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High Court Snub Raises Foreign Issuer Economic Concerns

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In Morrison v. National Australia Bank,[1] the U.S. Supreme Court held that Section10(b) of the Securities Exchange Act of 1934, and by extension, Rule 10b-5, only applies to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities."[2] This greatly reduced the exposure foreign issuers faced from U.S. securities litigation.[3]

Subsequently, circuit courts have taken differing views on applying the second prong of Morrison: What type of domestic transactions are suitable for adjudication under the Exchange Act, and what limitations — if any — apply to this second prong?

On June 24, the Supreme Court declined to explicitly address this issue by denying the petition for certiorari in Stoyas v. Toshiba Corp.,[4] a U.S. securities class action related to an alleged accounting scandal. This has created a situation where even foreign companies that played no active role in fostering the trading of their securities in the United States may face class action suits under the Exchange Act that survive motions to dismiss.[5]

Given the potential increased exposure for foreign issuers in light of Toshiba, this article provides a brief background on how securities issued by foreign companies can be transacted domestically, and then highlights some specific considerations and challenges raised in foreign issuer cases that can be addressed via economic analysis in securities litigation.

Overview of ADRs

An American depository receipt — also known as an American depositary receipt or ADR — is a security that represents claims on shares of non-U.S. companies that are held by a U.S. depository bank. ADRs allow U.S. investors to invest in non-U.S. companies and give non-U.S. companies easier access to the U.S. capital markets. Indeed, many non-U.S. issuers use ADRs to raise capital or establish a trading presence in the United States.[6]

There are two broad categories of ADRs:

- Sponsored ADRs are created by depository banks working in collaboration with the issuer. Sponsored program ADRs trade on either a U.S. stock exchange or in the U.S. over-the-counter, or OTC, market.[7]

- Unsponsored ADRs, on the other hand, are unilaterally established by a depository bank without the issuer's involvement — typically in response to or in anticipation of U.S. investor demand — and usually only trade OTC, as was the case for Toshiba.[8]

ADRs are also typically categorized into three levels by market participants, based on the extent to which the foreign company has accessed the U.S. market:

- Level 1 ADR programs — the only level for unsponsored ADRs — establish a trading presence on the OTC market, but may not be used to raise capital. Again, the Toshiba ADRs were Level 1 ADRs.[9]

- Level 2 ADR programs establish a trading presence for the sponsored ADRs on a national securities exchange, but cannot be used to raise capital.[10]

- Level 3 ADR programs are used both to establish a trading presence for the sponsored ADRs, and to raise capital for the foreign issuer.[11]

Unsponsored ADRs, Toshiba and Parkcentral's Foreign Elements Test

In Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE, the U.S. Court of Appeals for the Second Circuit explicitly chose not to extend Morrison's second prong to reach domestic transactions where foreign elements dominated.[12] The U.S. Court of Appeals for the Ninth Circuit took a completely different tack in Toshiba, effectively ruling that all domestic securities transactions are within Morrison's reach, regardless of any foreign-elements test.[13]

An important distinguishing element of Toshiba's situation is that the company had unsponsored ADRs trading OTC in the United States. Therefore, the first prong of Morrison did not extend to Toshiba's ADRs because they traded OTC and were not listed on a domestic exchange.

Regarding the second prong, as an unsponsored ADR the company had no involvement in creating or maintaining the ADR program — that was done autonomously by the depository bank — which Toshiba believed placed the trading of its securities in the United States outside Morrison's reach.[14]

The district court agreed, dismissing the case because, among other reasons, it deemed there were no U.S. transactions between Toshiba and the putative class members.[15] On appeal, however, the Ninth Circuit remanded the case back to the district, opining that the plaintiffs should have the opportunity to demonstrate that irrevocable liability was incurred in the United States.[16]

Toshiba petitioned the Supreme Court to address the apparent discrepancy between the Second and Ninth Circuits regarding a foreign-elements test. On June 24, the Supreme Court denied Toshiba's petition for certiorari without explanation,[17] effectively leaving open, for the time being, the question of what limitations — if any — apply to Morrison's second prong.

Although the mere fact of having an unsponsored ADR program is itself insufficient for a foreign issuer to avoid securities litigation in the United States, there nonetheless may be market structure aspects of the unsponsored ADRs that raise questions about market efficiency, damages or other issues central to class certification proceedings.

Class Certification Considerations in Foreign Issuer Cases

Economic analysis of pricing behavior across markets bears on class certification issues, such as price impact, whether the plaintiffs have described a damages model that hews to their theory of liability and measures only harm stemming from that theory (as Comcast requires[18]), and in some circumstances whether the plaintiffs have provided sufficient evidence on whether the market for the ADRs trading in the United States is efficient.

Many of these issues arise again at the merits stage of securities litigation. The fact that a foreign issuer has related securities trading in both the United States and its home country itself raises unique and testable questions regarding where the majority of price discovery occurs.

