Global Business & Development Law Journal

Volume 6 | Issue 1 Article 8

1-1-1993

Exploring American Depository Receipts: The International Augmentation of U.S. Securities Markets

Douglas B. Spoors

Exploring American Depositary Receipts: The International Augmentation of U.S. Securities Markets

Douglas B. Spoors*

TABLE OF CONTENTS

---

* Mr. Spoors is a sole practitioner in Sacramento, California. Mr. Spoors received his B.S., in Finance, at California State University, Fresno and his J.D. and LL.M., in Transnational Business Practice, at McGeorge School of Law, University of the Pacific. Mr. Spoors has practiced as an attorney in the U.S. and Bangkok, Thailand, with an emphasis on general business and international joint ventures.

I. INTRODUCTION

Although American Depositary Receipts (ADRs) have existed for over 60 years, dramatic changes in world economics and the flow of investment capital across international boundaries require a review of the ADR and its regulatory framework. Investment opportunities abound in the modern world economy.[1] Even at the turn of the century, investors recognized the great potential in extending the reach of their investment strategies, and they were eager to participate in foreign securities markets and in offerings of foreign securities in the United States. However, in addition to cultural differences, language barriers, and time lags, American investors who traded in foreign securities faced risks, delays, inconvenience, and transaction costs that were not typical of U.S. securities transactions.[2]

As the drawbacks to foreign-issued securities became more apparent, a common interest developed among investors, facilitators, and regulators in creating a system that would allow international investment in foreign securities while limiting the accompanying pitfalls. Early deposit agreements and substitution certificates of generic composition were developed to accommodate international finance and investment in foreign securities. The need for a

---

1. For example, in an EEC Council Directive of March 17, 1980, the EEC adopted a proposal regarding uniform securities listing, distribution, and reporting requirements. In the opening paragraphs of the Directive, the Council stated that:

> the market in which undertakings operate has been enlarged to embrace the whole Community and this enlargement involves a corresponding increase in their financial requirements and extension of the capital markets on which they must call to satisfy them... [and that] exchange restrictions on the purchase of securities traded on the stock exchanges of another Member State have been eliminated as part of the liberalization of capital movements. . . .

Thus, this measure in liberalizing EEC regulations stemmed in part from the Community's recognition that transnational investment strategies were arising in satisfaction of the needs for international flow of funds through the international market. Council Directive 80/390/EEC, Coordinating the Requirements for the Drawing Up, Scrutiny and Distribution of the Listing Particulars to Be Published for the Admission of Securities to Official Stock Exchange Listing, 1 Common Mkt. Rep. (CCH) ¶ 1731 (March 17, 1980); Commission Issues Policy Statement on International Securities Regulation, 20 Sec. Reg. & L. Rpt. (BNA) 1753 (Nov. 18, 1988).

2. Regis Moxley, *The ADR: An Instrument of International Finance and a Tool of Arbitrage*, 8 VILL. L. REV. 19, 20 (1962). Differences in the safeguards for investor protection and reporting requirements have been recognized as contributing not only to repression of securities issuers, but also to hindering investors (or potential investors) from participating in foreign direct equity investment and thereby inhibiting the financing of businesses throughout the European Community. Council Directive 80/380 EEC, Coordinating the Requirements for the Drawing Up, Scrutiny and Distribution of the Listing Particulars to Be Published for the Admission of Securities to Official Stock Exchange Listing, 1 Common Mkt. Rep. (CCH) ¶ 1731 (March 17, 1983). *See* Note, *SEC Regulation of American Depositary Receipts: Disclosure LTD.*, 65 YALE L.J. 861 (1956).

uniform system to facilitate trading in foreign securities culminated in the birth of the ADR.[3]

Since the birth of ADRs in 1927, they have become the most widely used vehicle for trading foreign securities in the U.S.[4] ADRs are negotiable receipts which evidence the deposit of foreign securities. The underlying securities are deposited with a bank, typically its foreign branch or affiliate, and the bank, acting as the depositary, issues receipts representing the securities to investors. The receipts are typically freely transferrable, normally traded on the NASDAQ over-the-counter market. Although they are not stock certificates in and of themselves, the receipts are similar to the extent they are traded in much the same way as their security counterparts.[5]

The ADR, as a vehicle for trading in foreign securities, has several distinct advantages over direct equity trading in traditional foreign securities. First, they avoid the complications in the initial purchase of foreign securities caused by the lack of timely bid quotations. Even on the domestic securities market, bid prices quoted in various media channels will differ on a given day between New York, Chicago, and Los Angeles.[6] In the international markets, quotations are significantly more perplexing, due to untimely transmission and the fact that they are published in a variety of forms that render such quotations difficult to understand.[7] Second, direct equity investment in foreign securities may be subject to various foreign transfer restrictions which control their purchase and resale, as well as physical transportation of the stock certificates.

In addition to these disadvantages, fluctuating exchange rates and high transportation costs increase the expense and delay of obtaining the proceeds from the sale of foreign securities. Although efforts are underway to improve clearance and settlement practices across international borders, no precise design has emerged to solve these problems.[8] In June 1989, Federal Reserve Board Chairman Alan Greenspan addressed members of the Senate Banking Securities Subcommittee on the subject of trends in globalized securities markets. Greenspan noted that there is a "systematic risk" in clearance and settlement (C/S) delays.[9] In the U.S., the maximum C/S window period is five days.[10] Greenspan warned that any float period in excess of five days introduces significant threats to investment in securities.[11]

The foreign corporate practice of issuing bearer certificates adds further difficulties to foreign direct equity investments. Since holders of the bearer certificates have no direct contact with the foreign corporation, no information relating directly to corporate activities

---

3. The true ADR was developed primarily by the Guaranty Trust Company of New York in cooperation with several prominent domestic and foreign arbitrage brokers and stock exchanges. Moxley, *supra* note 2, at 22.

4. Jonathan Royston, *The Regulation of American Depositary Receipts: Americanization of the International Capital Markets*, 10 N.C. J. INT'L L. & COM. REG. 87 (1985).

5. A depositary share is defined by the SEC as "a security, evidenced by an [ADR], that represents a foreign security or a multiple of or fraction thereof deposited with a depositary." 17 C.F.R. § 230.405 (1984).

