Case Law Settles on Sponsored ADRs as Within U.S. Regulatory Scope

by Prof. Olav A. Haazen, PhD.[1]

In July of 2016 we wrote of the uncertainty surrounding ADRs and synthetic securities and the lower courts' expansive readings of the prohibition on applying U.S. securities laws to ADRs traded in the United States in the wake of *Morrison v. National Australia Bank*, 561 U.S. 247 (2010). Some of that uncertainty is now fading for ADRs, as the courts appear to be settling on a bright-line rule that all ADRs *sponsored* by the issuer of the underlying foreign stock are within the scope of U.S. laws and regulations—even if the fate of *unsponsored* ADRs traded over-the-counter remains unclear.

The Supreme Court of the United States held in *Morrison* that under its new transactional test, the fraud provisions of Section 10(b) and Rule 10b-5 apply only to transactions in securities listed on U.S. exchanges and to sales and purchases of non-listed securities that took place in the United States. Accordingly, purchasers of foreign securities cannot sue for fraud under U.S. law. That raises questions about the status of American depositary receipts or ADRs. ADRs are receipts issued by a depositary bank that represent a specified amount of a foreign security that has been deposited with the depositary. The receipts may be traded on a U.S. exchange or over-the-counter. In *City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173 (2d Cir. 2014), the Second Circuit Court of Appeals held that, notwithstanding the Supreme Court's wording, an ADR's listing in the United States is not sufficient; the ADR must also be traded there. The district court in *Petrobras* followed that same rule in 2015. *In re Petrobras Sec. Litig.*, 150 F.Supp.3d 337 (S.D.N.Y. Dec. 20, 2015).

In the *Toshiba* matter, a federal court in California made a further attempt to change the law by placing even transactions that indisputably occurred in the United States beyond the scope of U.S. securities laws. *Stoyas v. Toshiba Corp.*, 191 F. Supp. 3d 1080 (C.D. Cal. 2016). Toshiba's common stock was listed in Tokyo and Nagoya, purchased there by the depositary bank, and sold *by the bank* as American depositary shares (similar to ADRs) to investors in the United States. The court reasoned that foreign issuers should have a chance to avoid liability under U.S. law by deciding not to sell their securities in the United States, and that finding liability in connection with unsponsored ADSs would be the direct result of the independent actions of depositary banks selling on over-the-counter markets. The court's reasoning ignores, of course, that liability would have been, first and foremost, the result of the defendant's own fraudulent actions, rather than the actions of the depositary.

Toshiba's holding is at odds with the Supreme Court's holding in *Morrison* that the relevant inquiry is simply 'whether the purchase or sale is made in the United States' and that the place of the transaction must be 'the exclusive focus.' *Morrison*, 561 U.S. at 268-70. It also conflicts with a series of similar cases, cited in our Vol. 4/2016 newsletter, involving synthetic securities.

Most recently, on January 4, 2017, another federal court in California has now held in the *Volkswagen* case that issuer-sponsored ADRs traded in the United States *are* subject to U.S securities laws, even when they involve the lowest level ('Level 1') ADRs that are not, as such, subject to the reporting requirements of the Securities Exchange Act. *In re Volkswagen "Clean Diesel" Mkt., Sales Pracs., and Prods. Liab. Litig.*, 2017 WL 66281 (N.D. Cal. Jan. 4, 2017). Pursuant to SEC Rule 12g3-2, disclosures must, however, comply with German law and be posted in English on Volkswagen's website. *See* 17 C.F.R. § 240.12g3-2. The court found that under those circumstances plaintiffs' purchases of Volkswagen's ADRs qualify as domestic transactions. By sponsoring the ADRs, Volkswagen had been directly involved in offering the securities to U.S. investors, and as part of that offering Volkswagen had agreed to comply with SEC rules requiring it to make information available to U.S. investors. While the *Volkswagen* court did not endorse *Toshiba*'s holding concerning unsponsored ADRs, *Volkswagen*'s reasoning appears to echo *Toshiba*'s rationale that the application of U.S. law turns on whether the transactions resulted from the foreign issuer's own decision or the independent actions of depositary banks. *See also Atlantica Holdings v. BTA Bank JSC*, 2015 WL 144165 (S.D.N.Y. Jan. 12, 2015).

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