Indeed, this issue was particularly germane in IBEW v. Deutsche Bank,[19] where the plaintiffs focused their assessment of market efficiency on the U.S. trading of Deutsche Bank's global registered shares. In addition to identifying problems with the market efficiency analysis the plaintiffs conducted for the U.S. market, the defendants' experts also established that the German equities market — for which the plaintiffs had conducted no analysis of market efficiency — was the leading venue for price discovery of the global registered shares. The court held that the plaintiffs had not met their burden to demonstrate market efficiency, and class certification was denied.[20]

In addition to where price discovery occurs, aspects of the U.S. market for the security in question may bear on an examination of market efficiency, and compel a careful and rigorous examination of whether the market is indeed efficient. Relatively thinly traded securities of foreign issuers in the United States may be subject to illiquidity, short sale constraints or other limits to the arbitrage mechanism necessary to foster market efficiency and discipline prices. To the extent that these limits apply, establishing market efficiency, and hence a presumption of reliance at the class certification stage of securities litigation, may not be a trivial exercise.[21]

Securities issued by foreign companies also raise unique considerations when it comes to conducting event study analysis, a commonly used methodology to examine the relationship between the release of new information and security price movements. Event studies are frequently used at the class certification stage of securities litigation, both to assess market efficiency via a showing of cause and effect,[22] and, following the Supreme Court ruling in Halliburton Co. v. Erica P. John Fund Inc.,[23] to examine whether there is evidence that the alleged misrepresentations have an impact on the security price.[24]

In the context of securities issued by foreign companies, event studies require careful consideration with respect to identifying the event window, or time period during which the relationship between information release and price movement is analyzed, and calculating the company-specific, or abnormal, return for the security.

For example, the identification of the event may be affected by where the information is first released (in the United States or in the home country), how price discovery occurs for the given security (i.e., Does the security price react to home country news?), and how market trading hours for the United States and the home country overlap. Identifying the abnormal return typically involves adjusting for price movements that are likely related to market and industry factors, so as to isolate the portion of the price movement that is likely related to company-specific information.

For securities that are issued by foreign companies, these may reflect conditions in the United States as well as in the home country. The security price may also change to reflect relative changes between the United States and the home country (e.g., exchange rate movements), which should also be considered in terms of isolating the company-specific price movement.

Additional Considerations in Foreign Issuer Cases

In addition to the class certification considerations discussed above, the structure and nature of securities issued by foreign companies often also raise questions with respect to estimated damages exposure, which may loom large in settlement negotiations. A detailed discussion of the nuances of damages considerations is beyond the limited scope of this article, but foreign issuers' means of access to U.S. capital markets may create situations where a security is fungible across U.S. and foreign markets.[25]

In such cases, one must carefully estimate shares actually purchased, and perhaps sold, within the United States. Indeed, under some circumstances, the typical trading models used by the plaintiffs may suggest that all of the eligible global pool of shares are damaged in the United States, even if the vast majority of trading volume is outside the United States. This mechanical mathematical result, which flows from the fact that shares damaged generally increase with time in such trading models, is incorrect, but may nonetheless influence settlement demands.

The Supreme Court's denial of the petition in Toshiba has created a situation where foreign issuers may now face increased litigation risk. In this environment, economic considerations, including price impact and market efficiency, as well as factors affecting aggregate exposure estimates, may become even more salient in cases involving foreigner issuers.

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[1] Morrison v. National Australia Bank Ltd., 547 F.3d 167 (2d Cir. 2008).

[2] Morrison v. National Australia Bank Ltd., 561 U.S. 247, 267 (2010).

[3] For example, according to a company press release dated Feb. 23, 2011, Vivendi announced that the U.S. District Court for the Southern District of New York had dismissed the claims of all purchasers of Vivendi's ordinary shares, and that the ruling would effectively eliminate more than 80% of the potential damages. Vivendi Press Release, "Vivendi: USA Class Action," Feb. 23, 2011.

[4] The case is Toshiba Corp. v. Auto. Indus. Pension Trust Fund et al., No. 18-486. See https://www.supremecourt.gov/orders/courtorders/062419zor_bp7c.pdf. (According to the petition for certiorari, "Mark Stoyas was the original plaintiff in the district court, but was not an appellant in the court of appeals below, and is not a respondent here." Petition for a Writ of Certiorari, Toshiba Corp. v. Auto. Indus. Pension Trust Fund et al., No. 18-486 (U.S. Oct. 15, 2018), at ii).

[5] Indeed, the Securities Class Action Filings 2019 Midyear Assessment recently published by Cornerstone Research (in collaboration with the Stanford Law School Securities Class Action Clearinghouse) found that filings against non-U.S. issuers have trended upward over time, and are on pace to be the highest on record in 2019. Cornerstone Research, Securities Class Action Filings — 2019 Midyear Assessment, 2019, p. 16, https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Filings-2019-Midyear-Assessment.

