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California Federal Court Holds That U.S. Securities Laws Do Not Apply to Unsponsored, Unlisted ADRs

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The U.S. District Court for the Central District of California held on May 20, 2016 that the federal securities laws do not apply to U.S. transactions in unlisted, unsponsored American Depositary Receipts (ADRs) for a foreign issuer's shares. The decision in *Stoyas v. Toshiba Corporation* also held that principles of international comity and *forum non conveniens* precluded U.S. investors from asserting claims under Japanese law arising from purchases of Toshiba securities on a Japanese stock exchange.

The *Toshiba* ruling is perhaps the first court decision squarely holding that the federal securities laws do not apply to unlisted, unsponsored ADRs. The decision reinforces the U.S. Supreme Court's effort to curtail the reach of U.S. securities laws and to allow other countries to regulate securities transactions on their own markets. The decision also cuts off attempted end-runs around those principles through assertions of foreign-law claims in U.S. courts.

Factual Background

The *Toshiba* case involved allegations of accounting fraud at a Japanese company, whose common stock traded only on exchanges in Japan. The putative U.S. class action was filed on behalf of (*i*) persons who had purchased Toshiba ADRs during the putative class period and (*ii*) all citizens and residents of the United States who had "otherwise acquired shares of Toshiba common stock" during the class period – presumably through purchases on a Japanese exchange.

Defendants moved to dismiss the securities-law claims in light of the U.S. Supreme Court's 2010 decision in *Morrison v. National Australia Bank*, which held that the federal securities laws apply only to allegedly fraudulent statements or omissions made "in connection with the purchase or sale of [i] a security listed on an American stock exchange, and [ii] the purchase or sale of any other security in the United States." Defendants argued that *Morrison*'s first prong did not apply because Toshiba's ADRs were not listed on an exchange; they were traded only on the over-the-counter (OTC) market, which is not a "stock exchange." Defendants further contended that *Morrison*'s second prong did not apply because Toshiba itself had not engaged in any U.S. transaction in connection with its unlisted, unsponsored ADRs.

Defendants also moved to dismiss the Japanese-law claims, asserting that principles of international comity and *forum non conveniens* barred U.S. litigation arising from purchases of Japanese securities on Japanese markets and allegedly fraudulent statements made in Japan.

The court agreed with defendants on all points.

The Court's Decision

Inapplicability of Federal Securities Laws

The court first held that "the OTC market in this case is not a domestic exchange satisfying the first prong of *Morrison*." In so ruling, the court followed an earlier decision by the U.S. Court of Appeals for the Third Circuit and noted that the securities laws distinguish between securities exchanges and OTC markets.

The court next concluded that plaintiffs had not satisfied *Morrison*'s second prong because they had not pled facts showing that Toshiba itself had been involved in a securities transaction in the United States in connection with its unlisted, unsponsored ADRs. The court's analysis turned on the nature of ADRs and the difference between sponsored and unsponsored ADR programs.

In an ADR transaction, a depositary bank purchases the foreign issuer's common shares on a foreign exchange and then sells receipts for those shares – the ADRs – to U.S. investors. The U.S. investor has therefore engaged in a transaction with the depositary bank, not with the foreign issuer. An ADR program can be sponsored or unsponsored. In a sponsored ADR program, the issuer is involved in setting up the program. An unsponsored program is established by the depositary bank without the issuer's involvement – and perhaps even without the issuer's consent.

The court ruled that, because Toshiba's ADR program was unsponsored, Toshiba itself had not been involved in the U.S. transactions through which U.S. investors had acquired ADRs from the depositary banks. The court concluded that "nowhere in *Morrison* did the [Supreme] Court state that U.S. securities laws could be applied to a foreign company that only listed its securities on foreign exchanges but whose stocks are purchased by an American depositary bank on a foreign exchange and then resold as a different kind of security (an ADR) in the United States." Allowing U.S. investors to sue the foreign issuer under U.S. law in these circumstances "would create essentially limitless reach of [securities] claims because even if the foreign defendant attempted to keep its securities from being sold in the United States, the independent actions of depositary banks selling on OTC markets could create liability. This is inconsistent with the spirit and law of *Morrison*."

Inappropriateness of Allowing Foreign-Law Claims

The court then turned to plaintiffs' claims under Japanese law on behalf of U.S. investors who had bought Toshiba stock in Japan. The court rejected this effort to circumvent *Morrison*'s restrictions on U.S. lawsuits against foreign issuers arising from foreign securities transactions.

The court first held that principles of international comity precluded U.S. litigation of a Japanese cause of action "for actions of a Japanese company that only lists its securities in Japan (which is also where the fraudulent accounting primarily took place)." The court noted that comity considerations had undergirded *Morrison*'s refusal to allow U.S. law to regulate foreign securities transactions.

The court also held that the doctrine of *forum non conveniens* mandated dismissal of the Japanese-law claims. The court concluded that litigating the case in the United States would be inconvenient because the relevant documents, parties, and witnesses were in Japan and because applying Japanese law would present a challenge.

Implications

The *Toshiba* decision marks an important step toward resolving an issue that has arguably remained open since the 2010 *Morrison* decision: whether the U.S. securities laws apply to suits against a foreign issuer arising from transactions in unsponsored, unlisted ADRs. Courts have addressed (not always with consistent results) sponsored and listed ADRs, sponsored but unlisted ADRs, swap transactions, contracts for difference, spread bets, and other derivative-type instruments. The *Toshiba* case now squarely addresses unsponsored, unlisted ADRs – and holds that the U.S. securities laws do not apply to them.

The ruling also reinforces other decisions that have rejected investors' attempts to assert foreign-law claims in U.S. courts in situations where *Morrison* bars claims under U.S. law.