

## Ninth Circuit Holds Transactions in Un-sponsored ADRs Can Be “Domestic” Under Morrison

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The [Toshiba Securities Litigation](#) stems from alleged violations of the [Exchange Act](#), as well as the [Financial Instruments and Exchange Act of Japan](#), against Toshiba Corp., in connection with its alleged accounting fraud and accompanying restatements of its financial reports. The plaintiffs represented a class of investors who had purchased [Toshiba’s American Depository Shares or Receipts \(ADRs\)](#) on the [over-the-counter \(“OTC”\) market](#), rather than direct purchases of Toshiba common stock, which trade in Japan. ADRs are financial instruments, issued by U.S. depository banks, which enable investors in the United States to buy and sell stock in foreign corporations whose common stock is publicly traded on a foreign stock exchange, without having to actually buy and sell on that foreign exchange. They also give foreign companies easier access to U.S. capital markets.

The plaintiffs alleged that they paid artificially inflated prices for the ADRs as a result of Toshiba’s alleged fraud. The district court dismissed the case with prejudice, holding [Morrison](#) precluded the plaintiffs from bringing claims for alleged losses on the ADRs because the OTC is not a “national exchange,” and that there was no transaction, in the United States, between the plaintiffs and Toshiba. The distinction between ADRs and common stock was critical to the district court’s dismissal of the Plaintiffs’ claims.

However, the [U.S. Court of Appeals for the Ninth Circuit](#) reversed and [determined that the ADR trades were domestic](#). Toshiba argued that, under the U.S. Supreme Court’s decision in *Morrison*, its ADRs were not governed by [Section 10\(b\)](#) of the Exchange Act, because the Exchange Act applies only to transactions on a national securities exchange. The court disagreed. It held that the Exchange Act could apply to the Toshiba ADRs because, under *Morrison*, another category of transactions covered by the Exchange Act is “domestic transactions in other securities.” Acknowledging that *Morrison* said that the act exclusively focuses on “domestic purchases and sales,” the Ninth Circuit adopted other [Circuits’ use of an “irrevocable liability” test](#) to determine when a securities transaction is domestic. The irrevocable liability test looks to where purchasers incurred the liability to take and pay for securities, and where sellers incurred the liability to deliver securities, and not where the alleged misconduct occurred. Noting that the Plaintiffs’ ADRs were purchased in the United States, and that the depository institutions sold the ADRs in the United States, the court held that the Exchange Act could apply to the Toshiba ADRs. Thus, the Ninth Circuit held that purchases of Toshiba ADRs traded on the OTC satisfied *Morrison’s* requirements to be considered domestic transactions.

In addition, the Ninth Circuit court looked to the definition of “security” under the Act and held that the Toshiba ADRs fit within the definition of security, specifically as “stock,” because ADR’s possess significant characteristics typically associated with common stock. The court pointed to the facts that (1) depository institutions transfer the dividends they receive on deposited Toshiba common stock to the corresponding Toshiba ADR owner; (2) Toshiba ADRs are negotiable in that they are traded through U.S. broker-dealers, in that Toshiba ADR holders may split or combine Toshiba ADRs into new instruments as they see fit; (3) nothing in the Toshiba ADRs restricts pledging or hypothecation; (4) each of the four Toshiba ADR depository institutions is willing to exercise the



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voting rights associated with the deposited Toshiba common stock as directed by the Toshiba ADR owners; and (5) Toshiba ADRs have the same interest in the management, profit and assets of Toshiba as investors in Toshiba common stock, because ADR value is directly linked to the value of Toshiba common stock. The court also reasoned that, broadly speaking, the ADRs, are “designed to allow seamless investment in foreign companies akin to owning shares of U.S. companies,” and as a result, are referred to and treated as securities by purchasers, depository institutions, the SEC, courts, and scholars.