6. Macklin, NASDAQ Experience and Emerging 24-Hour Global Equity Market, Current Developments in International Securities, Commodities and Financial Futures Markets 102-3, Singapore Conferences on International Business Law, Faculty of Law, National University of Singapore (1987).

7. *Id.*

8. *NASAA Calls For Focus On International Clearance*, 21 Sec. Reg. & Law Rep. (BNA) 277 (Feb. 17, 1989).

9. *Global Markets' Interdependence Makes Them More Vulnerable, Greenspan Warns*, 21 SEC. REG. & L. REP. (BNA) 877 (June 16, 1989).

10. *Id.*

11. *Id.*

such as meetings, dividend declarations, merger and takeover quests, and potential reorganizations reaches the equity holder. In response, the investor must rely heavily on trade publications of foreign origin, hoping that the information received is timely.[12] By contrast, within the framework of ADRs the depositary banks and their affiliates coordinate their efforts to process and disseminate timely information. Moreover, registration of ADRs requires that the depositary specify in the registration statement those provisions of the deposit agreement which relate to voting procedures, dividend distributions, and circulation of notices and proxy solicitations, along with other information of similar interest to an equity holder.[13] Thus, by eliminating, or at least significantly reducing, the problems with investing directly in foreign securities, the ADR became a welcome transactional vehicle.

Current trends in international securities trading lean towards complete globalization through highly sophisticated electronic processing and market linkages.[14] As global trading increases and its technical difficulties are overcome, computer networks between major investment banks located in major financial centers will gradually replace national securities exchanges.[15] In an address to the Senate committee, Chairman Greenspan stated that although the development of electronic systems for the execution of orders and for verification, clearance, and settlement on a real time basis has progressed, such systems are extremely expensive.[16] Even as development of these systems continues, the integration of international financial markets depends significantly on similar trading systems between participating markets, mutual confidence in regulatory agencies, and reciprocity in enforcement procedures.[17]

---

12. 2 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 774 n.72 (3d ed. 1989); Moxley, *supra* note 2, at 21.

13. *See infra* notes 101-105 and accompanying text.

14. For example, the Toronto Stock Exchange (TSE), the American Stock Exchange (AMEX), and the Midwest Stock Exchange (MSE) established an international trading link in efforts to gain efficiency and liquidity through coordinating their markets. With the linkage system TSE members are able to direct orders for inter-listed securities from the TSE trading floor to the AMEX trading floor for execution in U.S. dollars and complete the transaction within 30 seconds. Conversely, U.S. AMEX members can direct orders through the TSE exchange with only slight delays arising out of currency exchange rate equalization. Beck, INTERNATIONAL TRADING: TRADING LINKS BETWEEN TORONTO STOCK EXCHANGE, AMERICAN STOCK EXCHANGE AND MIDWEST STOCK EXCHANGE, CURRENT DEVELOPMENTS IN INTERNATIONAL SECURITIES, COMMODITIES AND FINANCIAL FUTURES MARKETS 111-12, Singapore Conferences on International Business Law, Faculty of Law, National University of Singapore, 1987.

In another pivotal milestone, on February 2, 1989, the Commodities Futures Trading Commission granted approval of the "Globex System," a computerized trading network for automated after-hours trading. The Globex system was introduced through joint efforts of the Chicago Mercantile Exchange and Reuters Information System, Inc. Globex allows various clearing, auditing, compliance, market surveillance, and information dissemination functions to be carried out after hours. Initially, Globex was designed to handle futures contracts for the Australian dollar, British pound, Canadian dollar, Deutsche mark, Swiss franc, French franc, Japanese yen, Eurodollar, U.S. T-bills, and gold. Leslie Hasking, Chief Executive and Director of the Sydney Futures Exchange and William Brodsky, President and Chief Executive Officer of the Chicago Mercantile Exchange, made a joint announcement that the two exchanges had reached an agreement in principle to admit the Sydney Futures Exchange as a partner in the Globex system. Sydney Futures Exchange to Join CME's Automated Trading Network, 21 Sec. Reg. & L. Rpt. (BNA) 253 (Feb. 10, 1989).

15. Beck, *supra* note 14, quoting from a speech by Van Agtmael, Division Chief of the Financial Operations Department of the World Bank.

16. *Global Markets' Interdependence Makes Them More Vulnerable, Greenspan Warns*, 21 Sec. Reg. & L. Rpt. (BNA) 877 (June 16, 1989). *See* Macklin, *supra* note 6, at 102-3.

17. Beck, *supra* note 14, at 111-19.

Notwithstanding the efforts towards harmonization of international equity investment, various intricate obstacles still exist. Of particular importance are the generally obscure remedial measures that protect investors in the international markets. As the interplay between international economic interests constantly increases, the ADR process is one vehicle that closes the investment gap between nations. However, a serious problem in closing the gap on investor protection remains. This Article reviews the ADR arrangement, provides an overview of relevant SEC regulations, the Glass-Steagall Act, and interpretive cases, and analyzes the bewildering problems related to registration integrity and investor protection. Underlying the research and preparation of this Article is the belief that the ADR will play a continuing role in the vitality of international finance, permitting international investors to participate in opportunities which have been unmanageable or unavailable to most people.

II. An Overview of ADRs and ADR Regulation

A. *ADR Practice and Participation in ADRs*

ADRs[18] are negotiable receipts issued by a U.S. bank or trust company, the depositary, to evidence ownership of a stated number of shares of the securities of a foreign company that the company or shareholder has deposited with the depositary's branch office, affiliate, or agent in the foreign country.[19] ADRs, which were originally developed for equity securities, are now also available for debt securities.[20] ADRs are typically registered in the name of the U.S. holder, and they represent depositary shares which are traded on the NASDAQ over-the-counter market in the U.S.[21]

18. Amidst the turmoil of several decades of definition, interpretation, and clarification of the meaning of "security," the ADR has been one of the strange breeds of securities that has resisted the turbulent definition process. The definitions of"security" contained in the Securities Act of 1933 and the Securities Exchange Act of 1934 are nearly identical. *Compare* the Securities Act of 1933 § 2(1), 15 U.S.C.S. § 77b(1) *with* the Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C.S. § 78c(a)(10). Inasmuch as the definitions are so similar, the courts have held that the definition of security should be construed the same under both Acts. Fargo Partners v. Dain Corp., 540 F.2d 912 (9th Cir. 1976), Fed. Sec. L. Rep. (CCH) ¶ 95,682; United California Bank v. THC Financial Corp., 557 F.2d 1351 (9th Cir. 1977), Fed. Sec. L. Rep. (CCH) ¶ 96,125; Oxford Finance Cos. v. Harvey, 385 F. Supp. 431 (E.D. Pa. 1974), Fed. Sec. L. Rep. (CCH) ¶ 94,942.