[6] U.S. Securities and Exchange Commission, Office of Investor Education and Advocacy, "Investor Bulletin: American Depositary Receipts," August 2012, p. 1, https://www.sec.gov/investor/alerts/adr-bulletin.pdf.

[7] Citi Issuer Services, "American Depositary Receipts (ADRs): A Primer," 2019, p. 1, https://depositaryreceipts.citi.com/adr/common/file.aspx?idf=1248; J.P. Morgan, "Level I ADRs: A Reference Guide for Issuers," November 2008, pp. 5–6, https://www.jpmorgan.com/cm/BlobServer/Level_I_ADRs_A_Reference_Guide_for_Issuers.pdf?blobkey=id&blobwhere=1158511329968&blobheader=application/pdf&blobheadername1=Cache-Control&blobheadervalue1=private&blobcol=urldata&blobtable=MungoBlobs.

[8] J.P. Morgan, "Level I ADRs: A Reference Guide for Issuers," November 2008, pp. 2, 5–6, https://www.jpmorgan.com/cm/BlobServer/Level_I_ADRs_A_Reference_Guide_for_Issuers.pdf?blobkey=id&blobwhere=1158511329968&blobheader=application/pdf&blobheadername1=Cache-Control&blobheadervalue1=private&blobcol=urldata&blobtable=MungoBlobs.

[9] Form F-6 would be the only required form to file with the SEC. U.S. Securities and Exchange Commission, Office of Investor Education and Advocacy, "Investor Bulletin: American Depositary Receipts," August 2012, p. 2, https://www.sec.gov/investor/alerts/adr-bulletin.pdf.

[10] The non-U.S. company is required to register and file annual reports on Form 20-F with the SEC. U.S. Securities and Exchange Commission, Office of Investor Education and Advocacy, "Investor Bulletin: American Depositary Receipts," August 2012, p. 2, https://www.sec.gov/investor/alerts/adr-bulletin.pdf.

[11] The non-U.S. company must file a registration statement on Form F-1, Form F-3, or Form F-4 in order to offer the ADRs. It would also be required to file annual reports on Form 20-F. U.S. Securities and Exchange Commission, Office of Investor Education and Advocacy, "Investor Bulletin: American Depositary Receipts," August 2012, p. 2, https://www.sec.gov/investor/alerts/adr-bulletin.pdf.

[12] Parkcentral Global Hub Ltd. v. Porsche Auto. Holdings SE, 763 F.3d 198 (2d Cir. 2014).

[13] Stoyas v. Toshiba Corp., 896 F.3d 933 (9th Cir. 2018).

[14] Stoyas v. Toshiba Corp., Memorandum of Points and Authorities in Support of Defendant Toshiba Corporation's Motion to Dismiss, No. 2:15-cv-04194-DDP-JC (C.D. Cal. Feb. 1, 2016), at 13–14.

[15] Stoyas v. Toshiba Corp., 896 F.3d 933 (9th Cir. 2018).

[16] Stoyas v. Toshiba Corp., 896 F.3d 933 (9th Cir. 2018).

[17] See https://www.supremecourt.gov/orders/courtorders/062419zor_bp7c.pdf.

[18] Comcast Corp. v. Behrend, 569 U.S. 27 (2013).

[19] IBEW Local 90 Pension Fund v. Deutsche Bank AG, No. 1:11-cv-04209-KBF (S.D.N.Y. 2013).

[20] For more information on IBEW v. Deutsche Bank, see https://www.cornerstone.com/Publications/Case-Studies/IBEW-Local-90-Pension-Fund-et-al-v-Deutsche-Bank.

[21] In addition to ADRs, foreign issuers can also access U.S. capital markets by cross-listing shares or through dual-listed companies (DLCs). These types of securities also provide instances of the potential limits to arbitrage. For example, with cross-listed shares, there may be disparities in security prices between the home country and the U.S. market, even after adjusting for exchange rate differences. The limits to arbitrage are of particular interest for shares in DLCs, given that the shares in the two companies (which are separately listed and traded) represent equivalent claims to underlying cash flows of the two companies. However, unlike cross-listed shares, the shares in DLCs are not fungible, which can lead to pricing disparities that cannot be immediately corrected by arbitrageurs.

[22] Cammer v. Bloom, 711 F. Supp. 1264, 1287 (D.N.J. 1989).

[23] Halliburton Co. v. Erica P. John Fund Inc., 134 S. Ct. 2398 (2014).

[24] It is worth noting that these issues may also arise in the context of establishing the existence of a class-wide methodology that measures only those damages that are attributable to the plaintiffs' theory of liability, that is, in order for the plaintiffs to meet the "Comcast requirement" at the class certification stage.

[25] This frequently occurs between the United States and Canada, but occurs between the United States and other jurisdictions as well.