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## California State Appeals Court Holds that ETF Investors Cannot Assert Securities Act Claims

On January 23, 2020, the Court of Appeal of the State of California issued its opinion in [\*Jensen v. iShares Trust\*](#),<sup>1</sup> affirming a trial court's holding, after a bench trial, that investor-plaintiffs who purchased shares of an ETF lacked standing to bring claims under the civil liability provisions (Section 11 and Section 12(a)(2)) of the Securities Act of 1933. Specifically, the court held:

- Section 11 standing is limited to persons who purchase securities that are the direct subject of (*i.e.*, “traceable” to) the allegedly misleading registration statement. Section 11 requires claimants to demonstrate that their shares were initially offered to the public by the issuer under the allegedly misleading registration statement or amendment thereto.
- Section 12(a)(2) of the Securities Act permits claims against a seller of a security by prospectus only by persons purchasing the security from that seller, thereby limiting the class of potential plaintiffs to those who purchased the security directly from the issuer of the prospectus, as well as certain solicitors deemed to be statutory sellers due to a direct relationship with the purchasers.

In *Jensen*, the plaintiffs alleged that the ETF's registration statements and amendments (“offering documents”) issued or filed between 2012 and 2015 were false or misleading because the offering documents failed to disclose the risks associated with using stop-loss orders with ETF shares in light of the possibility of flash crashes, such as the flash crash that occurred in August 2015, which resulted in losses to the investors. However, as described below, the court (like the trial court) did not have to address these allegations.

The investors purchased their ETF shares in the secondary market. Because the investors were unable to trace their purchases back to the allegedly misleading offering documents, the court affirmed the trial court's holding that the plaintiffs lacked standing to assert a claim under Section 11. The court also held that, because the plaintiffs did not allege sufficient direct contact with the ETF and other defendant-respondents (*e.g.*, the ETF's adviser and principal underwriter) – particularly in view of the fact that the investors purchased their ETF shares in the secondary market – the investors lacked standing to bring a claim under Section 12(a)(2).

### Observations

The California court's holding and thorough analysis in *Jensen* could prove to be valuable in defending ETF industry participants against future securities litigation. The civil liability provisions of the Securities Act impose essentially “strict liability” on defendants, meaning that plaintiffs need not allege or prove “scienter” – that is, an intent to mislead – to establish liability. This aspect has made the Securities Act the preferred tool of the plaintiffs' bar in asserting securities claims against traditional open-end mutual funds. In the open-end context, where fund shares are purchased directly from the issuing fund, establishing Securities Act standing is generally not a high hurdle. The reasoning in *Jensen* draws a clear distinction between traditional open-end funds and ETFs, providing a well-reasoned analysis as to why purchasing ETFs on the secondary market is no different than buying shares of a typical operating company for Securities Act purposes. Significantly, the California court was untroubled by the clear implication that, under its reasoning, most Securities Act claims against ETFs would effectively be precluded. Here, the court responded that was an issue for Congress, and that the court was simply applying the statute “as written.”

<sup>1</sup> 44 Cal. App. 5th 618, 2020 Cal. App. LEXIS 61, 2020 WL 373299.

*Jensen* is an intermediate appellate court decision, and the plaintiffs have filed an appeal to the California Supreme Court. Even assuming it is affirmed by the state's high court, the holding will not be binding on any federal courts or in any other state. However, given the court's very thorough analysis, *Jensen's* reasoning may prove to be persuasive to courts in other jurisdictions when considering similar ETF litigation in the future.

Another open question is whether *Jensen's* reasoning, even if embraced by other courts, will improve the chances of getting a motion to dismiss granted on standing grounds. To date, the case law has been quite forgiving at the pleading stage to plaintiffs regarding the tracing requirement. The plaintiffs' Section 11 claims in *Jensen* were dismissed only after a bench trial focused on the issue.

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