A variety of challenges have surfaced over the years in efforts to interpret the true meaning of "security." In 1946, the U.S. Supreme Court developed the Howey test (". . . [the question is] whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.") which still dominates in securities definitional analysis. S.E.C. v. W.J. Howey Co., 328 U.S. 293 (1946). Since that time, the standard itself has been interpreted and clarified. There should be no doubt, by statutory definition or judicial interpretation, that ADRs qualify as "securities" under current standards. *See* Moxley, *supra* note 2, at 20. Both the Securities Act of 1933 (SA) and the Securities Exchange Act of 1934 (SEA) include the phrase "certificate of deposit for a security" in the definition of a security. Securities Act of 1933 § 2(1), 15 U.S.C.S. § 77b(1) (Law. Co-op. 1991); Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C.S. § 78c(a)(10) (Law. Co-op. 1991).

19. Royston, *supra* note 4.

20. Moxley, *supra* note 2, at 33.

21. The terms depositary shares and depositary receipts are not synonymous. The depositary share is the underlying security and the depositary receipt is the certificate representing the depositary share, i.e., evidence that a deposit has been made. For a simplified analogy, a passbook savings record (analogous to the ADR) evidences funds deposited with a bank (analogous to the deposited shares).

ADR transferability stems from the depositary's status as the legal owner of the underlying securities. ADRs are initially issued in the U.S., in registered form only, upon cabled instructions from a foreign custodian of the deposit.[22] The depositary issues the ADR and maintains a registry of the ADR holders. Thereafter, transfers occur at two levels. First, any transfers of the underlying security, which normally occur on the foreign exchange, are accomplished by the depositary without effect on the ADR holders.[23] Thus, the depositary, rather than the ADR holder, deals with the complications of the transfer on the foreign market which involve, as discussed above, time consuming and unfamiliar transfer procedures, time lags for clearance and settlement, and exchange controls.

Secondly, ADR sales on the U.S. market are transacted in much the same way as American securities. The ADR is simply endorsed in blank and transferred to the purchaser. The transfer is accomplished at the office of the depositary in a manner similar to the transfer of domestic securities. The foreign correspondent or affiliate bank, on behalf of the depositary bank, actively watches for announcements of dividend declarations, collects any dividends, converts them to U.S. currency, and transfers them to the ADR holder's account, less any applicable fees.[24]

The foreign branch or affiliate of the depositary bank also acts as a local information network.[25] As legal owner of the securities, the depositary bank, through its foreign branch or affiliate, receives all legal notices and correspondence from the issuer to its shareholders. Additionally, the foreign branch or affiliate can easily translate reports of local trade publications and investment advisory syndications, which are often in the language of the country of origin, and relay them in useful form to the ADR holder.[26]

The foreign corporation issuing the securities does not necessarily participate in the arrangement. The depositary may have no direct connection with the corporation other than appearing on its records as a shareholder. The primary contractual relationship is not between the ADR holder and the corporation, but rather between the holder and the depositary bank. Although formal contracts or depositary agreements originally were prepared to memorialize the relationship between the depositary and the ADR holder, modern ADR arrangements include the terms of the arrangement on the ADR certificate itself.[27]

---

22. Moxley, *supra* note 2, at 23.

23. In such an arrangement, there is a significant reduction in the applicability of foreign inheritance taxes and probate complications.

24. Moxley, *supra* note 2, at 23. If the holder wishes, he can make a direct sale of the underlying security on the foreign market, surrender the corresponding ADR, and have the related foreign security released to his designee. *Id.*

25. The Depositary investigates the character and standing of the company, but does not warrant the corporations' integrity or stability, nor make any recommendations. LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 234 (1983).

26. LOSS & SELIGMAN, *supra* note 12, at 774. Note that the system now allows for 3-way arbitrage of ADRs. Original issues of the shares are deposited with a custodian in the country of origin. Depositary receipts may then be issued simultaneously with foreign affiliates, for example in the U.S. and the U.K. or other countries offering ADRs or equivalent regulator systems for international trading of such certificates. *Id.*

27. LOSS, *supra* note 25, at 247.

B. An Overview of ADR Regulation

1. The Voluntarism Principle

ADRs are classified as securities and as such are subject to SEC registration requirements.[28] In relation to these requirements, there are two theoretical forms of offerings subject to SEC scrutiny: offerings involving voluntary entry into U.S. securities markets and offerings of involuntary entry.[29] This concept, generally referred to as the voluntarism principle, stems from the SEC's recognition of the special problems related to foreign securities.[30]

In 1981, the SEC officially recognized the efforts of the European Economic Community (EEC), the Organization for Economic Cooperation and Development (OECD), the United Nations (UN), and the International Accounting Standards Committee in working toward the formulation of guidelines for uniform international disclosure standards.[31] By 1985, the EEC adopted a system for the harmonization of regulations concerning undertakings for collective investment in transferable securities (UCITS). A directive issued in Brussels on November 18, 1985, stated that those efforts

> ... intended to establish minimum common rules concerning the authorization, supervision, structure and investment policy of UCITS which fall within the scope of the directive and concerning the information they must publish.[32]

The purpose of the directive was to ensure equal protection for investors and to harmonize the conditions of competition between UCITS. The EEC intended to accomplish this end by minimizing transborder regulation and substituting the principle of "supervision by the country of origin."[33]

The SEC's original policy and the legislative intent behind the Securities Act was that foreign private issuers should be treated the same as domestic issuers.[34] The SEC's voluntarism principle arose out of a dichotomy of investor protection and the identical treatment policy, on the one hand, and the desire to further investment opportunities, on the other. In the SEC's view, subjecting foreign non-voluntary issuers to the same registration requirements as domestic issuers would stifle and restrict the flow of international commerce.[35] At the same time, if strict registration requirements were imposed and if foreign securities were restricted, U.S. investors would channel their foreign investments through foreign securities exchanges, where disclosure requirements may be grossly

---

28. Securities Exchange Act, 15 U.S.C.S. §§ 77b(1)-(15) (Law. Co-op. 1991).

29. SEC Securities Act Rel. No. 6360 [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,054, at 84,643 (Nov. 20, 1981) [hereinafter SEC Rel. 6360].

