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Unsponsored ADRs Falling Through the Cracks: Adapting a Domestic Securities Regime to a Global Marketplace

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Unsponsored ADRs Falling Through the Cracks: Adapting a Domestic Securities Regime to a Global Marketplace

ABSTRACT

Investing in the securities market has become a commonplace activity for expert and amateur investors alike. As more and more companies transcend national boundaries with their business activities, investment in their securities becomes coveted by international investors. Since securities are regulated on a country-by-country basis, it is unclear which law applies when conflict arises. In an attempt to clarify one such situation, simplify the application of US securities laws, and respect the legal regimes of other nations, the Morrison *decision created an unclear test which leaves investors in unsponsored American Depositary Receipts (ADRs), one of the most common international trading mechanisms, completely unprotected by the laws of any securities regulatory regime. This Note proposes using existing infrastructure to facilitate the trade of unsponsored ADRs as a way to ensure both protection of investors and efficiency of the global securities market.*

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The US legal system is often critiqued for its failure to adapt to the constant changes in technology in an efficient manner.[1] While troublesome in every industry or area of law, this shortcoming poses particularly acute danger in the securities market, where the lack of a functioning regulatory system stands to disrupt efficiency of the market at a global level. This not only affects the multimillion-dollar companies raising equity in the securities market, but also the average people who seek to invest.

Despite the fact that the creators of the US securities regulatory regime set out to establish a system that would both protect investors and ensure an efficient market,[2] today's lawmakers seem to have forgotten the importance of these overarching principles, opting to treat securities transactions as though the market's structure has not changed in the last eighty years. A market that was once confined to domestic transactions strictly regulated by mandatory disclosures and reporting requirements has transformed into one that is fast-paced, global, and driven by technology, containing mechanisms allowing uninformed investors to trade without protection.

One particularly troubling mechanism is the unsponsored American Depositary Receipt (ADR). Unsponsored ADRs allow US investors to gain ownership in foreign companies through off-exchange

1. Blair Janis, *How Technology Is Changing the Practice of Law*, GP SOLO, May/June 2014: Law Practice 20/20, http://www.americanbar.org/publications/gp_solo/2014/may_june/how_technology_changing_practice_law.html [https://perma.cc/DZ73-TRRG].

2. *See The Laws that Govern the Securities Industry*, U.S. SEC. AND EXCH. COMM'N (Oct. 1, 2013) http://www.sec.gov/about/laws.shtml [https://perma.cc/XWF4-YL4A] [hereinafter SEC]; Frederick H.C. Mazando, *The Taxonomy of Global Securities: Is the U.S. Definition of a Security Too Broad?*, 33 NW. J. INT'L L. & BUS. 121, 133 (2012).

transactions.[3] Unlike most traditional instruments, unsponsored ADRs escape regulation of any country, leaving investors unprotected from fraud by the issuing company.

This stands in stark contrast to the overarching goals of an efficient US securities market with investor protections—and even its creators' views on receipts in foreign companies. During a Senate committee hearing in the promulgation of the Exchange Act of 1934, the President of the New York Curb Exchange expressed the need for protection of investors in foreign receipts specifically.[4]

> [M]y observation is that the American public has taken a sufficient burning in [these] matters, and ought not have to again, and are entitled to a certain amount of honest information and protection which ought to be given to them. I cannot yield to the point that they are not given any protection.[5]

Nonetheless, more than eighty years later, in a world where global securities trade is as commonplace as domestic trade, these investors are still not granted any protection, which endangers the securities market on a global scale.

This Note examines the US legal system's struggle to adapt to advancing technology and increasing globalization in the securities market, particularly focusing on the trade of unsponsored ADRs. Part I provides a brief background of the structure and function of the securities market, its increasing globalization in recent years, and the legislative and judicial response to a globalizing market. Part II analyzes the implications and difficulties created by the static and dated securities regulatory framework in today's rapidly changing global marketplace. Part III advances three potential solutions using the existing framework of the Depository Trust Company (DTC), which currently exists as a holding company for both foreign and domestic securities trading in the US market.

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3. *See Unsponsored ADRs, Market Review*, DEUTSCHE BANK, GLOBAL TRANSACTION BANKING (May 2015) https://www.adr.db.com/drweb/public/en/docs/Whitepaper_Depositary Receipts_UnsponsoredADRsMarketReview.pdf [https://perma.cc/Z55H-JLJJ].

4. Note that the New York Curb Exchange is the previous name for what is known today as the American Stock Exchange. *See The American Stock Exchange Historical Timeline*, NYSE, https://www.nyse.com/publicdocs/American_Stock_Exchange_Historical_Timeline.pdf [https://perma.cc/S4FX-2XHA].

5. *Stock Exchange Regulation: Hearing on S. 2963, H.R. 7852, H.R. 8720 Before the H. Comm. On Interstate and Foreign Commerce*, 73d Cong. 371 (1934) (statement of E. Burd Grubb, President, NY Curb Exchange).

I. BACKGROUND OF THE US SECURITIES REGULATORY REGIME AND ITS RESPONSE TO GLOBALIZATION OF THE MARKET

A. Overview of the US Securities Market

While the US securities market has been in existence since the nation's inception in 1776,[6] its sophisticated and strict regulatory regime did not take shape until the 1900s.[7] The Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act") were enacted in the wake of the Great Depression.[8] Through mechanisms such as registration requirements, mandatory disclosure, and antifraud provisions, these initial statutes sought to protect investors and prevent abuses that could lead to financial crises.[9] Registration requirements and mandatory disclosures protect investors by allowing them to make informed decisions when purchasing securities.[10] Sanctions for fraudulent behavior allow investors to trust that the information received from issuers is reliable.[11] Similarly, because information drives efficient prices in the market, these mechanisms protect against abuses that could lead to financial crises.[12] While a lack of information increases risk, leading investors to discount the price of a security, sufficient information allows for accurate pricing of a security in the market.[13] Therefore, more information creates a more efficient market where issuing companies can raise capital at lower costs.[14]

More specifically, the Securities Act focuses on the regulation of the primary securities market, setting forth the registration requirements, disclosure requirements, and causes of action for misrepresentation.[15] Meanwhile, the Exchange Act is more

6. *See* Brian Murphy, *The Rise of an American Institution: The Stock Market*, THE GILDER LEHRMAN INS. OF AM. HIST., https://www.gilderlehrman.org/history-by-era/economics/essays/rise-american-institution-stock-market [https://perma.cc/SPK7-9YDC].

7. *See* Mazando, *supra* note 2, at 131–32.

8. *See id.*

9. *See* SEC, *supra* note 2; Mazando, *supra* note 2, at 133.

10. *See* SEC, *supra* note 2.

11. *See id.*

12. *Stock Exchange Regulation: Hearing on S. 2963, H.R. 7852, H.R. 8720 Before the H. Comm. On Interstate and Foreign Commerce*, 73d Cong. 783 (1934) (statement of Evans Clark, Director, Twentieth Century Fund, Inc.).

13. *See* James D. Cox, *Coping in a Global Marketplace: Survival Strategies for a 75-Year-Old Sec*, 95 VA. L. REV. 941, 962 (2009).

14. *See id.* at 953–54.

15. SEC, *supra* note 2. The primary securities market encompasses sales of securities directly from issuing companies to the first investors, while the secondary market encompasses all subsequent sales of securities between investors. *See* Vincent M. Chiappini, *How American*

expansive—regulating the secondary securities market, creating the Securities and Exchange Commission (SEC), and granting the SEC broad authority to derive and enforce rules.[16]

Among the many provisions promulgated by these original statutes, one of the most important, influential, and daunting for issuers and investors alike is the antifraud provision of the Exchange Act found in Section 10(b).[17] Section 10(b) grants a broad delegation of authority to the SEC to regulate the use of deceptive devices "in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered."[18] For years, the text of Section 10(b) and its legislative history have been interpreted to imply that the antifraud provision applies regardless of whether securities are traded on organized US markets.[19] Accompanying Section 10(b) is SEC Rule 10b-5, a similarly expansive rule creating a cause of action for fraudulent or deceptive behavior in the exchange of securities.[20] It has become the primary mechanism used by shareholders who wish to bring action alleging fraud against issuers.[21]

In the almost eighty years since these statutes were enacted, little has changed in the law, but much has changed with regard to the method of buying and selling securities.[22] For many years, securities transactions were purely paper-based;[23] transferring stock required the buyer to send the seller a check and the seller to mail the purchased stock certificates to the buyer.[24] With time, securities market traffic increased to a level that made manual transactions unfeasible, and in 1975, Congress passed legislation aimed at remedying these problems by centralizing the storage of stock certificates and ceasing to require physical movement in the effectuation of trades.[25] The brokerage industry took charge of

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Are American Depositary Receipts? ADRs, Rule 10b-5 Suits, and Morrison v. National Australia Bank, 52 B.C. L. REV. 1795, 1797–98 (2011).

16. *See* Chiappini, *supra* note 15, at 1798.

