contract,[277] criminal,[278] elderly,[279] family,[280] property,[281] tax,[282] and tort[283] matters. These applications are matched perhaps only

[273] *See, e.g.*, MARK HAPGOOD, PAGET'S LAW OF BANKING 372 (11th ed. 1996) ("A fundamental condition for property to be traced in equity is the existence of an equitable relationship."). *But cf. supra* note 152.

[274] *See, e.g.*, Amy A. Marasco, Note, *Tracing an Antitrust Injury in Secondary Line Price Discrimination Cases*, 50 FORDHAM L. REV. 909, 926-27 (1982) ("[C]ourts have taken a stricter approach to the concept of tracing and have allowed damages only when it has been clear that the injury did not result from any form of legitimate competition or the plaintiff's own inadequacies.").

[275] *See, e.g.*, Steve H. Nickels & Edward S. Adams, *Tracing Proceeds to Attorneys' Pockets (and the Dilemma of Paying for Bankruptcy)*, 78 MINN. L. REV. 1079, 1104-05 (1994) ("When the debtor commingles proceeds with non-proceeds, courts employ a fictional tracing method known as the lowest intermediate balance rule, derived from the *Restatement (Second) of Trusts*.").

[276] *See, e.g.*, Richard L. Barnes, *Tracing Commingled Proceeds: The Metamorphosis of Equity Principles into U.C.C. Doctrine*, 51 U. PITT. L. REV. 281, 282 (1990) ("In creating [a] principle of attribution, the drafters of [U.C.C.] section 9-306 . . . borrowed tracing rules from the laws of trusts, equity and restitution and infused Article Nine with them.").

[277] *See, e.g.*, Matthews v. Crowder, 69 S.W. 779, 780 (Tenn. 1902) ("[T]he supplementary subjection . . . results from . . . the doctrine that a *cestui que* trust may follow the trust fund wherever he may be able to trace it, except in the hands of innocent third persons.").

[278] *See, e.g.*, Newton v. Porter, 69 N.Y. 133, 136 (N.Y. 1877) ("[T]he owner of negotiable securities stolen and afterwards sold by the thief may pursue the proceeds of the sale in the hands of the felonious taker or his assignee with notice, through whatever changes the proceeds may have gone, so long as the proceeds or the substitute therefor [sic] can be distinguished and identified . . . .").

[279] *See, e.g.*, Janel C. Frank, Note, *How Far Is Too Far? Tracing Assets in Medicaid Estate Recovery*, 79 N.D. L. REV. 111, 144 (2003) ("Most states have interpreted [the Omnibus Budget Reconciliation Act] as allowing them to trace and recover assets that were once owned by the recipient spouse from the estate of the surviving spouse.").

[280] *See, e.g.*, J. Thomas Oldman, *Tracing, Commingling, and Transmutation*, 23 FAM. L.Q. 219, 223-24 (1989) ("[T]o establish a separate property claim to funds in existence at the time of divorce, a spouse must be able to trace such funds to separate property.").

[281] *See, e.g.*, ANDREW P. BELL, MODERN LAW OF PERSONAL PROPERTY IN ENGLAND AND IRELAND 462 (1989) ("The law of tracing embraces . . . rules relating to the situation where the subject-matter of an interest has been disposed of or undergone some change of form or mixing with other property.").

[282] *See, e.g.*, Alfred D. Youngwood & Christina M. Cerrito, *Tracing Property After Its "Owner" Changes: Sections 337, 704(c)(1), 737, 751, 382, 384, 1031, and 1374*, 51 TAX LAW. 511, 512 (1998) ("Congress has chosen to track the property movements in certain of these business arrangements . . . to prevent income or basis shifting among parties who might have the incentives and ability to do so.").

[283] *See, e.g.*, James Leonard, *Ubi Remedium Ibi Jus, Or, Where There's a Remedy, There's a Right: A Critique of* Ex Parte Young, 54 SYR. L. REV. 215, 245 n.230 (2004) ("Nineteenth century equity courts developed presumptions that permitted tracing of monies that had been illegally deposited in the tortfeasor's bank account and commingled with other funds.") (citing cases).

by the multiplicity of names tracing has assumed over the years.[284] More significantly, an absence of dialogue between legal domains has spawned different conceptions of tracing within securities and remedial law that engender radically divergent results. In securities law tracing deprives securityholders of private civil relief, whereas in remedial law, tracing provides restitutionary relief to victims deprived of their value.

Undoubtedly, these inverted conceptions of tracing are the product of unconscious accident, and not premeditated design. As one commentator has observed,

> Were symmetrical categories and doctrines joined, courts would have no trouble spotting their intra-connection; it is only when the Siamese-doctrines are severed that they may wander off in different directions.[285]

The principal difficulty, however, lies not in spotting these "intra-connections," but rather in convincing the law to use them. Centuries of remedial tracing jurisprudence stand ready for courts to reconsider the securities tracing requirement. All courts need to do is acknowledge the value of money.

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[284] *See supra* notes 165-169 and accompanying text.
[285] Hirsch, *supra* 66, at 1154.