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DISTRICT COURT RULING SETS HIGH BAR FOR EARLY-STAGE DISMISSAL OF LAWSUITS INVOLVING UNSPONSORED ADR PROGRAMS

On January 28, 2020, the District Court for the Central District of California denied a motion to dismiss by Toshiba Corporation ("**Toshiba**") in the ongoing *Stoyas v. Toshiba Corp*. case, which involves securities law claims made on behalf of a class of U.S. investors in unsponsored American Depositary Receipts ("**ADRs**"). This briefing discusses the details of this case and its implications for non-U.S. companies if their shares are the subject of an unsponsored ADR program in the United States. It also provides several suggestions for managing related risks.

What is Rule 10b-5 and what are the limits on the extraterritorial reach of this rule?

Rule 10b-5 under the U.S. Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), is frequently cited in lawsuits brought by U.S. investors as the basis for securities law liability. Rule 10b-5 makes it unlawful to, among other things, make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, in connection with the purchase or sale of a security in the United States. In *Morrison v. National Australia Bank, Ltd*., 561 U.S. 247 (2010), the U.S. Supreme Court limited the extraterritorial reach of Rule 10b-5 to:

- purchases or sales of securities listed on a U.S. exchange; or
- domestic transactions involving any other type of securities.

Sales or purchases of ADRs that are traded in the over-the-counter market in the United States are not listed on a U.S. exchange and would therefore need to qualify as domestic transactions to be subject to the jurisdiction of the U.S. courts. A domestic transaction would be established for these purposes if:

- a purchaser incurs the liability to take and pay for securities in the United States; or

What are ADRs?

ADRs evidence American Depositary Shares, which represent a specified number of shares issued by a non-U.S. company and held in a deposit facility. ADRs are issued by a depositary, typically a U.S. commercial bank, pursuant to the terms of a deposit agreement. Holders of ADRs are able to withdraw the underlying shares from the deposit facility, in which case their ADRs are cancelled.

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- a seller incurs the liability to deliver securities in the United States.

If one of the *Morrison* criteria is satisfied, all elements of a Rule 10b-5 claim would need to be proven for liability to be established. Given the typical lack of issuer involvement with unsponsored ADR programs, it was previously considered unlikely that any issuer misconduct would be considered to be connected with purchases and sales of unsponsored ADRs in the U.S. over-the-counter market.

If a U.S. court finds a valid basis for jurisdiction, plaintiffs may also seek adjudication of related claims arising under non-U.S. law in U.S. court.

The alleged facts of the *Toshiba* case

Toshiba is a Japanese multinational conglomerate whose shares of common stock are listed on the Tokyo Stock Exchange (TYO:6502). Toshiba's shares are not listed on a U.S. exchange, and the company does not otherwise maintain a sponsored ADR program in the United States. However, a number of U.S. depositary banks have established unsponsored ADR programs for Toshiba's shares, and the related ADRs trade in the U.S. over-the-counter market.

In the ongoing *Stoyas v. Toshiba Corp.* case, the plaintiffs allege that Toshiba deliberately used improper accounting practices over a period of at least six years to:

- inflate its pre-tax profits by more than $2.6 billion; and
- conceal at least $1.3 billion in impairment losses at its U.S. nuclear business.

The plaintiffs claim that, when this misconduct came to light, it resulted in a 40% decline in the price of Toshiba shares, resulting in a loss of $7.6 billion in market capitalization and causing hundreds of millions of dollars in damages to U.S. investors in Toshiba securities. The lead plaintiff, Automotive Industries Pension Trust Fund ("**AIPTF**"), had purchased unsponsored ADRs in the U.S. over-the-counter market.

The District Court for the Central District of California (the "**District Court**") initially dismissed the plaintiffs' complaint on the basis that there was no domestic transaction under the *Morrison* test described above. The U.S. Court of Appeals for the Ninth Circuit (the "**Court of Appeals**") subsequently reversed and remanded. The Court of Appeals held that the plaintiffs had not sufficiently alleged:

- a domestic transaction, as required by *Morrison*; or
- that the fraudulent conduct was "in connection with" the sale of securities.

Nevertheless, the Court of Appeals ruled that the plaintiffs should have been permitted to further amend their complaint, noting that "an amended complaint could almost certainly allege sufficient facts to establish that AIPTF purchased its Toshiba ADRs in a domestic transaction".

Toshiba subsequently sought to appeal the Court of Appeal's reversal to the U.S. Supreme Court, which declined the petition. The case was therefore remanded to the District Court to allow the plaintiffs to amend their complaint. After the plaintiffs amended their complaint, Toshiba again moved to dismiss the case on the basis

How does an unsponsored ADR program differ from a sponsored ADR program?