17. 15 U.S.C. § 78(j)(b) (2012).

18. *See* Genevieve Beyea, Morrison v. National Australia Bank *and the Future of Extraterritorial Application of the U.S. Securities Laws*, 72 OHIO ST. L.J. 537, 541 (2011).

19. *See* Leaseco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1336 (2d Cir. 1972); Beyea, *supra* note 18, at 541.

20. *See* Beyea, *supra* note 18, at 541.

21. *See id.* at 540.

22. *See* Cox, *supra* note 13, at 942; James W. Christian, Robert Shapiro, John-Paul Whalen, *Naked Short Selling: How Exposed Are Investors*, 43 HOUS. L. REV. 1033, 1047–48 (2006).

23. *See* Cox, *supra* note 13, at 942.

24. *See* Christian, *supra* note 22, at 1047.

25. 15 U.S.C. §78q-1(a) (2012); Christian, *supra* note 22, at 1047.

immobilizing and centralizing stock certificates through the creation of the Depository Trust Company (DTC) in 1973.[26] The DTC holds physical stock certificates representing actual market shares in its vaults and records sales by crediting investors' accounts.[27] This allows for purely electronic exchanges in the securities market through trades tracked by book entries in participant's DTC accounts.[28] In 1975, the DTC began servicing ADRs, reaching into the global marketplace.[29] Over the years, the DTC, now a subsidiary to the larger Depository Trust Clearing Corporation (DTCC), has become so prominent that it services more than fifty exchanges and equity trading platforms in the United States in addition to securities in 131 countries.[30]

B. Globalization of Securities Market

Advancements in technology have inevitably led to an interconnectedness of economies around the world.[31] The securities industry is no exception, as more and more companies seek to sell their securities in foreign markets.[32] The US market is particularly attractive to these companies for a variety of reasons. First, as mentioned, the strict regulatory regime increases trust in potential investors' minds and reduces the likelihood that investors will dramatically discount the price of a given security to account for a lack of information or other risks.[33] Therefore, by listing on the US market, foreign companies can raise capital at a lower price and increase the potential for financial gains.[34] Second, foreign companies choose to enter the US market to expand the pool of potential capital and investors and increase the liquidity of their shares, which leads to higher expected returns.[35] Third, placing securities on the US market

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26. *See* Christian, *supra* note 22, at 1050; DTCC, *Securing Today. Shaping Tomorrow.*, 4 [hereinafter DTCC, *Securing Today*], http://www.dtcc.com/~/media/Files/Downloads/About/DTCC_Capabilities.pdf?la=en [https://perma.cc/M47P-APU6].

27. *See* Christian, *supra* note 22, at 1050.

28. *See id.* at 1050–51.

29. DTCC Digital Museum, DTCC, http://www.dtcc.com/annuals/museum/index.html [https://perma.cc/5EMK-PZUS].

30. *See* DTCC, *Securing Today*, *supra* note 26, at 3.

31. *See* *International Investing*, U.S. SEC. AND EXCH. COMM. (Aug. 14, 2012), http://www.sec.gov/investor/pubs/ininvest.htm [https://perma.cc/DR8D-LQ6K].

32. *Id.*

33. Cox, *supra* note 13, at 953–54.

34. Amir N. Licht, *Corporate Governance: Bonding or Avoiding?*, 4 CHI. J. INT'L L. 141, 144 (2003); Pierpaolo Marano, *Cross-listing, Global Shares and Dematerialised Shares*, 11 UNIFORM L. REV. 267, 267 (2006).

35. *See* Licht, *supra* note 34, at 144.

can increase a foreign company's visibility and marketing capabilities.[36] Finally, listing securities on the US exchange increases a foreign company's success in effecting mergers and acquisitions, tender offers, and stock swaps with US companies.[37] Some argue that these attractive features of the US regime have influenced the securities regulations in other countries, closing the gap between the strictness of US regulations and foreign regulations and making the global market more efficient, transparent, and trustworthy as a whole.[38]

On the other hand, some argue that this strict regulatory regime actually works as a deterrent to foreign companies' entry to the market.[39] Despite the clear advantages of listing on the US market, there are also several disadvantages. First, registering on the US market is extremely expensive, requiring hundreds of thousands of dollars in direct fees in addition to costs associated with paying managers, underwriters, lawyers, accountants, printing fees, and fees for potential legal liability.[40] Second, the reporting requirements are difficult to comply with and expose companies to litigation.[41] Third, extensive reporting requirements require disclosing information to the public, regulators, and even competitors for free.[42] Finally, there are cheaper and less complicated alternatives in the private market.[43]

Despite these deterrents, many foreign companies seek to trade on US exchanges and have several modes of entry in order to do so. Most traditionally, they have the option of directly listing their securities on the US exchange, voluntarily subjecting themselves to the Securities Act of 1933, the Exchange Act of 1934, and all other SEC requirements and regulations.

There are substitute methods used by foreign companies to reach US investors that are less direct and allow these companies to bypass the strict and extensive regulations required for an ordinary listing. One alternative method is to use an American Depositary

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36. *Id.* at 145.

37. *Id.*

38. *See* Cox, *supra* note 13, at 984–86; *see also* Licht, *supra* note 34, at 142.

39. *See* Marano, *supra* note 34, at 267.

40. Licht, *supra* note 34, at 143.

41. *See* 15 U.S.C. § 77f(b) (2012) (sets base fee payable to SEC for processing of a registration statement); Brian R. Davis, *Securities Regulation: Pyramid Promotion of Self-Improvement Courses Involves Sale of Investment Contracts Within Coverage of Federal Securities Laws.* SEC v. Glenn W. Turner Enterprises, Inc., *474 F.2d 476 (9th Cir. 1973)*, 51 TEX. L. REV. 788, 802–03 (1973).

42. 15 U.S.C. §§ 77a–aa (2012); 15 U.S.C. § 78a–pp (2012).

43. 15 U.S.C. § 77d (2012); 17 C.F.R. § 230.500.

Receipt program.[44] ADR programs involve the placement of foreign shares into depositary banks where the securities are converted into negotiable certificates that represent an interest in shares of the foreign company.[45] These certificates are called American Depositary Receipts and are sold to interested US investors.[46] These programs simplify the process of investing in foreign securities for US investors, allowing them to trade in US dollars rather than in foreign currency.[47]

There are two general types of ADR programs—sponsored and unsponsored—which differ based upon the degree of involvement by the foreign company.[48] With sponsored ADR programs, the foreign company has a clear intent to enter the US market through an ADR program, and it retains the ability to exercise control over the program.[49] Sponsored programs are established through contractual agreements between the foreign company and a single depositary bank.[50] The company has control over terms and conditions of the ADR program, such as the number of registered ADRs, organization of recordkeeping, rights of shareholders, shareholder communications, and payment of dividends.[51] Sponsored ADRs may list on national exchanges, such as the New York Stock Exchange, or on over-the-counter (OTC) markets, explained in detail below.[52]

On the other hand, unsponsored ADR programs are created and managed with absolutely no cooperation by the foreign company.[53] Instead, broker-dealers establish these programs in response to perceived investor demand using a Form F-6 to register the ADRs with the SEC. Not only do these arrangements involve no legal relationship between the depositary bank and the issuer, no costs to the issuer, and no requirements that the issuer comply with Sarbanes-Oxley or GAAP Principles, the foreign issuer often does not

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44. *See generally* MATTHEW D. BERSANI ET AL., ADR PROGRAMS: IMPACT OF UNSPONSORED PROGRAMS ON NON-US ISSUERS (2009), http://www.shearman.com/~/media/Files/NewsInsights/Publications/2009/03/ADR-Programs-Impact-of-Unsponsored-Programs-on-N__/Files/Click-here-to-view-article-ADR-Programs-Impact-o__/FileAttachment/CM040209ADRProgramsImpactofUnsponsoredProgramson__.pdf [https://perma.cc/8CFN-2U6G].

45. SEC OFFICE OF INV'R EDUC. & ADVOCACY, INVESTOR BULLETIN: AMERICAN DEPOSITARY RECEIPTS 1 (2012), http://www.sec.gov/investor/alerts/adr-bulletin.pdf [https://perma.cc/R66Y-UE2K] [hereinafter INVESTOR BULLETIN].

46. *See id.*

47. *See id.*

48. *See* BERSANI, *supra* note 44, at 1.

49. *See* INVESTOR BULLETIN, *supra* note 45, at 1–2.

50. *See id.*

51. *See id.*; BERSANI, *supra* note 44, at 1.

52. *See* Am. Depositary Receipts, Release No. 274 (May 23, 1991); Yuliya Guseva, *Cross-Listings and the New World of International Capital: Another Look at the Efficiency and Extraterritoriality of Securities Law*, 44 GEO. J. INT'L L. 411, 427 (2013).

