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California Federal Court Holds U.S. Securities Laws Inapplicable to Unsponsored, Unlisted ADR Transaction Preceded by Purchase of Common Stock Outside the U.S.

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The U.S. District Court for the Central District of California held on January 7, 2022 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 where the ADR purchases depended on prior purchases of the underlying common stock on a foreign exchange. The decision in the long-running *Stoyas v. Toshiba Corporation* case illustrates the importance of investigating the factual circumstances underlying purchases of unlisted ADRs even if securities claims based on those transactions might survive a motion to dismiss, as they had done here.

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 alleged misstatements 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.

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 case 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.

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 investment manager in New York.

The case continued, and the parties litigated certification of a class of ADR purchasers. The court declined to certify the class, holding that the lead plaintiff's claims were not typical because the lead plaintiff had not purchased its ADRs in a domestic transaction.

The Court's Decision

The court held that, even if the plaintiff had committed itself in the United States to buy the ADRs, the plaintiff's domesticity analysis "ascribe[d] little importance to the first step in the ADR conversion process: the purchase of Toshiba common stock." The facts of this ADR transaction showed that the ADR purchase "was contingent upon the purchase of underlying shares of common stock that could be converted into ADRs." That purchase had occurred in Japan, when traders bought the common shares on the Tokyo Stock Exchange.

The traders had purchased the common stock in Japan specifically because of the plaintiff's ADR transaction. But for that ADR transaction, the traders would not have put their money at risk in Japan. Accordingly, "the moment [the traders] completed the transaction for Toshiba common stock on the Tokyo Stock Exchange, . . . [the plaintiff] became logically and legally bound to perform its contractual obligations" to buy the ADRs even though the common stock had not yet been converted into ADRs. The plaintiff therefore incurred irrevocable liability to take and pay for the ADRs when the common stock was purchased in Japan, so the ADR transaction was not a domestic one under the Ninth Circuit's "irrevocable liability" standard.

The court acknowledged the "possibility" that, on a different set of facts, "a purchaser might acquire unsponsored ADRs in a domestic transaction." Here, however, the evidence showed that "the underlying shares of Toshiba common stock were purchased in Japan, on the Tokyo Stock Exchange, prior to conversion" into the ADRs. Because the plaintiff was bound to take and pay for the ADRs as soon as the Japanese transaction involving the common stock took place, the plaintiff incurred irrevocable liability in Japan, not in the United States.

Implications

The court's holding shows the importance of examining the facts underlying particular transactions in unlisted, unsponsored ADRs. The plaintiff had survived a motion to dismiss based on its allegations that it had placed an order for the ADRs through its investment manager in New York; the investment manager had placed a buy order through its broker in New York; the broker had purchased the ADRs using the OTC Link trading platform; and the plaintiff had paid for the ADRs by transferring funds from its New York bank to the New York broker. Those allegations, on their own, sound like a domestic transaction.

But, as the court ultimately ruled, the complaint had not explained that the New York actions had all depended on the prior purchase of the common stock on the Tokyo Stock Exchange – a transaction that required the plaintiff to buy the ADRs once the common stock was converted. The development of those facts ended up changing the outcome of the case.

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