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[Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION—
9th Cir.: Exchange Act could apply to ADR transactions, as domestic
transactions not registered on an exchange, \(Jul. 18, 2018\)](#)

Securities Regulation Daily Wrap Up

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By Rebecca Kahn, J.D.

Purchasers of Toshiba American Depository Shares or Receipts (ADRs) sued for violations of Exchange Act Sections 10(b) and 20(a) due to Toshiba's admittedly fraudulent accounting practices. A Ninth Circuit panel reversed and remanded the lower court's [dismissal](#) of the complaint. Although the complaint failed to sufficiently allege a domestic violation of the Exchange Act, allowing amendment would not, as the lower court ruled, be futile. While the over-the-counter market that sold the ADRs was not an "exchange" under the Exchange Act, the Act could still apply to the Toshiba ADRs as "domestic transactions in securities not registered on an exchange." An amended complaint, the panel noted, "could almost certainly allege sufficient facts to establish that [plaintiff] purchased its Toshiba ADRs in a domestic transaction ([Stoyas v. Toshiba](#), July 17, 2018, Wardlaw, K.).

Toshiba's admitted fraud. Headquartered in Tokyo, Toshiba Corporation is a worldwide enterprise that develops, manufactures, and sells electronic and energy products and services. In the wake of Toshiba's admission of substantial institutional accounting fraud and accompanying restatements of pre-tax profits, investors filed this securities fraud class action, in June of 2015, against Toshiba and its current and former CEOs.

First Amended Complaint. Automotive Industries Pension Trust Fund (AIPTF) became lead plaintiff based on its purchase of Toshiba ADRs in the U.S. on an over-the-counter (OTC) market. AIPTF and New England Teamsters & Trucking Industry Pension Fund (together, the "Funds") filed their first amended complaint (FAC) in December of 2015. It asserted violations of American and Japanese law on behalf of U.S. purchasers of Toshiba common stock and ADR purchasers. The FAC alleged that Toshiba committed accounting fraud by misrepresenting its financial condition to investors until 2015, when announced investigations into the company's accounting practices and a subsequent restatement of previously issued financial results caused Toshiba securities to plunge more than 40 percent. The complaint alleged that, over six years, Toshiba improperly overstated its pre-tax profits by more than \$2.6 billion and concealed at least \$1.3 billion in impaired losses at its U.S. business.

Dismissal and appeal. The California district court dismissed the FAC with prejudice in May 2016. Applying the U.S. Supreme Court decision in *Morrison v. National Australia Bank*, the district court held that the OTC market was not a "stock exchange" within the meaning of the Exchange Act, and that the FAC failed to allege Toshiba's involvement in the subject ADR transactions, rendering Section 10(b) inapplicable. Having dismissed the Funds' Exchange Act claims, the district court also dismissed the Japanese law claim on the basis of comity and forum non conveniens. Finding that any amendment would be futile, the district court dismissed with prejudice. The Funds appealed.

In *Morrison*, Australian individuals brought Exchange Act fraud claims against the then-largest bank in Australia. One of the bank's subsidiaries, headquartered in Florida, had allegedly engaged in deceptive conduct and made public, misleading statements. The plaintiffs had purchased ordinary shares, not traded on any U.S. exchange, and sought to represent a class of foreign purchasers of the bank's ordinary shares. The U.S. Supreme Court held that Section 10(b) did not apply extraterritorially. It ruled that Section 10(b) only punishes deceptive conduct "in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered." *Morrison* squarely held that the Exchange Act did not apply where the Australian

bank's shares were not listed on a U.S. exchange and "all aspects of the purchases" took place outside the U.S., even though a subsidiary and its executives "engaged in the deceptive conduct" in the U.S.

Reversed. The Ninth Circuit panel unanimously reversed the dismissal here, stating that the Exchange Act could apply to the Toshiba ADR transactions bought on an OTC market, as domestic transactions in securities that are not registered on an exchange. The panel recognized that this OTC market was not even an "exchange" under the Exchange Act and held that Toshiba ADRs were "securities" under the Exchange Act. The Ninth Circuit panel concluded: "plaintiffs must be allowed to amend their complaint to allege that the purchase of Toshiba ADRs on the over-the-counter market was a domestic purchase, and that the alleged fraud was 'in connection with' the purchase." As to the Japanese law claims, because the district court's opinion "predicated dismissal" of those claims on dismissal of the Exchange Act claims, the Ninth Circuit declined to address whether dismissal "remains appropriate notwithstanding the Exchange Act claims' viability."

Suggested revisions. The FAC alleged that AIPTF's ADRs were purchased in the U.S. and one of the depository institutions sold the ADRs in the U.S. Although the FAC made no allegations as to where the parties incurred irrevocable liability, AIPTF is a U.S. entity; its executives direct, control, and coordinate its activities in the U.S.; and its headquarters are in California. OTC Markets Group operates the Toshiba ADRs' seller, OTC Link, in the U.S, and the Toshiba ADR depository institutions' principal executive offices, agents for service, and offices where ADR holders can exchange their ADRs for common shares are all in New York. Accordingly, the panel noted, an amended complaint would not be futile and could almost certainly allege sufficient facts to establish that AIPTF purchased its Toshiba ADRs in a domestic transaction.

The case is [No. 16-56058](#).

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Companies: Toshiba Corp.

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