53. *See* INVESTOR BULLETIN, *supra* note 45, at 2.

even know that its shares are being traded in the United States as ADRs.[54] This lack of control by foreign companies and the informality of this system allow multiple depositary institutions to create programs with inconsistent shareholder services that the foreign private issuers are unable to influence.[55] As a result, unsponsored programs create huge risks of investor confusion and a lack of sufficient investor protection.[56] The investor protection issues are only exacerbated by another aspect of Form F-6, which allows depositary institutions to create a fictitious "issuer" of these ADRs, whose role is purely ministerial.[57]

Unsponsored ADRs also differ from sponsored ADRs in that they cannot trade on national securities exchanges, such as the New York Stock Exchange or the American Stock Exchange.[58] Instead, they must be bought and sold on what are referred to as the OTC market.[59] The OTC market typically houses those securities that cannot meet the requirements necessary for trading on national exchanges.[60] Therefore, these securities are more risky, their prices are less efficient, and their protection under securities laws is minimal or nonexistent.[61] Due to the inherent risks associated with purchases of securities on OTC markets,[62] purchasers attempting to seek relief under Rule 10b-5 often fail to meet the required presumption of reliance.[63]

However, unsponsored ADRs vary drastically from those securities that typically trade on the OTC market. Unlike the small, risky companies that trade on the OTC market because they cannot meet registration requirements, Foreign Private Issuers (FPIs) with unsponsored ADRs on the OTC market are typically as large and established as the US companies trading on national exchanges.[64]

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54. *See* DEUTSCHE BANK, *supra* note 3, at 3.

55. *See* BERSANI, *supra* note 44, at 1.

56. *See id.*

57. *See* Mark A. Saunders, *American Depositary Receipts: An Introduction to U.S. Capital Markets for Foreign Companies*, 17 FORDHAM INT'L L.J. 48, 66 (1993).

58. Am. Depositary Receipts, Release No. 274 (May 23, 1991); *see* Guseva, *supra* note 52, at 427.

59. *See* DEUTSCHE BANK, *supra* note 3, at 3.

60. Randall Dodd, *Markets: Exchange or Over-the-Counter*, INT'L MONETARY FUND, http://www.imf.org/external/pubs/ft/fandd/basics/markets.htm [https://perma.cc/M2YM-KAZS].

61. *See id.*; Merritt B. Fox, *Securities Class Actions Against Foreign Issuers*, 64 STAN. L. REV. 1173, 1248 (2012).

62. Lucy McKinstry, *Regulating a Global Market: The Extraterritorial Challenge of Dodd-Frank's Margin Requirements for Uncleared Otc Derivatives & a Mutual Recognition Solution*, 51 COLUM. J. TRANSNAT'L L. 776, 788–94 (2013).

63. *See* Fox, *supra* note 61, at 1247.

64. *See id.* at 1248.

Also, shares of FPIs are well established with efficient prices on their home markets and matching prices in other markets they have volitionally entered due to cross-market arbitraging.[65] Therefore, when brought to the US OTC market through depositary trust companies in the form of unsponsored ADRs, they are traded at roughly the same price, making them almost as efficient as companies on national exchanges.[66]

Recent regulatory amendments have facilitated an increase in the creation of unsponsored ADR programs.[67] Under Exchange Act Section 12(g), certain registration and disclosure requirements are triggered when a company has three hundred or more US shareholders.[68] This is especially concerning for foreign companies whose US shareholder base may be established through unsponsored ADRs over which they have little to no control.[69] Therefore, previously, in order for foreign companies to be exempted from automatic disclosure and registration requirements, foreign companies had to formally apply for an exemption by submitting required documents under Rule 12g3-2(b).[70] However, recent amendments to Rule 12g3-2(b) allow for the exemption to be met less formally and without any action by the company.[71] The amended Rule deems companies exempt so long as sufficient information is included on its company website.[72] Form F-6 was accordingly amended, allowing certain unsponsored ADR filing requirements to be satisfied so long as depositary banks relied in good faith on the adequacy of information on a company's website under amended Rule 12g3-2(b).[73]

Although these amendments sought to create a positive effect—such as increasing trade of foreign securities in the United States—they create several potentially negative consequences.[74] For instance, the good faith requirement seems to dramatically decrease

65. *See id.*

66. *See id.* Note that several years after the Securities and Exchange Acts were passed, the SEC felt that the value of an ADR on the domestic market should match its value in the foreign market. *Compare* Am. Depositary Receipts Representing Ordinary Stock of Cable & Wireless (Holding) Ltd., 37 Fed. Reg. 2452 (Aug. 2, 1937) (rejecting application of an ADR security where the receipt was not "substantially equivalent" to the value of the share overseas), *with In re* Am. Depositary Receipts Representing Ordinary Registered Shares of The De Havilland Aircraft Co., 37 Fed. Reg. 2664 (Aug. 31 1937) (approving application of an ADR security where its value was shown to be substantially equivalent to the underlying share).

67. *See* BERSANI, *supra* note 44.

68. *See id.*

69. *See id.*

70. *See id.*

71. *See id.*

72. *See id.*

73. *See id.*

74. *See id.*

the amount of information required by a particular company and fails to ensure that information's legitimacy. This lowers the regulatory bar, putting investors in a riskier position than they expect when trading on the US market. This conflicts with the legislative history of the 1934 Exchange Act discussing ADRs, which expresses an interest in protecting Americans investing in ADRs through access to adequate and accurate amounts of information.[75]

C. Globalization and Extraterritoriality Addressed

1. Legislative Perspective

Despite a clear desire for the SEC to have expansive oversight over all securities, including those on OTC markets,[76] Congress recognized a need to avoid oversight that could disrupt domestic trading, complicate existing regulatory regimes, or impose regulations on foreign issuers who did not voluntarily enter the United States to raise capital.[77] Therefore, Congress granted the SEC authority to exempt foreign securities, partially or completely, so long as "the exemption [wa]s in the public interest and consistent with the protection of investors."[78]

The SEC utilized this authority first by choosing to exempt ADRs from the 1964 Amendments to both the Securities and Exchange Acts, which expanded reporting and registration

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75. *Stock Exchange Regulation: Hearing on S. 2963, H.R. 7852, H.R. 8720 Before the H. Comm. On Interstate and Foreign Commerce*, 73d Cong. 371 (1934) (statement of E. Burd Grubb, President, NY Curb Exchange) ("It is inconceivable that the companies whose stocks are thus held in the form of receipts in this country would file the information required by the bill, or any information. . . . Do you not think the American public is entitled to a little better information for its protection than it has had with reference to dealing with bonds and stocks. . . . [Y]our argument is that you should do nothing with reference to foreign stocks or bonds. But my observation is that the American public has taken a sufficient burning in those matters, and ought not to have to again, and are entitled to a certain amount of honest information and protection which ought to be given to them. I cannot yield to the point that they are not given any protection.").

76. 15 U.S.C. § 78(j) (2012) (covering "any security not so registered"); Superintendent of Ins. of State of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 11 (1971) ("For 10(b) bans the use of any deceptive device in the 'sale' of any security by 'any person.' And the fact that the transaction is not conducted through a securities exchange or an organized over-the-counter market is irrelevant to the coverage of s 10(b).").

77. *See* S. Rep. No. 379 at 29–31 ("As a practical matter, however, enforcement of the registration and reporting requirements of S. 1642 against foreign issuers outside the jurisdiction of the United States who do not voluntarily seek funds in the American capital markets or listing on an exchange would present serious difficulties. To prevent the securities of such issuers from being traded in the U.S. markets would seriously affect American holders of millions of dollars of such foreign securities.").

78. Adoption of Rules Relating to Foreign Securities, Exchange Act Release No. 8066 (Apr. 28, 1967).

requirements. The SEC reasoned that ADRs are not securities within themselves, but rather represent an interest in an underlying security over which the SEC has limited control and investors would not be provided new or novel information if ADRs were registered. However, these securities are not totally unregulated, as Exchange Act 12(g) kicks in when a company has three hundred or more US shareholders.

However, this exemption has interesting implications with regard to unsponsored ADRs traded over-the-counter. The SEC has consistently exhibited reluctance in specifying how and which SEC rules apply to unsponsored ADRs. For instance, Rule 12(g)(3) states that FPIs who have previously listed securities on US exchanges are subject "to the provisions of sections 14 and 10 of the Act."[79] Over time, similar uses of rulemaking silence with regard to unlisted FPIs, or instances where rulemakers spoke only with regard to FPIs registered on US exchanges, have been used to distinguish FPIs that have listed from those that have never listed on an established national exchange.[80]

2. Judicial Perspective

With securities trading globally in a world with increasingly integrated financial markets, there has been a steady increase in both transnational securities fraud and transnational securities fraud litigation.[81] However, since each country has its own unique regulatory scheme, it can be difficult to determine which country's regulatory scheme applies in a particular transaction.[82] In addition, one country's regulatory scheme may be more attractive than another's.[83] Since the US regime is often viewed as most attractive to investors, this leads to a relentless attempt by defrauded investors around the world to bring Rule 10b-5 actions within the United States, even when the transaction in question has little or no connection to the United States.[84]

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79. Adoption of Rules Relating to Foreign Securities, Exchange Act Release No. 8066 (Apr. 28, 1967) (codified in Rule 12g3-2(b)).