In a sponsored ADR program, a non-U.S. company enters into the related deposit agreement with the depositary and otherwise participates in the establishment of the program. In contrast, in an unsponsored ADR program, the non-U.S. company that has issued the underlying shares is not a party to the deposit agreement and does not participate in setting the share to ADR ratio. If a non-U.S. company has not already sponsored an ADR program for its shares, one or more depositary banks may create unsponsored ADR programs on their own initiative. To establish an unsponsored ADR program, the depositary bank must file a Form F-6 registration statement with the U.S. Securities and Exchange Commission (the "**SEC**"). In doing so, the depositary bank is required to have a reasonable, good faith belief (after reasonable diligence) that the issuer of the relevant securities is exempt from certain U.S. registration requirements pursuant to Rule 12g3-2(b). Applicable SEC rules do not require an ADR depositary bank to obtain the consent of the issuer of the underlying securities before establishing an unsponsored ADR program.

of *Morrison*, arguing that the plaintiffs continued to fail to allege a domestic transaction or that Toshiba's conduct was in connection with AIPTF's purchase of ADRs in the U.S. over-the-counter market. Toshiba argued that many of the allegations in the plaintiffs' complaint were unsubstantiated, based on industry customs and conjecture, and unlikely to be proven at trial. However, the District Court denied Toshiba's motion to dismiss. While this ruling may be appealed, it provides precedential influence for any cases with similar facts in the near term – especially in the Ninth Circuit.

Why did the District Court deny Toshiba's motion to dismiss?

In order to survive a motion to dismiss in U.S. federal court, a plaintiff's complaint must satisfy a very low threshold: it must contain "sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face". In this context, a U.S. federal court must accept a plaintiff's allegations of material fact as true and must construe those facts in the light most favorable to the plaintiff.

In the *Toshiba* case, after reviewing the material facts alleged in the plaintiffs' amended complaint, the District Court determined that the plaintiffs had sufficiently alleged:

- that AIPTF purchased ADRs in a domestic transaction; and
- Toshiba's alleged fraud was "in connection with" AIPTF's purchase of the ADRs.

Domestic transaction. The District Court concluded that the plaintiffs had sufficiently alleged a domestic transaction, as required by *Morrison*, based on the following allegations:

- AIPTF's purchase was directed by its outside investment manager, ClearBridge Advisors LLC, located in New York;
- ClearBridge placed the buy order for the purchase through a broker located in New York;
- the broker purchased the ADRs on the over-the-counter market using the OTC Link trading platform (a service offered by the OTC Markets Group), both of which are based in New York, and the purchase order and trade confirmation were routed through OTC Link's servers;
- the depositary bank issued the ADRs from its New York office;
- AIPTF made payment from a New York-based bank; and
- Transfer of title to the ADRs was recorded in New York.

Toshiba's connection to the ADR transactions. The District Court also concluded that the plaintiffs had sufficiently alleged that Toshiba's misconduct was "in connection with" AIPTF's purchase of ADRs based on Toshiba's alleged participation in the establishment of an unsponsored ADR program. In arriving at this conclusion, the District Court noted that the amended complaint now alleged, among other factors, the nature of the Toshiba ADRs and ADR program and Toshiba's "plausible consent" to the sale of its stock in the United States as ADRs. In addition, the District Court focused on the fact that one of the ADR depositories

was among Toshiba's ten largest shareholders during the relevant time period, holding 1.3% of Toshiba's outstanding common stock. The District Court accepted as plausible the plaintiffs' allegation that it was unlikely that this depositary could have acquired so many shares in the open market without the consent, assistance or participation of Toshiba.

Managing the risks presented by an unsponsored ADR program

Minimizing connections to an unsponsored ADR program

In light of the District Court's recent ruling in the ongoing *Toshiba* case, any connection between an issuer and an unsponsored ADR program may increase the issuer's exposure to civil claims for securities law violations in U.S. court, particularly U.S. federal courts in the Ninth Circuit. This connection may be established not only by a non-U.S. issuer's overt cooperation with a depositary bank, but also by its contextual behavior, like facilitating a depository's purchase of its shares. To manage this risk, a non-U.S. issuer may consider sending a written objection letter to the depositary regarding the establishment or existence of an unsponsored ADR program, clearly indicating that the issuer is not consenting to the establishment or existence of the program.