30. *Id.* at 84,643.

31. *Id.* at 24 SEC Dock. 3, 6 (1981).

32. Coordination of Undertakings for Collective Investment in Transferable Securities to Promote European Capital Market, Press Release of the Council of European Communities, No. 10429/85 (Presse 173), Brussels, November 18, 1985, [New Developments Transfer Binder] Common Mkt. Rep. (CCH) ¶ 10,741.

33. *Id.*

34. *Hearings on S. 875 Before the Comm. on Banking and Currency*, 73rd Cong., 1st Sess. 89-90 (1933); *Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73rd Cong., 1st Sess. 12-13 (1933).

35. SEC Rel. 6360, *supra* note 29, at 84,645.

inadequate. Thus, an overly strict regulatory scheme would undermine the protection that the SEC hastens to provide to investors. The SEC effected a compromise of the two positions by a slightly more lenient registration process for foreign non-voluntary issuers.[36]

2. *Voluntary versus Non-Voluntary Entry*

In one instance, a foreign issuer may not be involved in the depositary arrangement when a foreign dealer or shareholder deposits securities with the depositary. Similarly, the depositary may solicit deposits of shares against the proposed issuance of ADRs. Under these circumstances, the issuer is deemed to have not voluntarily entered the U.S. market.[37] When there is no voluntary entry, registration should be much more lenient than for foreign issuers who directly initiate public offerings or trade their securities on the U.S. market.[38] However, when the foreign issuer is the sponsor of the ADR arrangement as the principle depositor, it is subject to greater SEC control. This additional control is essentially a bootstrap link to Section 11 liability of issuers.[39] Thus, under the instructions to Form F-6, a foreign issuer who sponsors an ADR arrangement must sign the registration statement,[40] thereby activating Section 11 liability protection against itself.

III. BANKS, BANKING, AND REGULATION: HOW MANY HATS CAN ONE BANK WEAR?

An analysis of the history of banking and securities regulation reveals that the regulation of neither industry is clear, and that although attempts have been made to segregate the two industries, accomplishing that goal poses difficult problems reachable only after serious compromise. The SEC once tended to allow banks to go about the business of banking without substantial interference. Generally, banks were exempt from SEC registration and

---

36. *Id.*

37. The SEC's position on voluntary entry into the U.S. market is that foreign issuers that list securities on a U.S. exchange or undertake to make a public offering have voluntarily entered into the U.S. securities markets. SEC Rel. 6360, *supra* note 29, at 84,643.

38. Royston, *supra* note 4, at 89.

39. *See infra* notes 85-96 and accompanying text (relating to the "issuer dilemma").

40. Form F-6, 2 Fed. Sec. L. Rep. (CCH), ¶ 7001 at 6161 (1988) (Adopted in Rel. No. 33-6459, ¶ 83,329, March 18, 1983, effective March 24, 1983, 48 Fed. Reg. 12346). If the foreign issuer is also the sponsor of the ADRs, in addition to the issuer signing the ADR registration, the principal executive officers, chief financial officer, controller or principal accounting officer, a majority of the board of directors, and the issuer's authorized U.S. representative must also sign the registration statement. *Id.* For an analysis of ADR registration, see *infra* notes 96-119 and accompanying text.

reporting requirements, even though they frequently transgressed into the securities arena.[41] Those days, however, are largely gone.

A. *The Bankers' Exemption: Section 3(a)(2)*

The passage of the Securities Act of 1933 permitted banks to issue securities, within specified limits, under Section 3(a)(2) without complying with registration requirements.[42] Through various amendments, the act's correlated legislative history indicates that Congress intended a broad application of this Section 3(a)(2) exemption. Restrictive and conservative Supreme Court decisions gave rise to the Congressional debate linked to Section 3(a)(2)'s "public instrumentality" and "essential government functions" provisions.[43] The result was an expanded view by Congress and the SEC of the exemption, but an important issue remained unresolved until 1955. Before 1955, banks were in a quandary over whether the Section 3(a)(2) exemption applied only to their own securities or also to voting trusts, deposit certificates, and other trust certificates under which the bank acted as trustee, controlling the management of the trust assets.[44] The controversy encompassed the question of whether ADRs were within Section 3(a)(2)'s exempt classification. The focus of the analysis shifted, however, to the question of whether the bank was to be defined as the issuer in trust certificate and ADR arrangements.

B. *The Glass-Steagall Act*

In many areas of banking and securities regulation, the Comptroller of the Currency and the SEC are clashing titans attempting to conquer the territory of regulation which is rightfully theirs. In the last several decades, the territory which each claimed has overlapped significantly. The Banking Act of 1933, or the Glass-Steagall Act,[45] was Congress' effort to compartmentalize various areas of the banking industry, particularly banking and investment banking. As will be discussed further, the Glass-Steagall Act has continued to

---

41. In 1924 Rep. McFadden (Pa.), Chairman of the House Committee on Banking and Currency, promoted a bill that was designed to liberalize the branch banking system. Recognizing the interplay between the banking industry and the securities industry, Rep. McFadden stated to the Senate Banking and Currency Committee:

> It has been said that we are permitting national banks to engage in a new business without proper safeguards . . . . [N]ational banks have for many years been engaged in the business of buying and selling investment securities without any restrictions whatsoever . . . . [Security affiliates] are found in every national bank . . . . The authority is from Section 5136 [of the Federal Reserve Act] . . . empowering national banks to negotiate "other evidences of debt" . . . . Modern banking requires the conduct of an investment securities business.

Hearings on the Consolidation of National Banking Associations, Subcom. Sen. Banking and Currency Com., S. 1782, 69th Cong., 1st Sess. 22 (1926).

42. 15 U.S.C.S. § 77c(a)(2) (Law. Co-op. 1991) exempts securities issued or guaranteed by a bank, including securities issued or guaranteed by a "public instrumentality" which performs "essential government functions."