80. *See e.g.*, '08 SEC Rule (codified in 17 C.F.R. § 239) (failing to discuss the issue of antifraud with regard to FPIs' securities intended for non-US market trade that ended up trading on the OTC market); Offshore Offers and Sales, 55 Fed. Reg. 18306-01 (May 2, 1990) (codified in 17 C.F.R. § 230 (2015)) (establishing that antifraud provisions applied to securities intentionally sold into the United States).

81. *See* Beyea, *supra* note 18, at 539.

82. Samuel Wolff, *Extraterritoriality and the Securities Laws: Post-*Morrison *Developments*, 34 NO. 9 SEC. & FED. CORP. L. REP. 1 (2012).

83. *See id.*

84. *See id.*

US courts recognized the increased likelihood for transnational security fraud and were tasked with creating rules to mitigate this problem without any clear Congressional guidance.[85] Using policy considerations and their best judgment, courts generally agreed that Congress "would not have wanted wrongdoers offshore to be free to cause harm in the United States, or for the United States to be used as a base for fraudulent schemes directed at foreigners, even if the actual transaction affected by the fraud took place overseas."[86] As a result of this consensus, two tests dominated transnational securities fraud jurisprudence for many years: the conduct test and the effects test.[87]

The conduct test focused "on the nature of [the] conduct within the United States as it relates to carrying out the alleged fraudulent scheme."[88] In promulgating this test, courts inferred that Congress wanted to deter issuers from choosing the United States as a platform for defrauding investors.[89] In applying this test, circuit courts adopted a variety of methods for determining what conduct was sufficient to bring the action within the purview of Rule 10b-5.[90]

Meanwhile, the effects test asked whether fraudulent foreign actions "caused foreseeable and substantial harm to interests in the United States."[91] These interests included US investors, US markets, and securities traded on US exchanges or issued by its entities.[92] Despite the widespread use of these two tests among the judicial circuits, for over forty years, each faced criticism for requiring extremely fact-specific inquiries that resulted in unpredictable outcomes.[93] This led to pressure to move toward a more bright-line test, which the Supreme Court sought to enact with its 2010 decision

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85. *See* Study on the Cross-Border Scope of the Private Right of Action Under Section 10(b) of the Securities Exchange Act of 1934, U.S. SEC. & EXCH. COMM'N 10 (2012) [hereinafter SEC Study].

86. *See id.*

87. *See id.*; Beyea, *supra* note 18, at 542.

88. *See* SEC Study, *supra* note 85, at 11 (quoting Psimenos v. E.F. Hutton & Co., 722 F.2d 1041, 1045 (2d Cir. 1983)).

89. *See* Beyea, *supra* note 18, at 543.

90. *See* SEC Study, *supra* note 85, at 11.

91. *See id.*

92. *See id.*; Beyea, *supra* note 18, at 542.

93. *See* Christina M. Corcoran, *The Post-*Morrison *Challenge—The Growing Irrelevance of a Transaction-Based Test in an Interconnected World: An Analysis of the Extraterritorial Application of Section 10(b) of the Securities Exchange Act of 1934 and the International Comity Implications in the Wake of* Morrison, 26 N.Y. INT'L L. REV. 77, 77 (2013); Grant Swanson, *A Comparative Law Analysis of Private Securities Litigation in the Wake of* Morrison v. National Australia Bank, 87 CHI.-KENT L. REV. 965, 967 (2012).

Morrison v. NAB.[94] This bright-line test establishes the current state of the law.[95]

The *Morrison* case involved what is classified as a "foreign-cubed" action, meaning it involved foreign plaintiffs suing foreign defendants for misconduct in connection with securities trading on foreign exchanges.[96] More specifically, the case involved Australian investors who purchased Australian Common Stock from an Australia-based company that also owned a Florida-based company.[97] The investors brought a claim under Rule 10b-5 on the grounds that fraudulent bookkeeping occurred within the Florida company, causing a decrease in the share price of the investor's Australian shares.[98] Therefore, the case's only connection to the United States was that the alleged deceptive conduct occurred in Florida.[99]

The Court held that the SEC's jurisdiction under Rule 10b-5 is not dependent on the place where the alleged deception originated, but is limited to "transactions in securities listed on domestic exchanges and domestic transactions in other securities."[100] Therefore, *Morrison* set forth a new two-pronged, transaction-based approach asking whether the transaction was (1) listed on a domestic exchange or (2) a domestic transaction in other securities.[101] In creating this test, the Court sought to promote predictability, international comity, and preservation of the language of the Exchange Act.[102] In support of the first prong of the test, it reasoned that transactions conducted on domestic exchanges and OTC markets affected a national public interest, whereas transactions on foreign exchanges did not.[103] However, the Court provided no clarification as to the meaning of "other securities" in the second prong, or how this aspect of the purported test was to be applied.[104]

The Court stressed that the presumption against extraterritoriality applies in all cases.[105] It stated that this

94. Vincent M. Chiappini, *How American Are American Depositary Receipts? ADRs, Rule 10b-5 Suits, and* Morrison v. National Australia Bank, 52 B.C. L. REV. 1795, 1822 (2011).

95. Morrison v. NAB, 561 U.S. 247 (2010).

96. *See* Beyea, *supra* note 18, at 538.

97. *See Morrison*, 561 U.S. at 251.

98. *See id.* at 251–53.

99. *See id.* at 250–53.

100. *Id.* at 266–67.

101. *Id.*

102. *See* Chiappini, *supra* note 94, at 1822.

103. *See Morrison*, 561 U.S. at 267.

104. *See* McKinstry, *supra* note 62, at 812.

105. *See Morrison*, 561 U.S. at 261.

presumption is not rebutted by the definition of interstate commerce, which includes "trade, commerce, transportation, or communication between any foreign country," nor by the section of the Securities Exchange Act dealing with actions abroad that might conceal a domestic violation.[106] As a result, the Court deemed the foreign-cubed transaction at issue outside the purview of SEC Rule 10b-5.[107]

D. The Aftermath of Morrison

The legislature responded quickly to *Morrison*'s plea for legislative guidance with the Dodd-Frank Wall Street Reform and Consumer Act of 2010 ("Dodd-Frank").[108] Section 929P(b)(2) of Title IX of Dodd-Frank essentially allows US district courts to continue to apply the conducts and effects tests in SEC and Department of Justice (DOJ) enforcement actions.[109] However, its guidance only pertains to the governmental actions just described. The Act is silent with regard to private causes of action brought by individual investor plaintiffs, leaving *Morrison* as the controlling law.

From a judicial standpoint, the Court's attempt in *Morrison* to clarify the reach of Rule 10b-5 liability with its transactional test instead created a very specific rule that left many questions unanswered.[110] In addition, the Court seemed to ignore the increasing interconnectedness of the world's financial markets.[111] What is clear from the *Morrison* opinion is a desire by the Court to significantly reduce the ability of plaintiffs to bring Rule 10b-5 actions with foreign elements in US federal court.[112] However, the *Morrison* decision dealt specifically with Rule 10b-5 liability in a foreign-cubed situation involving actual securities and employed broad and vague language in establishing a rule. Therefore, lower courts were left with little to no

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106. *Id.* at 262–64.

107. *Id.* at 264–65.

108. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010) (codified as amended at 15 U.S.C.A. § 78aa (West 2000 & Supp. 2011)) [hereinafter Dodd-Frank]; Corcoran, *supra* note 93, at 79–80.

109. Dodd-Frank, *supra* note 108 ("EXTRATERRITORIAL JURISDICTION.—The district courts of the United States and the United States courts of any Territory shall have jurisdiction of an action or proceeding brought or instituted by the Commission or the United States alleging a violation of the antifraud provisions of this title involving—(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.").

110. *See* Beyea, supra note 18, at 539–40.

111. *See id.* at 554.

112. *See* David He, *Beyond Securities Fraud: The Territorial Reach of U.S. Laws After* Morrison v. N.A.B., 2013 COLUM. BUS. L. REV. 148, 152 (2013).

guidance on how to approach cases involving transactions with different foreign elements. Not to mention the fact that in a modern, electronic, and technologically advanced world where borders are effectively seamless, it is often difficult or impossible to define a "domestic transaction."[113]

In cases dealing with purchases on foreign exchanges, district courts have predominantly, if not exclusively, dismissed these claims as foreign transactions.[114] In *Stackhouse v. Toyota Motor Co.*, a particularly influential California district court case, the court interpreted a purchase of a security on a foreign exchange as if "the purchaser or seller ha[d] figuratively traveled to that foreign exchange—presumably via a foreign broker—to complete the transaction."[115] The physical location of the investor while the transaction took place was deemed irrelevant.[116] In the *In re Alstom* case, investors purchased securities from a French company that dual-listed its securities on the Euronext exchange and the New York Stock Exchange (NYSE) in the United States.[117] Even though the securities were technically "listed on a domestic exchange," the court held that the clear focus of *Morrison* and, more broadly, the Exchange Act was the location where the transaction took place.[118]

Attempts to determine *Morrison*'s applicability to ADRs has resulted in confusion and inconsistency. Some courts have approached the issue by deeming ADRs purchases as domestic transactions under *Morrison* because they are listed and traded on domestic exchanges.[119] Other courts look at the economic realities of individual transactions, with different courts reaching different results.[120] In viewing the economic realities of ADR transactions, several courts noted that purchases and sales of ADRs could be considered domestic transactions without actually deciding the issue.[121] Meanwhile, others have held that the mere listing of ADRs

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113. *See* Wolff, *supra* note 82.