If a depositary does not terminate the ADR program in response to an objection, the issuer should consider taking additional steps to minimize any actual or perceived involvement with that unsponsored ADR program. For example, the issuer could adopt a written policy pursuant to which it restricts activities that could be perceived as connections to the unsponsored ADR program. Such a policy could include the following elements:

- instructing employees not to refer to the ADRs or the unsponsored ADR program or provide any market price information for the ADRs in any communications with investors or the public, including via the issuer's website or on social media;
- restricting any U.S.-based employees from investing in any such ADRs;
- prohibiting sales of any newly issued shares or treasury shares to the ADR depositary; and
- instructing relevant employees not to support or consent to any other unsponsored ADR programs that any other depositary bank may seek to establish.

However, for a non-U.S. company that is eligible for the Rule 12g3-2(b) exemption from Exchange Act registration, the only effective method to prevent the establishment or continuation of an unsponsored ADR program may be for the company to sponsor its own ADR program. Although sponsoring its own ADR program would necessarily increase such a company's connection to the program and potential exposure to liability under U.S. securities laws, a sponsored ADR program may have other commercial or investor relations benefits for the company.

What does Rule 12g3-2(b) provide?

The Exchange Act generally requires any company that has total assets exceeding $10 million at fiscal year-end to register with the SEC a class of equity securities that is held of record world-wide by:

- **2,000** or more persons; or
- more than **500** persons who do not qualify as accredited investors.

Ongoing U.S. public reporting requirements apply to companies that register under the Exchange Act.

An exemption to this registration requirement is available under Rule 12g3-2(b) for any company that:

- is a foreign private issuer (tested annually as of the last business day of its second fiscal quarter);
- has a primary trading market listing on a non U.S. exchange;
- is not already subject to the Exchange Act's public reporting requirements; and
- publishes, in the English language, on its website or other electronic information delivery system, all material information that it distributes to its security holders, makes public under the laws of its home country or files with its principal securities exchange.

When a non-U.S. company with shares listed on an exchange outside the United States publishes financial and other material information in the English language on its website, a depositary bank may conclude that the non-U.S. company qualifies for the Rule 12g3-2(b) exemption, and establish an unsponsored ADR program.

Ceasing to qualify for the Rule 12g3-2(b) exemption

Once established, an unsponsored ADR program may be terminated if the depositary bank is notified that the issuer of the underlying shares does not qualify for the exemption from Exchange Act registration provided by Rule 12g3-2(b). This exemption would not be available, for example, if a company:

- no longer has its shares traded on a non-U.S. exchange as its primary trading market;
- stops publishing its material information in the English language; or
- no longer qualifies as a foreign private issuer.

Depending on the composition of its shareholder base, a non-U.S. issuer that is no longer eligible for the Rule 12g3-2(b) exemption could become subject to Exchange Act registration and associated U.S. public company reporting requirements. However, an alternate exemption from the Exchange Act registration requirements would be available pursuant to Rule 12g3-2(a) if fewer than **300 holders** of a company's equity securities are resident in the United States as of fiscal year-end. If a company intends to rely on the Rule 12g3-2(a) exemption but has a significant number of U.S. holders, it can consider implementing a share buy-back program or launching a cash tender offer to reduce the number of U.S. holders. Issuers should also bear in mind that terminating an ADR program may increase the number of an issuer's U.S. holders, as the underlying shares held by the depositary bank will be distributed to the ADR holders upon the program's termination.

Companies considering taking steps that could lead to the termination of an unsponsored ADR program also need to be aware of the potential adverse consequences for investors. For example, U.S. investors may be subject to portfolio limitations that would require them to sell the shares they receive when the program is terminated. These sales could result in downward pressure on the price of the company's shares. If a company elects to no longer make English language translations of company reports available, negative market perceptions may develop that could also result in lower share prices. Accordingly, companies will need to carefully consider whether it is in their best interest to take steps that could result in the termination of an unsponsored ADR program.

What benefits do ADR programs provide to U.S. investors?

U.S. investors benefit from ADR programs because they are able to use customary U.S. settlement procedures and receive any dividend payments in U.S. dollars. In addition, ADR programs allow U.S.-based mutual funds, pension funds and other institutions to invest in non-U.S. equity securities without being subject to limitations they may have on purchasing and holding securities outside of the United States.

Conclusion

A non-U.S. issuer that has issued shares that are later deposited in an unsponsored ADR program may be subject to U.S. securities law liability if it has consented to the sale of its shares in the United States as ADRs. The District Court's recent denial of Toshiba's motion to dismiss indicates that it may be difficult to obtain early-stage dismissals of securities law claims by investors in unsponsored ADRs.

A non-U.S. issuer that discovers an unsponsored ADR program involving its shares may want to consider sending a written objection to the depository bank and adopting policies limiting its connection to that ADR program. It may also consider taking additional steps that would result in its no longer qualifying for the Rule 12g3-2(b) exemption. Any such steps could, however, have adverse consequences and would need to be carefully considered.

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