43. As Senator Fletcher stated, conservative courts "refused to regard as 'essential governmental functions' such activities as the furnishing of light, transportation, power, and even water." H.R. Rep. No. 1838, 73rd Cong., 2d Sess. 40 (1934).

44. After 1934 amendments to Section 3(a)(2), the exemption extended to "any security issued by or representing an interest in or a direct obligation of a Federal Reserve Bank." Former versions applied to "... any such security issued by any national bank." *See* 3 LOSS & SELIGMAN, *supra* note 12, at vol. III, 1156, n.36.

45. 48 Stat. 162, *codified at* 12 U.S.C.S. §§ 2, 3, & 6 (Law. Co-op. 1992).

be a motivation benchmark for change and redefinition of the role which banks play in today's investment arena.

1. Divorce and Reconciliation of Commercial and Investment Banking

Courts and scholars often refer to the Glass-Steagall Act as the divorce of commercial banks and investment banks,[46] which divorce was in fact Congress' intent.[47] Before the passage of the Glass-Steagall Act, commercial banks regularly participated in securities underwriting through affiliates and trust companies.[48] The picture changed in 1933 with the new distinction drawn between essentially two separate service areas of banking. The following section discusses the main portions of the Glass-Steagall Act that apply directly to securities related-services offered by banks, and how the courts expanded and contracted the role of banks in securities services.

a. Section 24(7): The Separation Provision

Section 24 is the primary "separation" statute.[49] It essentially separates banks from investment institutions and defines, almost ad nauseam, the powers of banks in its extremely lengthy text, especially part seven. The part of Section 24(7) pertinent to this discussion, addressing the powers of banks, provides as follows:

> Seventh. To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of title 62 of the Revised Statutes. The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock. . . .[50]

Thus, this section defines the parameters for banks in their association with the securities industry. While creating a minimal operating space for banks to buy or sell securities only for customers' accounts, it still prevents banks from fully entering into securities and underwriting for its account.

---

46. "Demand for divorcing banking and securities activities followed in the wake of the stock market crash of 1929." Securities Industry Ass'n. v. Federal Reserve Sys., 839 F.2d 47, 49 (2d Cir. 1988).

47. *See generally* Edwin Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 483, 505 (1971).

48. *Id.*

49. 12 U.S.C.S. § 24 (Law. Co-op. 1992).

50. 12 U.S.C.S. § 24 (Law. Co-op. 1992) (Seventh).

b. *Section 78: The Exclusion Provision*

Section 78 is an exclusion statute that prohibits banks from employing securities dealers and underwriters.[51] This is the second tier of statutory separation excluding banks from actively trading in securities. Under Section 24(7), banks could not engage in the business of securities. Section 78 enlarges that prohibition. The text of Section 78 provides:

> No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments.[52]

The apparent purpose behind enacting this section was to create a safety valve by not allowing banks to obtain the proper tools necessary to engage in securities trading.

c. *Sections 377 and 378: The Criminal Prohibitions*

Sections 377 and 378 criminalize transgressions by bankers into the sale and underwriting of securities. More precisely, Section 377 prohibits banks from affiliating with brokers, dealers, and underwriters, on pain of daily fines and possible revocation of their banking charter.[53] Section 378 is the commercial banking counterpart of Section 377. Section 378 criminalizes participation in commercial banking by brokers, dealers and underwriters, establishing daily fines and imprisonment for violations.[54]

---

51. 12 U.S.C.S. § 78 (Law. Co-op. 1992).

52. *Id.*

53. The text of Section 377, in pertinent part, provides:

> [N]o member bank shall be affiliated in any manner... with any corporation, association, business trusts, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities.

12 U.S.C.S. § 377 (Law. Co-op. 1992).

54. The text of Section 378 is as follows:

> (a) [I]t shall be unlawful —
>
> (1) For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor: Provided, that the provisions of this paragraph shall not prohibit national banks or State banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers from dealing in, underwriting, purchasing, and selling investment securities, or issuing securities to the extent permitted to national banking associations by the provisions of section 24 of this title.

12 U.S.C.S. § 378 (Law. Co-op. 1992). "Investment securities" referred to in Section 378 are primarily government securities. These include U.S. Treasury bonds, state and municipal bonds, federal and state housing

2. *The Subtle Hazards Doctrine*

The courts have not been consistent in establishing the permissible boundaries of the role of banks engaging in securities-related services. In *Investment Co. Institute v. Camp,*[55] the Supreme Court analyzed the scope of the Glass-Steagall Act and determined that a bank which participated in the offering of mutual fund units violated the commercial bank and investment bank separation statutes.[56] In *Camp*, the First National City Bank of New York obtained approval of the Comptroller of the Currency to establish and operate a collective investment fund. The National Association of Securities Dealers (NASD) launched an attack on the Comptroller's authorization, claiming that the approval violated various provisions of the Glass-Steagall Act. Rejecting the Comptroller's argument to permit banks to participate in mutual fund offerings, the Court cut to the heart of Congressional intent behind the Glass-Steagall Act. As the Court stated:

> The Glass-Steagall Act shows that Congress . . . repeatedly focused on the more *subtle hazards* that arise when a commercial bank goes beyond the business of acting as a fiduciary or managing agent and enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments.[57]

The subtle hazards of which the Court spoke is a standard by which courts and regulators can assess the integrity of a bank under a variety of circumstances. In *Camp*, the Court identified a number of such hazards. First, the relationship between a commercial bank and its investment bank or securities affiliate is too close for the practical separation of one's hardships from the other's hardships.[58] The Court evidently believed that if its affiliate failed, the bank would be compelled to resurrect the affiliate through unstable loans. Second, Congress enacted the statute in part because of strong investor reliance on the association between the bank and the affiliate, so that if heavy losses occurred, customers would quickly abandon a bank that might be in critical need of customer confidence.[59] Third, if banks were open to the promotional opportunities of investment banking, they could too easily promote substandard loans to direct funds towards securities purchases.[60] Finally, the Court concluded that banks or their affiliates which found themselves in the precarious position of needing to bail out of a securities issue catastrophe would be overly tempted to adopt a self-preserving philosophy, leaving their customers holding the bag.[61] The subtle hazards standard remains as an integrity bench mark for the determination of whether banks should engage in certain securities activities. Essentially, in any given set of

---

and education loan guarantee institutions, and limited corporate debt instruments. *Id.*

55. 401 U.S. 617 (1971).