114. *See, e.g.*, Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d 620, 624–26 (S.D.N.Y. 2010).

115. Stackhouse v. Toyota Motor Co., No. CV 10-0922 DSF (AJWx), 2010 WL 3377409, at *1 (C.D. Cal. July 16, 2010).

116. *See id.*

117. *See In re* Alstom SA Sec. Litig., 741 F. Supp. 2d 469, 471–72 (S.D.N.Y. 2010); He, *supra* note 112, at 174–75.

118. *See In re Alstom SA Sec. Litig.*, 741 F. Supp. 2d at 472–73.

119. *See Cornwell*, 729 F. Supp. 2d at 621; *Stackhouse*, 2010 WL 3377409, at *1–2.

120. *See* Christopher Calfee, *Can't See the Forest for the Trees: Where Does a Purchase or Sale of Securities Occur?*, 2 AM. U. BUS. L. REV. 153, 170 (2012).

121. *See In re* Vivendi Universal, S.A. Sec. Litig., 765 F. Supp. 2d 512, 521 (S.D.N.Y. 2011); *In re* Royal Bank of Scotland Grp. PLC Sec. Litig., 765 F. Supp. 2d 327, 337 (S.D.N.Y. 2011).

on the US exchange is insufficient to trigger Rule 10b-5 liability when the actual trade occurs on a foreign exchange. For example, the District Court for the Southern District of New York took an especially narrow approach in *In re Societe Generale Securities Litigation*, which involved purchases of unlisted ADRs on the OTC market.[122] The court held that ADR transactions were "'predominantly foreign securities transactions" because they represent trading in foreign securities and are "traded in a less formal market with lower exposure to US-resident buyers."[123] While the general trend of courts seems to be classifying ADR claims as foreign, this line of cases exhibits no consistency in outcomes or reasoning, leaving investors and foreign companies uncertain whether US courts have jurisdiction over ADR claims under the *Morrison* test.

Similarly, determining applicability to off-exchange transactions has posed an increasingly difficult task for lower courts, as the only pertinent guidance from *Morrison* is the second part of its holding pertaining to "domestic transactions in other securities." As mentioned the *Morrison* Court itself provided no guidance as to the interpretation of this prong of its test.[124] Courts have taken several approaches, specifically: the economic realities approach,[125] the irrevocable liability approach,[126] and the transfer of title approach.[127] Due to the variety of approaches and different courts interpretations of how to apply them, predictability is difficult for investors and issuers alike. The irrevocable liability approach is likely the most egregious of the three, requiring courts to determine the moment at which the investor has "incurred an irrevocable liability to take and pay for the stock."[128] If that moment occurs in the United States, the transaction is subject to Rule 10b-5.[129]

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122. *See e.g.*, *In re* Societe Generale Sec. Litig., No. 08 CIV. 2495 (RMB), 2010 WL 3910286, at *1, *6 (S.D.N.Y. Sept. 29, 2010).

123. *See id.* at *6.

124. *See* McKinstry, *supra* note 62, at 812.

125. *See e.g.*, SEC v. Credit Bancorp, Ltd., 738 F. Supp. 2d 376, 396–97 (S.D.N.Y. 2010); *In re* Banco Santander Sec.-Optimal Litig., 732 F. Supp. 2d 1305 (S.D. Fla. 2010); *see also* Calfee, *supra* note 120, at 170–72.

126. *See e.g.*, Basis Yield Alpha Fund (Master) v. Goldman Sachs Grp., 798 F. Supp. 2d 533 (S.D.N.Y. 2011); SEC v. Goldman Sachs & Co. (*Tourre*), 790 F. Supp. 2d 147 (S.D.N.Y. 2011); Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co. 753 F. Supp 2d 166 (S.D.N.Y. 2010); *see also* Calfee, *supra* note 120, at 173–76.

127. *See e.g.*, Quail Cruises Ship Mgmt., Ltd. v. Agencia de Viagens CVC Tur Limitada, 732 F. Supp. 2d 1345, 1347 (S.D. Fla. 2010), *vacated*, 645 F.3d 1307 (11th Cir. 2011); Calfee, *supra* note 120, at 177.

128. *See* He, *supra* note 112, at 176–77; *Basis*, 798 F. Supp. 2d at 537; *Plumbers'*, 753 F. Supp. 2d at 177.

129. *See* He, *supra* note 112, at 176–77.

While these factors are seemingly straightforward, courts have never clarified the factors or circumstances in which a plaintiff can succeed under this test. Rather, it seems that every time this method is applied, the court deems the transaction foreign, pointing only to factors that indicate that the transaction falls outside of *Morrison*'s purview.[130] For instance, two lower courts using the "irrevocable liability" approach in cases with strikingly similar fact patterns involving penny stocks reached opposite findings.[131] In *Cascade Fund LLP v. Absolute Capital Management*, the court found a foreign transaction when the plaintiff entity purchased foreign penny stocks on the US OTC market.[132] The court argued that irrevocable liability existed only when defendants accepted the application to invest while in the Cayman Islands, not when money was transferred from the United States.[133] Meanwhile, despite a similar fact pattern and holding in *Absolute Activist v. Ficeto*, the court noted that "facts concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money" may indicate a domestic transaction.[134] This is in direct contention with the idea in *Cascade* that transfer of money is insufficient.[135]

II. ANALYZING THE LACK OF PROTECTION AFFORDED TO INVESTORS AND ITS EFFECT ON THE FUNCTIONING OF THE GLOBAL ECONOMY

As a result of the current regulatory regime and recent case law, unsponsored ADRs fall through the cracks when it comes to antifraud protection, leaving investors with no remedy from any regime. This ultimately results in a failure to meet or an outright contradiction of the overarching goals sought by the *Morrison* opinion—predictability, international comity, and preservation of the language and goals of the Securities and Exchange Acts.[136] In turn, this lack of protection results in inefficiency in not just the US market, but the global securities market. With advancements in technology facilitating further interconnectedness of markets, something must be

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130. *See Basis*, 798 F. Supp. 2d at 537; *Tourre*, 790 F. Supp. 2d at 159, *Plumbers'*, 753 F. Supp. 2d at 178.

131. *Compare* Absolute Activist Value Master Fund Ltd. v. Ficeto, 677 F.3d 60 (2d Cir. 2012), *with* Cascade Fund v. Absolute Capital Mgmt., 2011 No. 08-CV-01381-MSK-CBS, 2011 WL 1211511 (D. Colo. Mar. 31, 2011).

132. *Cascade*, 2011 WL 1211511, at *7.

133. *Id.*

134. *Absolute Activist*, 798 F.3d at 70; Calfee, *supra* note 120, at 178.

135. *See Cascade*, 2011 WL 1211511, at *7.

136. *See* Chiappini, *supra* note 94, at 1822.

done to avoid the global inefficiencies that could deter foreign trade and interrupt the global economy.

A. Lack of Antifraud Protection for Unsponsored ADRs

The current regulatory regime allows unsponsored ADRs to fall through the cracks when it comes to regulation, leaving investors completely unprotected by the regulations of any regime. Unsponsored ADRs escape antifraud liability because they are usually considered foreign transactions under *Morrison*.[137] Even if they fall within the purview of *Morrison*, both foreign private issuers and depositary banks would be absolved from issuer liability,[138] narrowing the parties from whom injured plaintiffs can seek relief.

The discussion of *Morrison* and post-*Morrison* cases above indicates that transactions with unsponsored ADRs would likely fall outside of *Morrison's* purview. First, although treatment of sponsored ADRs has been inconsistent, the recent cases that actually decided the issue deemed them foreign transactions under *Morrison*.[139] Second, while the examination of off-exchange transactions provides little guidance on how courts are applying *Morrison*, there seems to be a general pattern toward considering transactions on the OTC market as foreign transactions.[140] Finally, the most closely analogous case, *In re Societe Generale Securities Litigation*, addressed ADRs trading on the OTC market and concluded that these were foreign transactions.[141] Therefore, despite some inconsistencies in applications of *Morrison*,[142] the cases that address ADRs,[143]

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137. *See, e.g.*, *In re* Societe Generale Sec. Litig., No. 08 CIV. 2495 RMB, 2010 WL 3910286, at *6 (S.D.N.Y. Sept. 29, 2010).