Toshiba also argued that the Exchange Act should not apply to Toshiba’s ADRs because the ADRs were unsponsored—meaning, as the Ninth Circuit explained, that “the depository institutions each filed Form F-6 without Toshiba’s ‘formal participation’ and possibly without its acquiescence.” The court also rejected that argument, concluding that the Exchange Act’s requirement that there must be a “connection between the misrepresentation or omission and the purchase or sale of a security” must be read flexibly so that “it may very well be that the Morrison test in some cases will result in the Exchange Act’s application to claims of manipulation of share value from afar.”

Despite these holdings, the Court also concluded that the Plaintiffs’ complaint was still missing specific allegations establishing Toshiba’s connection to the ADR transaction. According to the Court:

Toshiba’s connection to the ADR transactions requires clearly setting forth the transactions. However, the FAC omits basic details about ADRs. It also fails to include factual allegations regarding the over-the-counter market on which Toshiba ADRs are listed, whether Toshiba ADRs are sponsored, the depository institutions that offer Toshiba ADRs, the Form F6’s they used to register the Toshiba ADRs, the trading volume of Toshiba ADRs, and the Toshiba ADRs’ contractual terms (along with relevant variants between depository institutions). And it lacks detail regarding [the Plaintiff’s] purchase of the Toshiba ADRs, including how the purchase was made and which particular depository institution holds the corresponding Toshiba common stock.

Additionally, according to the Ninth Circuit, the complaint lacked allegations concerning Toshiba’s involvement in the establishment of the ADRs, even though the Plaintiffs argued that issuers are generally involved in establishing unsponsored ADRs. Specifically, the Plaintiffs relied on (1) a letter sent by one of the Toshiba ADR depository institutions to the Securities and Exchange Commission during ADR rulemaking in 2008 stating that “in practice, depository banks typically obtain the issuer’s consent before establishing an unsponsored ADR facility,” (2) a law firm memorandum about the 2008 rulemaking which states that depository issuers of unsponsored ADRs “typically request[] a letter of non-objection” from the foreign company; and (3) the fact that Toshiba made it possible for depository institutions to issue unsponsored Toshiba ADRs by meeting certain regulatory requirements, including posting its annual report in English on its website and by not establishing a sponsored ADR (which would preclude unsponsored ADRs). However, none of these facts connecting Toshiba to the unsponsored ADRs were alleged in the complaint.

As a result, the court held that the Plaintiffs’ complaint did not sufficiently allege a domestic violation of the Exchange Act because it did not allege a connection between Toshiba’s alleged misstatements and the ADR transactions. The Court did, however, rule that, contrary to the district court’s opinion, the deficiencies in the complaint were curable, and it allowed the Plaintiffs leave to amend their complaint.

The Ninth Circuit also held that the district court needed to address the viability of the Japanese law claims, the merits of which were not addressed in its first decision. Notably, the Japanese law claims under Article 21-2 of the Financial Instruments and Exchange Act of Japan appear to be similar in nature to strict liability claims under [Section 11 of the Securities Act](#).

The Ninth Circuit’s ruling highlights the key similarities between ADRs and common stock and clarifies the rights and remedies available to plaintiffs, under U.S. law, who own ADRs, including unsponsored ones. This decision is important for institutional investors because it provides a roadmap of how to adequately plead a 10(b) case involving unsponsored ADRs, and thus eliminates, in some circumstances, the necessity of pursuing such litigation in foreign countries.

On August 3, 2018, Toshiba filed a motion with the Ninth Circuit seeking to stay the court’s decisions. In the filing, Toshiba stated that it intends to file a writ of certiorari seeking Supreme Court review of the Ninth Circuit’s decision, and argued that the Ninth Circuit’s decision conflicts with the Second Circuit’s 2014 decision in [Parkcentral Global HUB Ltd. v. Porsche Auto. Holdings SE](#). The Ninth Circuit granted the stay on August 8, and ordered that the stay will continue until final disposition by the Supreme Court.

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