56. The Court concluded that "[t]he literal terms of [the Glass-Steagall] Act clearly prevent what the Comptroller has sought to authorize here . . . . We conclude that the operation of an investment fund . . . involves a bank in the underwriting, issuing, selling and distributing of securities in violation of . . . the Glass-Steagall Act." *Id.* at 640.

57. *Id.* at 631 (emphasis added).

58. *Id.* at 632 (noting that the failure of the Bank of the U.S. in 1930 was due, in part, to its extensive affiliation to securities).

59. *Id.*

60. *Id.* at 633.

61. *Id.* at 634.

circumstances, it enables courts to assess whether a bank is acting in its proper capacity, either as a fiduciary or as a managing agent, or whether it is going beyond prescribed limits into the investment banking business, thereby violating the statutory restrictions.

In 1981, ten years after *Camp*, the Supreme Court considered, in *Board of Governors, Etc. v. Inv. Co. Institute*,[62] whether the services of an investment adviser to a closed-end investment company were within permissible limits of banking, so that a bank holding company could own the investment company. The Federal Reserve Board took the position in the suit that the connection between a bank holding company and an affiliate investment advisor was permissible because the investment advisor's activities were "so closely related to banking or managing or controlling banks as to be a proper incident thereto."[63] Passing on the Reserve Board's position, the Supreme Court analyzed various provisions of the Bank Holding Act.[64] Although the Reserve Board pointed out the strong similarities between this case and *Camp*, the Court felt that closed-end investment shares were an entirely different class of securities. The Court distinguished closed-end investment shares on the basis of their being securities that "are not issued, sold, or underwritten by the investment advisors."[65] By contrast, the share units in the mutual fund considered in *Camp* qualified distinctly as a security issued and sold by the bank. In the Court's view, Congress probably did not intend for managing customer accounts to be "investment banking," rather than "commercial banking,"[66] and it seemed to believe that investment advisors were engaged in the business of advising, not issuing or underwriting. Thus, their principal business was fairly within the authorized activity of bank holding companies.

In 1984, the Supreme Court considered Bank of America's acquisition of Charles Schwab & Company.[67] A controversy arose out of an attempt by the Securities Industry Association (SIA) to block the acquisition. The SIA argued that such a merger of a commercial bank and a securities brokerage was clearly prohibited by the Bank Holding Act and the Glass-Steagall Act. The Court countered, however, that the business of discount brokers, such as Schwab, is "essentially confined to the purchase and sale of securities for the account of third parties, and without the provision of investment advice to the purchaser or seller."[68] This view was in agreement with the Federal Reserve Board's finding that Schwab was not principally engaged in any prohibited activities that would bar the acquisition. The Court held that the public sale of securities relates to the issue, flotation, underwriting, and distribution of securities, none of which were involved in discount brokerage. The Court further held that none of the subtle hazards identified in *Camp* existed in the proposed acquisition of Schwab. Because Schwab acts only as an agent in the transfer of securities, the investor was not subject to the dangers arising from the subtle hazards of the securities industry.[69]

However, the SIA continued to press its arguments against commercial banks. In 1986 the SIA again challenged the Federal Reserve Board. In the commercial paper case,[70] the

62. 450 U.S. 46, 53 (1981).
63. *Id.*
64. *Id.*
65. *Id.* at 67.
66. *Id.* at 64.
67. Securities Industry Ass'n v. Board of Governors, 468 U.S. 207, 220 (1984).
68. *Id.*
69. *Id.*
70. Securities Industry Ass'n v. Board of Governors, 807 F.2d 1052 (Cir. 1986).

SIA challenged the authorization of Bankers Trust Company to place commercial paper offered by third parties. The panel noted that commercial paper comprises unsecured, large denomination promissory notes written with maturities of less than nine months and normally issued only to large corporations in need of temporary capital flow. To reach its conclusion that commercial paper was within the permitted activity of banks, the panel found that the "subtle hazards" of *Camp* did not exist in the commercial paper offerings by third parties. The court first noted that the most obvious hazard, the investment of bank funds in securities, simply was not at issue in the case. It then addressed conflict of interest issues and found that there was no link between the bank's loan interests and the commercial paper transactions. Absent some dual specter of the bank making loans to issuers to ensure success of its own issue, no conflict would exist.

In 1987, the Supreme Court revisited the Bank America-Schwab plan. In the facts of *Clarke v. Securities Industry Association,*[71] Security Pacific National Bank applied to the Comptroller for permission to establish an affiliation with a Discount Brokerage firm. Before the District Court, the SIA attempted to block the affiliation, again arguing that the Glass-Steagall Act prohibits national banks from offering discount brokerage services.[72] The District Court rejected the argument and the Supreme Court did not reach the issue because the SIA did not pursue it on appeal.[73] Placing the cases discussed on a continuum of separation between commercial banks and investment banks reveals the interesting point that no matter how steadfastly the securities industry has pressed for the complete separation of commercial and investment banking, the Federal Reserve Board, with the aid of the courts, has gradually opened the door to their reconciliation.

3. *The Financial Modernization Act of 1988*

Congress also has taken steps to reconcile commercial and investment banks. Although the Glass-Steagall Act is by no means dead and gone, signs of change are apparent. In 1988, the Senate passed the Proxmire Financial Modernization Act of 1988 by a vote of 94-2.[74] In an account of the bill, Senator Wirth[75] stated that in view of regulating the banking and securities industries, "... an emerging and perplexing goal is to chart the U.S.' place in the world economy. Until we mark our position more clearly, it is difficult to imagine international financial institutions rationalizing their interrelationships."[76] Senator Wirth further stated that the "pothole approach" to correcting banking and securities policy and regulation was not the answer.[77] In his view, the Financial Modernization Act was a complete overhaul of the banking industry, as well as "a measured approach to the repeal of the Glass-Steagall Act."[78]

---

71. 479 U.S. 388 (1987) (consolidating case nos. 85-971 and 85-972).
72. Securities Industry Ass'n v. Comptroller of Curr., 758 F.2d 739 (D.C. Cir. 1985); Securities Industry Ass'n v. Comptroller of the Currency, 765 F.2d 1196 (D.C. Cir. 1985).
73. *Clark*, 479 U.S. 388.
74. *See generally* Introductory remarks by Senator Dixon, S.305, 101st Cong., 1st Sess. 135 Cong., Rec. S.864 (daily ed. Jan. 31, 1989); *see also* S.1886, 100th Cong., 2d Sess., 134 Cong. Rec. S.3520 (daily ed. Mar. 31, 1988). The Bill was introduced by Senators Dixon, Garn, Graham, and Wirth.
75. Member of the Senate Committee on Banking, Housing and Urban Affairs.
76. Senator Timothy Wirth, *The Financial Modernization Act of 1988*, 8 ANN. REV. BANKING L. 331, 333 (1989).
77. *Id.*
78. *Id.* at 334.