138. *See* S. Rep. No. 379, at 29-31 (1963) ("As a practical matter, however, enforcement of the registration and reporting requirements of S. 1642 against foreign issuers outside the jurisdiction of the United States who do not voluntarily seek funds in the American capital markets or listing on an exchange would present serious difficulties. To prevent the securities of such issuers from being traded in the U.S. markets would seriously affect American holders of millions of dollars of such foreign securities."); Beyea, *supra* note 18, at 540; Saunders, *supra* note 57, at 66.

139. *See, e.g.*, *In re Societe Generale*, 2010 WL 3910286, at *6.

140. *See* SEC v. Goldman Sachs & Co. (*Tourre*), 790 F. Supp. 2d 147, 159 (S.D.N.Y. 2011); Basis Yield Alpha Fund (Master) v. Goldman Sachs Group, Inc., 798 F. Supp. 2d 533, 537 (S.D.N.Y. 2011), Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co., 753 F. Supp 2d 166, 178 (S.D.N.Y. 2010).

141. *See In re Societe Generale*, 2010 WL 3910286, at *6.

142. *See* Beyea, *supra* note 18, at 553.

143. *See In re* Vivendi Universal, S.A. Sec. Litig., 765 F. Supp. 2d 512, 521 (S.D.N.Y. 2011); *In re* Royal Bank of Scotland Grp. PLC Sec. Litig., 765 F. Supp. 2d 327, 337 (S.D.N.Y. 2011); Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d 620, 621 (S.D.N.Y. 2010); *In re Societe Generale*, 2010 WL 3910286, at *6; Stackhouse v. Toyota Motor Co., No. CV 10-0922 DSF

off-exchange transactions,[144] and ADRs in off-exchange transactions all imply that unsponsored ADRs would not be subject to Rule 10b-5 liability in the United States.[145]

Even if *Morrison* were to apply to transactions involving unsponsored ADRs, these securities would still escape Rule 10b-5 liability due to failure to identify a viable issuer from whom to seek relief.[146] Rule 10b-5 claims are typically brought against the issuer.[147] While it is usually simple to determine the issuer in a given securities transaction, this question becomes much more complicated in the realm of unsponsored ADRs. While it is clear that the foreign company issues the underlying security, it seems unfair to consider it the issuer of unsponsored ADRs when it made no affirmative effort to raise capital in the US market.[148] A look at legislative history confirms this intuition.[149] As discussed above, the SEC chose to exempt ADRs from the additional reporting requirements of the 1964 amendments to the Securities Act and Exchange Act.[150] Also, the SEC's constant application of rules specifically to FPIs who had previously listed on US exchanges, such as Rules 10 and 14, shows an explicit distinction between FPIs who demonstrated an active intention to enter the US market from those who had not.[151] In other words, drafting silence with regard to FPIs who had never previously listed indicates an intent to exempt FPIs who had not voluntarily chosen to list on the US markets from Sections 10 and 14 of the Exchange Act. FPIs with unsponsored ADRs are FPIs who have not voluntarily chosen to enter the US market.[152] Therefore, they could not be subject to liability under Section 10 as the issuer. Also, as FPIs play no role in selling these securities to consumers on the US OTC

(AJWx), 2010 WL 3377409, at *1–2 (C.D. Cal. July 16, 2010); *see also* Calfee, *supra* note 120, at 169–70.

144. . *See Basis*, 798 F. Supp. 2d at 537; *Tourre*, 790 F. Supp. 2d at 159; *Plumbers'*, 753 F. Supp 2d at 178.

145. *See In re Societe Generale*, 2010 WL 3910286, at *6.

146. *See* Saunders, *supra* note 57, at 65–66.

147. *See* Beyea, *supra* note 18, at 554.

148. *See* S. Rep. No. 379, at 29–31 (1963) ("As a practical matter, however, enforcement of the registration and reporting requirements of S. 1642 against foreign issuers outside the jurisdiction of the United States who do not voluntarily seek funds in the American capital markets or listing on an exchange would present serious difficulties. To prevent the securities of such issuers from being traded in the U.S. markets would seriously affect American holders of millions of dollars of such foreign securities.").

149. *See id.*

150. *See* BERSANI, *supra* note 44.

151. Adoption of Rules Relating to Foreign Securities, Exchange Act Release No. 8066 (Apr. 28, 1967) (codified in Rule 12g3-2(b)).

152. *See* Chiappini, *supra* note 94, at 1822.

markets,[153] injured investors would likely fail in any attempt to bring an action in the FPI's home country.

Since the FPI cannot be held liable as the issuer in a Rule 10b-5 suit, one might presume liability should fall to the depository trust company that is responsible for the unsponsored ADRs listing on the US OTC market. However, they escape issuer status as well.[154] As mentioned above, Form F-6 allows depositaries to create a fictitious issuer of ADRs, making their role in the facilitation of unsponsored ADRs purely ministerial and absolving them from liability.[155] Therefore, if a plaintiff injured by fraud with regard to his purchase of an unsponsored ADR seeks relief under Rule 10b-5, there is no one from whom to seek a remedy.

B. Far-Reaching Effects

Many argue that investors' inability to seek Rule 10b-5 relief for fraud associated with unsponsored ADRs sold on the OTC market is a just result.[156] Since those selling securities on the OTC market typically do so because they cannot meet the SEC requirements to sell on official markets,[157] it is presumed that trading on the OTC market is inherently risky and that those who buy these securities are aware of and comfortable with that risk.[158] Also, the SEC's failure to require registration or reporting from FPIs or depositary trust companies not only indicates an intent to absolve them from liability,[159] but also further bolsters the assumption of risk by unsponsored ADR investors. However, this reasoning ignores the fact that allowing unsponsored ADRs to fall through the cracks is illogical with respect to the goals of *Morrison* and the goals of securities regulation generally—and negatively impacts the US and global economies alike.

1. Goals of *Morrison* Not Met

Morrison sought to create predictability, international comity, and preserve the language and intent of the Exchange Act.[160] The example of unsponsored ADRs demonstrates that the *Morrison* test

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153. *See* INVESTOR BULLETIN, *supra* note 45.
154. *See* 17 C.F.R. § 239 (2015).
155. *See* Saunders, *supra* note 57, at 66.
156. *See* McKinstry, *supra* note 62, at 812–13.
157. *See* Dodd, *supra* note 60.
158. *See id.*
159. Adoption of Rules Relating to Foreign Securities, Exchange Act Release No. 8066 (Apr. 28, 1967) (codified in Rule 12g3-2(b)).
160. *See* Chiappini, *supra* note 14, at 1822.

has, in fact, failed to meet these goals. An examination of lower courts' application of *Morrison* to ADRs of all kinds immediately demonstrates *Morrison*'s failure to create a predictable test.[161] The *Morrison* Court only provided guidance with regard to foreign-cubed transactions, making it extremely difficult for lower courts to apply the test in all other transactions with foreign elements.[162] Also, in attempting to apply this test in a bright-line predictable fashion, lower courts have moved closer and closer to dismissing all cases involving off-exchange transactions instead of grappling with their complicated and intricate nature.[163]

Morrison's international comity goal emanates from an aversion to imposing duplicative or conflicting regulations, forcibly imposing US law in other countries, or interfering with foreign markets in any way.[164] However, this goal must be balanced with the desire to facilitate global investment in an interconnected world.[165] For all of the reasons discussed above, global investment is extremely beneficial and mutually desired by issuers, investors, and individual countries alike.[166] However, the *Morrison* test, while strongly adhering to its international comity goal, goes too far and may actually deter foreign investment. The test, coupled with other regulatory apparatuses, leaves investors in unsponsored ADRs completely unprotected from the laws of any regime. Due to this lack of relief for investors, unsponsored ADRs may become risky to a point that will deter most rational investors.[167] Since increased globalization of securities is inevitable and unsponsored ADRs form one of the most common means of foreign investment, some argue that continued regulatory sovereignty is infeasible in today's economy.[168]

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161. *See* Calfee, *supra* note 120, at 162.

162. *See* SEC v. Goldman Sachs & Co. (*Tourre*), 790 F. Supp. 2d 147, 158–59 (S.D.N.Y. 2011); Basis Yield Alpha Fund (Master) v. Goldman Sachs Grp., Inc., 798 F. Supp. 2d 533, 537 (S.D.N.Y. 2011); *In re* Vivendi Universal, S.A. Sec. Litig., 765 F. Supp. 2d 512, 527 (S.D.N.Y. 2011); *In re* Royal Bank of Scotland Grp. PLC Sec. Litig., 765 F. Supp. 2d 327, 337 (S.D.N.Y. 2011); Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co., 753 F. Supp 2d 166, 178 (S.D.N.Y. 2010); *In re* Alstom SA Sec. Litig., 741 F. Supp. 2d 469, 470–71 (S.D.N.Y. 2010); Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d 620, 621 (S.D.N.Y. 2010); *In re* Societe Generale Sec. Litig., No. 08 CIV. 2495 RMB, 2010 WL 3910286, at *1, *6 (S.D.N.Y. Sept. 29, 2010); Stackhouse v. Toyota Motor Co., No. CV 10-0922 DSF (AJWx), 2010 WL 3377409, at *1–2 (C.D. Cal. July 16, 2010); Beyea, *supra* note 18, at 554; He, *supra* note 112, at 150–51.

