

Central District of California: Denies Class Certification Because Unsponsored ADRs Were Purchased in a Foreign Transaction (Securities Law Alert)

03.01.22



(Article from *Securities Law Alert*, February 2022)

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On January 25, 2022, the Central District of California denied class certification in a putative securities fraud class action alleging violations of the Exchange Act against a corporation headquartered in Japan. *Stoyas v. Toshiba*, 2022 WL 220920 (C.D. Cal. 2022) (Pregerson, J.). The court determined that the plaintiff pension funds could not establish that the unsponsored American Depositary Receipts (“ADRs”)[1] of defendant were purchased in a “domestic transaction” as required under *Morrison v. National Australia Bank*, 561 U.S. 247 (2010). The court further determined that the investment manager of one of the funds (and by extension, that fund) incurred irrevocable liability in Japan when the investment manager’s broker acquired the shares of defendant’s common stock on the Tokyo Stock Exchange.

Background

Plaintiffs alleged that one of the pension funds purchased shares of unsponsored ADRs of defendant on the over-the-counter (“OTC”) market[2] in the United States. The fund accessed the OTC market through its investment manager, which placed a buy order for the unsponsored ADRs through its broker. The broker then purchased the ADRs for the fund on the OTC market. Notably for the outcome of the case, before the ADRs were available to purchase on the OTC market, the broker had to purchase the defendant’s common stock on the Tokyo Stock Exchange to be converted into ADRs.

After commencing this litigation, plaintiffs moved to certify a class of securities purchasers[3] under Federal Rule of Civil Procedure 23. Defendant argued that plaintiffs could not satisfy the typicality requirement under Rule 23(a) with respect to the Exchange Act claims, because, unlike the members of the proposed class, the fund did not acquire defendant’s securities in the United States.

Class Certification Depends on Whether a “Domestic Transaction” Occurred Under the Second Prong of *Morrison*

Beginning its analysis, the court explained that under *Morrison*, “to state a fraud claim under the Exchange Act, fraudulent statements or omissions must be made in connection with the purchase or sale of (i) a security listed on an American stock exchange or (ii) the purchase or sale of any other security in the United States.” Because unsponsored ADRs only trade on the OTC market, which is not a domestic stock exchange, the court stated that the typicality issue depends on whether a “domestic transaction” occurred. Defendant argued that the fund acquired its shares as common stock in Japan, and therefore the relevant purchase was a foreign transaction.

Whether a Domestic Transaction Occurred Depends on Where Irrevocable Liability to Take and Pay for the ADRs Occurred

The court pointed out that in 2018 the Ninth Circuit addressed the domesticity issue in this case, on appeal from the first motion to dismiss, by adopting the Second Circuit’s “irrevocability test” from *Absolute Activist Value Master Fund v. Ficeto. Stoyas v. Toshiba*, 896 F.3d 933 (2d Cir. 2018). Applying the test, the Ninth Circuit examined whether plaintiffs alleged sufficient facts to support an inference that the fund purchased the unsponsored ADRs in a domestic transaction. Interpreting the Ninth Circuit’s decision, the court observed that the “test focuses squarely on ‘where the purchaser incurred irrevocable liability to take and pay for the securities[.]’” which can “determine the locus of a securities purchase or sale.”

The court held that the fund incurred irrevocable liability to take and pay for the ADRs in Japan, not in the United States. The court took issue with plaintiffs’ approach, stating that it “ascribes little importance to the first step in the ADR conversion process: the purchase of [defendant’s] common stock. Plaintiffs’ argument glosses over the fact that [the fund’s] ability to acquire ADRs was contingent upon the purchase of underlying shares of common stock that could be converted into ADRs.” The court found that the evidence indicated that the broker executed the purchase of defendant’s common stock for conversion, on behalf of the investment manager for the fund. The court determined that once the broker fully executed the purchase of the common stock on the Tokyo Stock Exchange, the fund was “logically and legally” bound to take and pay for the ADRs, once converted. Accordingly, the transaction was not domestic.

- [1] Unsponsored ADRs are implemented by a depositary bank without the cooperation of the issuing foreign company.
- [2] The OTC market is where securities are traded via a broker-dealer network, as opposed to on a centralized exchange.
- [3] The class of securities purchasers was defined as: “All persons who purchased securities listed under the [corporation’s] ticker symbols . . . between May 8, 2012 and November 12, 2015 using the facilities of the OTC Market (‘American Securities Purchasers’)[.]”

Authors and
Contacts

Meaghan Kelly

Partner
mkelly@stblaw.com
+1-202-636-5542

David Elbaum

Senior Counsel
david.elbaum@stblaw.com
+1-212-455-2861

George Wang

Partner
gwang@stblaw.com
+1-212-455-2228