The 1988 Bill, however, never passed the House of Representatives before the October recess. Consequently, the bill was re-introduced the following year as the Proxmire Financial Modernization Act of 1989.[79] One of the interesting aspects of the 1989 bill was its proposed repeal of Sections 78 and 377 of the Banking Act.[80] Not only would the bill have repealed those sections, it also would have amended Section 4(c) of the Banking Act[81] by specifically authorizing bank affiliates to engage in underwriting, distribution, brokerage, private placement, and investment advising and to deal in securities of any type.[82] Barbara Lucas, general counsel for Citicorp North American Investment Bank in New York, observed that the business of securities and the business of banking has become "one in the same," and that the trend in this direction is irreversible.[83]

The Financial Modernization Act brings banking and securities policy full circle. When the Federal Reserve Board attempted to close the gap between commercial banks and investment banks, the securities industry objected. Even so, the courts have tended to comply with the Board's wishes. As the title of the Bill denotes, the banking industry is in need of modernization through regulation. As they developed the Financial Modernization Act, the sponsoring Senators considered a variety of information, including a report of the General Accounting Office (GAO) on the subject of the Glass-Steagall Act. In that report, the GAO advised Congress that:

> [i]t is worth recalling the motivation that prompted the passage of the Glass-Steagall Act in 1933, a determination that depositors would never again face the risks that stemmed from the near-collapse of the U.S. commercial banking system as the Great Depression deepened in the 1930s. The original intent of Glass-Steagall laws remains just as valid today as it did then.[84]

Although the motivations behind the Glass-Steagall Act are timeless, the act should accommodate the banking industry's natural progress. Neglecting the needs of a changing industry will suffocate its usefulness. Considering these needs, the relationship between banking and investment banking cannot be minimized. Each industry has its proper space and expertise, and the balance of expertise and defined boundaries between the two gives rise to the opportunity for their cooperation and coordination.

IV. SEC REGULATION

A. *The Issuer Dilemma*

Competing theories of the SEC and bankers creates the difficulty of determining whether Congress intended for ADRs to be exempt under Section 3(a)(2). The question is really two-fold. It depends first on whether the bank is an issuer whose securities are

---

79. S. 305, 101st Cong., 1st Sess.; 135 Cong. Rec. S. 865 (daily ed. Jan. 31, 1989).

80. 12 U.S.C.S. §§ 78, 377 (Law. Co-op. 1992). For a dicussion of Sections 78 and 377, addressing exclusions and criminal sanctions, see *supra* notes 51-54 and accompanying text.

81. 12 U.S.C.S. § 4(c) (Law. Co-op. 1992).

82. *See generally* S. 305, *supra* note 79.

83. *Foreign Exchanges Plan to Sell Option Products in U.S.*, 22 Sec. Reg. & L. Rep. (BNA) 93 (Jan. 19, 1990).

84. Wirth, *supra* note 76, at 334.

exempt, with the exemption based on the regulation of banks by the Controller of the Currency[85] which therefore requires no further regulation by the SEC, and, second, on who is responsible for Section 11 issuer liability[86] if the bank is not an issuer. SEC registration requirements do not identify any party in the ADR arrangement which assumes the traditional issuer liability in non-voluntary ADR issues. The foreign company is typically uninvolved and does not sign the registration statement. However, the depositor, under a former SEC policy, would have issuer responsibility under Section 11 because it performed the acts and assumed the duties of managing the deposit.[87]

Under the original version of depositary arrangements, the depositor was generally an American investment house which desired to facilitate the sale of a block of shares it owned in a foreign company. Depositors were also foreign, and sometimes domestic, shareholders who undertook to have their shares lodged with the depositary's foreign agent in return for the ADRs. In the latter situation, the depositor retained control over the management of the deposit, while the bank acted merely as the custodian of the underlying share certificates. Under that arrangement, the depositor was clearly the issuer. However, under more modern arrangements, it is now common for a bank to initiate an offer to issue receipts against the deposit of designated foreign securities. Foreign corporations frequently seek depositaries as a vehicle to enter their securities into the U.S. market.[88] In arrangements in which a bank takes away control over the deposit from the depositors, it may be considered the issuer under the statutory definition.[89] If the depositor and depositary maintained joint control, they may both be co-issuers. Thus, depending on the circumstances, the issuer may be the depositor, the depositary, or both. If the statutory definitions remain intact and a bank assumes the role of deposit manager, the issuer status should logically transfer to the bank. Nevertheless, the SEC has expressly stated that the depositary is not the issuer.[90] If the bank is an issuer, as bankers would claim, then ADRs would be exempt from registration requirements under section 3(a)(2) of the Securities Act of 1933[91] and therefore not subject to the SEC's regulatory authority. ADR mechanisms themselves do not identify the party who is the issuer and who would assume the issuer's functions of registration and periodic reporting. Thus, the SEC lacked a party to tag with the issuer's responsibilities. Under this dilemma, ADRs would have become an independent exempt security with no detectable issuer identity, which obviously would be contrary to the very fiber of SEC policy.

85. It was the opinion of Congress in 1933 that "adequate supervision of securities of a national bank [was] exercised by the Controller of the Currency." H.R. Rep. No. 85, 73rd Cong., 1st Sess. 14 (1933).

86. Section 11 of the Securities Act provides a private remedy for false or misleading statements or the omission of material information as required by the registration statement. 15 U.S.C.S. § 77k (Law. Co-op. 1991).

87. Note, *SEC Regulation of American Depositary Receipts*, 65 YALE L.J. 861, 867 (1956).

88. Royston, *supra* note 4, at 96.

89. 17 C.F.R. § 240.3b-4(c) (1992); *see* LOSS, *supra* note 25, at 247.