163. *See Basis*, 798 F. Supp. 2d at 537; *Tourre*, 790 F. Supp. 2d at 159, *Plumbers'*, 753 F. Supp 2d at 178.

164. *See* Chiappini, *supra* note 14, at 1822.

165. *See* Cox, *supra* note 13, at 953–54; Marano, *supra* note 34; Licht, *supra* note 34, at 142–43, 145.

166. *See* Cox, *supra* note 13, at 984–86.

167. *See id.*

168. *See* Cox, *supra* note 13, at 978.

Nonetheless, extremely complicated global regulatory regimes that might diminish the effectiveness of foreign investment must be avoided.[169]

Finally, the *Morrison* test arguably adheres to the language of the Exchange Act because the Act is silent regarding extraterritorial reach.[170] However, its application in the unsponsored ADR context demonstrates that it does not align with the Securities and Exchange Acts. While Congress did grant the SEC authority to exempt certain foreign securities from registration,[171] legislative history indicates that investors in ADR instruments should be protected.[172] Also, unsponsored ADRs look and operate much differently than most unsophisticated securities that typically trade on the OTC market. Unsponsored ADRs represent interests in sophisticated foreign companies, and their prices are more or less efficient because they are traded at roughly the same price as similar securities traded in other foreign markets.[173] Because of these attributes, which make them resemble more sophisticated securities, potential investors will be more likely to trust these investments despite their lack of registration and reporting requirements. Therefore, failure to protect investors in unsponsored ADRs seems to directly violate the goals of the Securities and Exchange Acts. This argument is strengthened by the fact that the nearly identical, yet less dangerous, sponsored ADRs traded on the OTC market are susceptible to Rule 10b-5 liability.[174]

2. Deterring a Long-Term Problem

As established above, the securities regulations were instituted in the United States in order for the securities market to function

169. *See* Marano, *supra* note 34, at 147.

170. *See* Chiappini, *supra* note 94, at 1822.

171. Adoption of Rules Relating to Foreign Securities, Exchange Act Release No. 8066 (Apr. 28, 1967).

172. *Stock Exchange Regulation: Hearing before the H. Comm. On Interstate and Foreign Commerce on* S. 2963, H.R. 7852, H.R. 8720, 73d Cong. 371 (1934) (statement of E. Burd Grubb, President, NY Curb Exchange) ("It is inconceivable that the companies whose stocks are thus held in the form of receipts in this country would file the information required by the bill, or any information. . . . Do you not think the American public is entitled to a little better information for its protection than it has had with reference to dealing with bonds and stocks. . . . [Y]our argument is that you should do nothing with reference to foreign stocks or bonds. But my observation is that the American public has taken a sufficient burning in those matters, and ought not to have to again, and are entitled to a certain amount of honest information and protection which ought to be given to them. I cannot yield to the point that they are not given any protection.").

173. *See* Fox, *supra* note 61, at 1248.

174. 17 C.F.R. § 240.10b-5.

most efficiently and effectively.[175] Since unsponsored ADRs are escaping the regulations of any country, the resulting inefficiencies will reach past the US market into the global securities market, creating a continuous, growing, long-term issue.[176]

Integration of the world's securities markets may be a relatively recent phenomenon, but it is not one that is going to cease or reverse anytime soon.[177] Unfortunately, the existing US regulatory scheme was instituted more than eighty years ago in the context of a domestic securities market.[178] Its drafters neither contemplated this state of the world nor could have created a system to anticipate it. Today, however, technology allows the securities market to operate at a global level.[179] As a natural result, transnational securities fraud has become more prominent, leading to escalated litigation and demands for investor protection in this area.[180] In a world desperately in need of securities regulation reform,[181] some consider the *Morrison* decision a "major step back for . . . investors around the world."[182]

III. USING EXISTING DTC FRAMEWORK TO PROTECT INVESTORS AND HOLD FOREIGN PRIVATE ISSUERS ACCOUNTABLE FOR FRAUDULENT ACTIVITY

This Note proposes a solution for the lack of protection of unsponsored ADRs in the US marketplace which aims to clear up confusion regarding liability in the unsponsored ADR realm and to ensure better promotion of the goals of *Morrison* and the Securities and Exchange Acts in today's global security market. It involves using the existing technology and infrastructure of the Depository Trust Company (DTC) to protect investors. The DTC provides an existing infrastructure that streamlines trade of a wide variety of securities traded both domestically and abroad.[183] Since the DTC was created for the purposes of reducing costs, risks, and inefficiencies in the trade

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175. *See generally* SEC, *supra* note 2; Mazando, *supra* note 2, at 133.

176. *See* Corcoran, *supra* note 93, at 77 (suggesting that unsponsored ADR's create a method for "offshore wrongdoers" to cause harm in the US).

177. *See International Investing*, U.S. SEC. AND EXCH. COMM'N (Aug. 14, 2012), http://www.sec.gov/investor/pubs/ininvest.htm [https://perma.cc/W2FT-86PN].

178. Mazando, *supra* note 2, at 132.

179. *See International Investing*, *supra* note 177.

180. *See* Beyea, *supra* note 18, at 539.

181. *See id.* at 557.

182. *See id.* at 556.

183. *See* DTCC, *Securing Today*, *supra* note 26, at 3; DTCC, *An Introduction to DTCC: Services and Capabilities* 1, http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/2010/2010_0701_DTCCServices.pdf [https://perma.cc/ZL9X-S2JN] [hereinafter DTCC, *Introduction*].

of securities, it is the perfect institution for organizing the trade of unsponsored ADRs.[184] Since issuers and investors have traded through the DTC for over forty years, both are familiar with its functionality.[185] Since the DTC system already exists and works with unsponsored ADRs,[186] this solution should not be exceedingly costly or difficult to implement.

However, use of the DTC to institute these solutions raises several issues. First, the DTC is not a regulatory apparatus.[187] Rather, it is a company that has stepped in to create infrastructure and holding facilities to eliminate reliance on paper in the securities market.[188] Therefore, uncertainties arise as to whether it can also serve the legal function set forth by this solution. However, the DTC was created in response to the legislative call for action set forth in 15 U.S.C. 78(q).[189] Since it has served as a solution to a legal issue in the past,[190] certainly it should be able to promote a similar initiative now. Also, the DTC works regularly with regulators.[191] This solution would simply be another project for DTC and regulator collaboration.

Presuming the preliminary issues listed above can be overcome, this Note proposes that the DTC implement one of the following technological functions into its system as a solution to the issues detailed in Part II: (a) institute a function that prevents unsponsored ADR from trading in the United States; (b) institute an alert system which notifies investors of the risks associated with investment in unsponsored ADRs; or (c) institute an alert system that notifies issuers that unsponsored ADRs associated with their company are trading on the US market.

A. Field Unsponsored ADRs

Since the DTC's infrastructure provides for centralized processing of securities deposits,[192] it could create a function

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184. *See* DTCC, *Securing Today*, *supra* note 26, at 15.

185. *See id.* at 3.

186. SEC. EXCH. COMM'N, NOTICE OF FILING OF PROPOSED RULE CHANGE TO ELIMINATE THE OPTION TO RECEIVE A PHYSICAL CERTIFICATE FROM DTC FOR UNSPONSORED AMERICAN DEPOSITARY RECEIPTS THAT ARE PART OF THE FAST AUTOMATED TRANSFER PROGRAM 2, https://www.sec.gov/rules/sro/dtc/2010/34-61507.pdf [https://perma.cc/8VEM-BCZG].

187. *See* DTCC, *Securing Today*, *supra* note 26, at 3.

188. *See id.* at 3, 5, 6.

189. 15 U.S.C. § 78(q) (2012); DTCC, *Introduction*, *supra* note 183.

190. DTCC, *Introduction*, *supra* note, 183.

191. DTCC, *Government Relations*, http://www.dtcc.com/about/government-relations [https://perma.cc/E5HR-DLZ5].

192. DTCC, *Deposit Service: Overview: About*, http://www.dtcc.com/matching-settlement-and-asset-services/securities-processing/deposits-service [https://perma.cc/UTP9-M8MG].

disallowing all unsponsored ADRs from entry and withdrawal from its system. In other words, due to the inherent risk of unsponsored ADRs, the DTC could prevent their trade altogether.

