



# FINEX Alert

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## U.S. Securities Exchange Act Section 10(b) applies to Sponsored, Level 1 ADRs

By Rob Yellen

In a January 4, 2017 decision, the Honorable Charles R. Breyer, U.S.D.J. denied defendants' motion to dismiss claims under the U.S. Securities Exchange Act Section 10(b). The decision [\[linked here\]](#) held that because defendants sponsored American Depositary Receipts ("ADRs") in the United States and plaintiffs purchased the ADRs in the United States, and because the United States has an interest in protecting domestic investors against securities fraud, Section 10(b) applies to the defendant's ADRs and that plaintiffs' claims were properly before the Court.

### Why this decision matters

Since [Morrison v. National Australia Bank Ltd., 561 U.S. 247 \(2010\)](#), some believed that ADRs, especially Level 1 ADRs, did not materially expose non-U.S. directors, officers or issuers to U.S. securities litigation. This district court decision held otherwise. While we can expect the decision to be appealed, for now expect Section 10(b) of the Securities Exchange Act to potentially apply to Sponsored ADRs.

### The underlying claims

Plaintiffs are a proposed class of all persons who purchased defendant's sponsored Level 1 American Depositary Receipts (ADRs) on an over-the-counter (OTC) market in the United States from November 19, 2010 through January 4, 2016.

**"Because [defendants] sponsored the ADRs in the United States and Plaintiffs purchased the ADRs here, and because the United States has an interest in protecting domestic investors against securities fraud, the Court concludes that Section 10(b) applies..."**

Honorable Charles R. Breyer, U.S.D.J.

Plaintiffs asserted claims alleging that defendants made material misrepresentations and omissions regarding emissions regulation compliance and financials.

Plaintiffs asserted claims against defendants for violations of the U.S. Securities Exchange Act under:

- 1. Section 10(b)** and Securities Exchange Commission (SEC) Rule 10b-5 because defendants allegedly "made untrue statements of material fact and omitted to state material facts necessary to make their statements not misleading"; and
- 2. Section 20(a)** for issuer's allegedly fraudulent conduct as "controlling persons" of certain corporate defendants.  
Link: [Consolidated Securities Class Action Complaint](#)

## Key issues and rationale

### Section 10(b)

In *Morrison v. National Australia Bank Ltd.*, the United States Supreme Court considered the extraterritorial application of Section 10(b) of the Securities Exchange Act. It found that Section 10(b) only applies to:

- (1) transactions in securities listed on U.S. exchanges, and
- (2) domestic transactions in other securities to which Section 10(b) applies.

After *Morrison*, courts have applied that two-prong test to determine whether a particular securities transaction is properly within the territorial reach of Section 10(b).

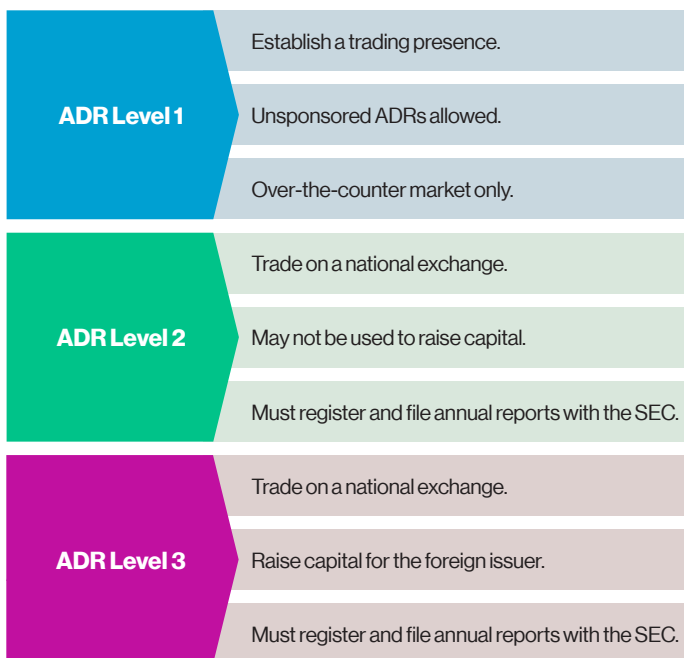
The District Court held the sponsored, Level 1 ADRs satisfied prong two of *Morrison*, and was not persuaded by defendants' argument that Level 1 are beyond the reach of Section 10(b).

### Section 20

Since the District Court concluded that at least parts of plaintiffs' Section 10(b) claims were sufficient to move forward as to each of the entity defendants alleged to be controlled, the District Court rejected defendants' motion to dismiss the Section 20 claims on grounds that plaintiffs had not sufficiently pled a primary violation as to the entities.

Nevertheless, the District Court did grant the motion to dismiss the Section 20 on the grounds that plaintiffs' conclusory allegations failed to plead with sufficient particularity that the individual defendants exercised actual control over the alleged violators.

### ADR Levels



### What are ADRs?

An ADR is a negotiable certificate that evidences an ownership interest in American Depositary Shares (ADSs) which, in turn, represent an interest in the shares of a non-U.S. company that have been deposited with a U.S. bank. It is similar to a stock certificate representing shares of stock.

A depositary bank creates the ADRs when a non-U.S. company, or an investor who already holds underlying non-U.S. securities, delivers securities to the bank or its custodian in the non-U.S. company's home country. The bank will then issue ADRs to the investor in the U.S. The investor will be able to re-sell the ADRs on a U.S. exchange or the over-the-counter market.

### “Sponsored” vs. “Un-sponsored”

**Sponsored ADRs**—the non-U.S. company enters into an agreement directly with the U.S. depositary bank to arrange for recordkeeping, forwarding of shareholder communications, payment of dividends, and other services.

**Un-sponsored ADRs** may be set up without the cooperation of the non-U.S. company; however, they may not be established unless the non-U.S. company is either:

- (1) subject to the reporting requirements under the Securities Exchange Act of 1934 or
- (2) exempt under the Act.

### SEC registration

- ADR are always registered with the SEC on a Form F-6 registration statement. Disclosure under Form F-6 relates only to the contractual terms of deposit under the deposit agreement and includes copies of the agreement, a form of ADR certificate, and legal opinions. A Form F-6 contains no information about the non-U.S. company.
- If a foreign company with ADRs wishes to raise capital in the United States, it would separately file a registration statement on Form F-1, F-3, or F-4.
- If a foreign private issuer seeks to list ADRs on a U.S. stock exchange, it would separately file with the SEC a registration statement on Form 20-F. Registration statements used to raise capital or list ADRs on an exchange are required to contain extensive financial and non-financial information about the issuer.

## Action items:

- Non-U.S. issuers and their directors and officers should take a fresh look at their American Depositary Receipt exposure. Unless ADR's are unsponsored and are not traded on an exchange, assume exposure to U.S. securities laws and U.S. litigation.
- Review directors and officers liability coverage.
  - Make sure the coverage does not have a territorial limitation that excludes U.S.-based claims or litigation in the U.S.
  - Review limits adequacy. ADR exposure can vary in significance. Your Willis Towers Watson broker can help you evaluate your exposure using our D&O Quantified tool.
  - If your executives do not have excess DIC Side-A coverage—coverage that is not shared with potential entity defendants—we suggest re-reviewing that opportunity to protect directors and executives with critical, last-line-of-defense coverage.

Please do not hesitate, consult with your Willis Towers Watson broker to find out about opportunities that may have become available to your company.

## Contact

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