California Federal Court Holds that U.S. Securities Laws Apply to Unsponsored, Unlisted ADRs

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The U.S. District Court for the Central District of California held on January 28, 2020 that the federal securities laws 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* do not preclude an exercise of supplemental jurisdiction over U.S. investors' claims under Japanese law arising from purchases of a Japanese company's ordinary shares on a Japanese stock exchange.

The *Stoyas* ruling is perhaps the first decision to address whether alleged misrepresentations or omissions affecting unsponsored ADRs can satisfy the Securities Exchange Act's "in connection with" requirement. The answer appears to turn on the facts concerning the issuer's involvement (if any) with the ADR program even if the issuer did not actually sponsor that program.

Factual Background

The *Stoyas* 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 unsponsored, unlisted ADRs.

Defendants also moved to dismiss the Japanese-law claim arising from purchases on the Japanese market. Defendants asserted 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 District Court held for the defendants on all points, but the U.S. Court of Appeals for the Ninth Circuit reversed and remanded the ruling in 2018. The Ninth Circuit agreed that the OTC market was not a "stock exchange," so *Morrison*'s first prong did not apply. But the Ninth Circuit held that ADRs – even if derivative of the underlying non-U.S. shares – are themselves "securities" under the Exchange Act and, if purchased in domestic transactions, are subject to the U.S. securities laws under *Morrison*'s second prong. The court appeared to save questions about the derivative nature of ADRs for the separate "in connection with" requirement under § 10(b) of the Exchange Act: the complaint must sufficiently plead the non-U.S. issuer's connection to the transactions in unsponsored ADRs.

As for whether the unsponsored ADRs had been purchased in U.S. transactions, the Ninth Circuit adopted the Second and Third Circuits' "irrevocable liability" standard: a securities transaction occurs when and where the parties incur irrevocable liability to take and pay for, or to deliver, a security. Relevant facts can include where the contract was formed, where the purchase orders were placed, where title passed, and where money was exchanged

The Court's Decision

Federal Securities-Law Claims

On remand, the District Court held that the plaintiff had plausibly alleged that it had incurred irrevocable liability to buy the ADRs in non-exchange transactions in the United States. The amended complaint pled that the plaintiff had placed buy orders and paid the purchase price in the United States, using funds from a New York bank, that title had transferred in the United States, and that the purchase had been directed by the buyer’s outside investment manager in New York.

Perhaps more interesting, because a more novel question, was the court’s analysis of § 10(b)’s “in connection with” requirement to determine whether a substantive violation of the Exchange Act had occurred. The court ruled that the plaintiff had satisfied that requirement (in part) by alleging “the nature of the [Toshiba] ADRs, the OTC Market, the Toshiba ADR program, including the depositary institutions that offer Toshiba ADRs, the Form F-6s, the trading volume, the contractual terms, and Toshiba’s plausible consent to the sale of its stock in the United States as ADRs.” The court also focused on the allegation that a major U.S. bank was one of Toshiba’s ten largest shareholders during the class period and that “‘it is unlikely that [that] many shares [needed to support the ADR program] could have been acquired on the open market without the consent, assistance or participation of Toshiba.’” The court therefore held that the plaintiff had “sufficiently alleged Toshiba’s plausible participation in the establishment of the ADR program.”

Japanese-Law Claim

The District Court previously had refused to exercise supplemental jurisdiction over the claim under Japanese law on behalf of U.S. investors who had bought Toshiba stock in Japan. The court had ruled 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)” and that the doctrine of *forum non conveniens* also mandated dismissal. The Ninth Circuit did not rule on that portion of the District Court’s decision; it “decline[d] to address in the first instance whether dismissal of the [Japanese-law] claim remains appropriate notwithstanding the Exchange Act claims’ viability.”

On remand, the District Court held that, in light of its conclusion that the plaintiff had sufficiently pled Exchange Act claims, comity and *forum non conveniens* "d[id] not compel dismissal" of the Japanese-law claim.

Implications

The court's holding that the Exchange Act can apply to purchases of unsponsored ADRs adds to the handful of cases discussing ADRs and represents a fairly routine application of the now-familiar "irrevocable liability" standard in light of the Ninth Circuit's decision. But the court's analysis of the "in connection with" requirement is something new. The Ninth Circuit had departed from the Second Circuit's willingness to consider – at least in some circumstances – whether the derivative nature of an unlisted security (here, an unsponsored ADR) could remove that instrument from *Morrison*'s second prong. The Ninth Circuit had held, in effect, that a security (an ADR) is a security even if it is derivative of another security (the Japanese ordinary shares), and it had shifted to the "in connection with" analysis the question about the non-U.S. issuer's involvement or lack of involvement in the issuance of the unsponsored ADRs.

The District Court was therefore required to conduct that analysis as part of the "in connection with" requirement. And its decision seems to have turned on facts suggesting (at least at the pleading stage) that Toshiba somehow must have consented to or participated in the depositary institutions' issuance of the ADRs even if Toshiba had not actually sponsored the ADR program. The opinion does not lay out many of the specific factual allegations that led to that conclusion, but the magnitude of a large U.S. bank's holdings of Toshiba's shares seems to have been a significant factor. Future cases will likely explore what types of facts can satisfy the "in connection with" requirement for unsponsored ADRs.

The ruling also illustrates that, if U.S. investors' Exchange Act claims can withstand a motion to dismiss, a court might be willing to exercise supplemental jurisdiction over U.S. citizens' and residents' foreign-law claims for purchases on non-U.S. markets.

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