This function would fulfill the goals of *Morrison*. *Morrison*'s application to unsponsored ADRs would be predictable because trade of unsponsored ADRs would have few, if any, connection to the United States. The removal of trade via the DTC, a huge domestic component of these transactions, would remove much of the confusion surrounding whether trade of unsponsored ADRs should be deemed foreign or domestic. Also, as established by *Stackhouse*, the fact that a purchaser is located in the United States while the transaction occurs is insufficient to establish a Rule 10b-5 claim.[193] With this solution, it would be difficult for foreign securities to reach the US market without the FPI's knowledge. This would provide investors with a clear issuer to sue under Rule 10b-5 in situations where a transaction had sufficient ties to the United States to pass *Morrison*. Similarly, international comity would be preserved since these transactions will not be considered actionable under Rule 10b-5 in the United States. Finally, preventing the trade of unsponsored ADRs on the DTC provides strict investor protection as investors are denied the most convenient form of trading these instruments. This solution further eliminates investor confusion by preventing multiple depositary institutions establish unsponsored ADR programs for the same company, allowing for consistent shareholder services.[194]

However, due to this solution's near-complete elimination of the trade of unsponsored ADRs in the United States, it raises several issues. Since more than 815 unsponsored ADR programs were traded in 2014 alone,[195] this solution appears to stifle a huge sector of international securities trade, something that is universally desired.[196] Nonetheless, even if this solution did have the effect of reducing international securities trade, this reduction would be temporary. Once the market adapted to the system, the universal desire for international securities trade would find a way to work within this framework. In fact, a temporary hit to the market is justifiable when the outcome is a more globally efficient market. Also, instead of stifling securities trade, it may instead allow for the market to adjust to a more efficient model. Disallowing unsponsored ADR trade on the

193. Stackhouse v. Toyota Motor Co., No. CV 10-0922 DSF (AJWx), 2010 WL 3377409, at *1 (C.D. Cal. July 16, 2010).

194. *See* BERSANI, *supra* note 44.

195. *See* DEUTSCHE BANK, *supra* note 3.

196. *See* Cox, *supra* note 13, at 953–54, 985–86; Marano, *supra* note 34; Licht, *supra* note 34, at 142, 143, 145.

DTC might force a legal relationship between the depositary and the issuer.[197] This would likely allow injured investors to bring cause of action against both the issuer and the depositary institution.

Second, while it will provide more US investors in foreign securities with protection, there is a chance that investors in unsponsored ADRs that manage to reach the United States without use of the DTC will still remain remediless in the event of fraud. Overcoming this obstacle might be impossible without adjustments to the existing securities regime. However, perhaps the "assumption of risk" argument expressed above[198] would be more appropriate to apply to unsponsored ADRs not trading on the DTC if this regime existed. Since most investors are familiar with the DTC and know of its sophistication and legitimacy, it is more reasonable to assume investors know that securities that do not trade through the DTC are inherently risky than to assume that investors consider any unsponsored ADR risky.

B. Alert Investors of Risks Associated with Unsponsored ADRs

The DTC could adopt a simple alert system used in the trade of unsponsored ADRs that would alert and inform investors of the risks of investing in these instruments and direct them to information that would better inform their decision-making regarding these trades. Trades are completed electronically through the DTC. If investors make a trade, they could be alerted before completion of the trade to consider the risks associated with investing in an unsponsored ADR, such as likely failure to bring suit under Rule 10b-5. The alert could be simple, but contain easy-to-follow links to detailed information about the risks involved. If a broker completes the trade for an investor, a similar alert could be directed toward the broker requiring the broker to inform investors or provide requisite information to investors to apprise them of the risks before the transaction is completed.

This solution fits neatly with the existing state of the law. It will allow continuation of the trend of post-*Morrison*, considering unsponsored ADRs "foreign transactions," while providing predictability, international comity, and fulfilling the goals of the Securities and Exchange Acts. It creates predictability for both issuers and investors. Issuers will be certain that they will not face Rule 10b-5 liability, and investors will be certain that they are making

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197. *See* DEUTSCHE BANK, *supra* note 3.

198. *See* Dodd, *supra* note 60 (suggesting that investors in unsponsored ADRs should be aware of their inherent risk).

a risky investment. This promotes international comity by preventing the United States from overstepping its authority by reaching into US markets. Finally, although it still prevents the ability to bring Rule 10b-5 liability under *Morrison*, it provides investor protection demanded by the Securities and Exchange Acts. This solution protects and informs investors of the risks inherent in investing in unsponsored securities. Instead of assuming that investors are completely aware of these risks by virtue of investment, this solution ensures that they have received actual notice of these risks. While it is unlikely that all investors will read or fully consider the information regarding these risks, this solution creates much more protection than the existing system. Also, the SEC has repeatedly viewed the mere availability of information sufficient to protect investors.[199]

Similar to the first solution, this could significantly reduce the use of unsponsored ADRs. Alerting investors of the risks associated with investing in these securities will deter risk-averse investors. As established above, however, this reduction would likely be temporary and will cease to exist when the market adjusts to the change. Even if it does not reduce or eliminate unsponsored ADRs, it will slow the process of their trade. However, this is a small price to pay for increasing global market efficiency and investor protection. Finally, this solution may not clarify from whom an injured investor may seek relief.

C. Alert Foreign Companies that Unsponsored ADRs Are Trading in US Market

A third solution requires the DTC to alert foreign companies of US trade of unsponsored ADRs representing interests in their companies. When an unsponsored ADR is first deposited into the DTC, the foreign company would be notified. This would eliminate foreign companies' arguments that they are absolved from liability due to lack of "voluntary" entry into the market.[200] This will allow these companies a chance to improve the information they make

199. *See* SEC, *supra* note 2.

200. *See* S. REP. NO. 379 at 29–31 ("As a practical matter, however, enforcement of the registration and reporting requirements of S. 1642 against foreign issuers outside the jurisdiction of the United States who do not voluntarily seek funds in the American capital markets or listing on an exchange would present serious difficulties. To prevent the securities of such issuers from being traded in the U.S. markets would seriously affect American holders of millions of dollars of such foreign securities.").

available or attempt to step in and remove the unsponsored ADRs from the US market.

This solution creates more predictability by informing foreign companies of their securities entry into the US market specifically. This creates the potential for investor relief through Rule 10b-5 liability since foreign issuers can no longer argue involuntary entry into the market. On the other hand, it may create less predictability since, unlike solution (b), the question of whether unsponsored ADRs are considered foreign or domestic under *Morrison* is left unresolved. This solution promotes international comity because the DTC only alerts foreign companies of those unsponsored ADRs that have entered the US market. Since the DTC would only alert foreign companies of potential liability with regard to "securities traded on the US market," as set forth by the statute, it is not overstepping into regulation of securities traded abroad. The goals of the Securities and Exchange Acts also seem protected as this solution clearly identified whom an injured investor can sue. It promotes dissemination of information that, in turn, creates more accurate pricing of these securities. This solution will positively impact the efficiency of both the domestic and global marketplaces.

D. How to Proceed

Considering the three possible solutions presented above, the most effective way to remedy the issues presented by unsponsored ADRs is to use the DTC to both alert investors and foreign companies. Instituting these two ideas in concert will slightly alter their effect in an optimal way. Instead of leaving investors to absorb all of the risk, as the "Alert Investors" solution requires, or leaving investors uninformed, as the "Alert Foreign Companies" solution may entail, investors will be aware of the riskiness associated with these instruments while maintaining the ability to seek remedy from foreign investors. This will provide the most protection to investors while apprising issuers that unsponsored ADRs representing interests in their companies are trading in the United States. As a result, the process of buying and selling unsponsored ADRs moves closer to the ideal trading atmosphere envisioned by the Securities and Exchange Acts, where investors are protected by access to information and the ability to seek remedy in the event of fraudulent activity by the issuer.

Unlike the "Fielding All Unsponsored ADRs" solution, this strategy does not immediately annihilate the trade of unsponsored

ADRs, but allows the market to adjust to issuer and investor awareness of the risks associated with unsponsored ADRs more gradually. This will allow the marketplace to come to an efficient equilibrium over time without drastically disrupting efficiency or global trade generally. Since continuing globalization of the securities market is inevitable, this strategy allows for the legal regime to catch up with technology in a seamless and efficient fashion.

IV. CONCLUSION

While many changes must be made before the securities market can function seamlessly at a global level, this solution allows for a huge step in the right direction. By using the DTC to field unsponsored ADR investments altogether, alert investors of unsponsored ADRs' inherent risks, or alert foreign companies of the trading of unsponsored ADRs representing their shares—or a combination of the three—not only will unsponsored ADRs receive more regulatory attention, but also the global marketplace will function at a much more efficient level.

Perhaps someday securities regulations or infrastructure like the DTC can function at a global level, which would likely solve many of the issues discussed in this Note by facilitating global trade in a market that is accountable, information-rich, and efficient. However, a solution of that magnitude will require global collaboration, which could take years to (or might never) occur. In the meantime, this solution allows for a huge step in the direction of a securities market that can function seamlessly at a global level.

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