90. The instructions to Form F-6 state that "[t]he legal entity created by the agreement for the issuance of ADRs shall sign the registration statement as the registrant. The depositary may sign on behalf of such entity, but the depositary for the issuance of ADRs itself shall not be deemed to be an issuer . . . ." Form *F-6, supra* note 40. *See* Moxley, *supra* note 2, at 30; *see also* LOSS, *supra* note 25, at 247.

91. Section 3(a)(2) is codified at 15 U.S.C.S. § 77c(a)(2) (Law. Co-op. 1991).

In a parallel but related situation involving trust certificates, the House Committee on Banking and Securities expressed its view in connection with the Trust Indenture Act[92] that if securities "issued by" banks were exempt from the Bill, it would not be possible for an issuer to evade compliance by making a bond or mortgage with a bank and subsequently having the bank issue certificates as evidence of the bond or mortgage. To reach this conclusion, the Committee stated that:

> Similar questions have arisen under the Securities Act, and under such circumstances the company itself, rather than the bank which performs purely ministerial functions, has been regarded by the Commission as the "issuer" of the certificate of participation.[93]

However, the SEC believed the better view to be that the issuer of the trust certificates was the trust entity, rather than the trustee.

In 1955 the SEC held extensive discussions with a number of banks over whether the Section 3(a)(2) exemption for securities issued by a bank should apply to ADRs. The SEC concluded that the exemption did not apply to ADRs, while it reinforced its policy that the bank was not an issuer.[94] This very issue came to the forefront of policy debate the same year when the Irving Trust Company announced that it planned to issue ADRs representing 35 issues of securities listed on the London and Dutch stock exchanges. It intended to issue the ADRs under the Section 3(a)(2) exemption. After the SEC considered whether or not the exemption should apply, it filed a report to Congress which stated that:

> Section 3(a)(2) was intended to provide an exemption only for a bank's own securities. To permit a bank to claim this exemption for any trust or similar entity that it might devise would permit the creation of voting trusts, investment trusts and a variety of other securities for which the disclosure requirements of the Securities Act of 1933 could be avoided. Furthermore, the concept of supervision by banking officials included in section 3(a)(2) did not appear to embrace the issuance of ADRs so as to afford purchasers the protection intended by that section.[95]

The SEC apparently believed that ADRs were such a strange breed of security that it, rather than the banking regulators, was better equipped to oversee such transactions.

The solution, for lack of a better description, amounted to a sidestep in theory to conveniently avoid a mind trap. By avoiding any conclusive remedy, the SEC formally adopted the fictional entity clause of Form F-6. The clause allows the depositary bank to assume the issuer role, while shielding the bank and its officers from liability arising out of the contents of the registration document. Thus, the SEC developed a combination of

---

92. Trust Indenture Act, 15 U.S.C.S. § 77aaa et seq. (Law. Co-op. 1983 & Supp. 1992). The Trust Indenture Act was a buttress against securities regulations. The Act provides for independent trustees under indentures to protect and enforce the rights of securities holders issued under the Act by linking registration under the Securities Act of 1933.

93. H.R. Rep. No. 1016, 76th Cong., 1st Sess. (1939).

94. Interestingly enough, when the SEC was faced with issuer identity relating to banks in 1950, the SEC expressed its view, at that time, that if a bank were an "issuer" in an ADR transaction, then the Section 3(a)(2) exemption would apply. 3 LOSS & SELIGMAN, *supra* note 12, at 1157 n.38.

95. SEC Securities Act Release 3593 [1952-1956 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,372; 22 SEC ANN. REP. 43 (1956).

exempting banks without exempting the ADRs from registration, a non-exempt exemption for banks which became known as the double entity theory. Under this theory the bank, as the depositary or custodian, is the provider of a service, while the service it offers receives an entity identity as the issuer. The theory's effect keeps anyone from issuer liability under Section 11,[96] a mystery which remains unresolved and unchallenged.

B. Registration

The registration of ADRs is separate from registration of the underlying securities. The underlying securities may or may not be registered in the U.S. because certain exemptions apply to foreign-issued securities.

1. ADR Registration

ADRs are registered by filing Form F-6. Under the current criteria, Form F-6 may be used if three conditions are met:

(1) The holder of the ADRs is entitled to withdraw the deposited securities at any time subject only to (i) temporary delays caused by closing transfer books of the depositary or the issuer of the deposited securities or the deposit of shares in connection with voting at a shareholders' meeting, or the payment of dividends, (ii) the payment of fees, taxes, and similar charges, and (iii) compliance with any laws or governmental regulations relating to ADRs or to the withdrawal of deposited securities;

(2) The deposited securities are offered or sold in transactions registered under the Securities Act or in transactions that would be exempt therefrom if made in the U.S.; and

(3) As of the filing date of this registration statement, the issuer of the deposited securities is reporting pursuant to the periodic reporting requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 or the deposited securities are exempt therefrom by Rule 12g3-2(b) . . . unless the issuer of the deposited securities concurrently files a registration statement on another form for the deposited securities.[97]

The differences between ADR registration and the registration of domestic securities are not within Form F-6, but rather are in the registration of the securities underlying the ADRs. As noted above in paragraph (2), the deposited shares must be either offered through transactions registered under the Securities Act or exempt from it. The registration of the deposited securities in ADRs may be on "any other form the registrant is eligible to use,"[98] which gives rise to the departure. Where domestic issuers typically file registration

96. LOSS, *supra* note 25, at 248.

97. *See* Fed. Sec. L. Rep. (CCH) ¶ 7001.

98. *See* General Instructions, Section I. *B. Registration of Deposited Securities*, at Fed. Sec. L. Rep. (CCH) ¶ 7,002.

statements using Forms S-1, S-2, or S-3,[99] foreign issuers register their securities using Forms F-1, F-2, or F-3.[100]

Although both the S series forms and the F series forms incorporate various provisions from Regulation S-K[101] and Regulation S-X,[102] several requirements from Regulation S-K are revised or omitted for F series registrants.[103] Item 1 of Regulation S-K[104] requires the registration to include the complete identity of the depositary and the specific title of the ADRs and the underlying securities represented by the ADRs. It also requires the general terms of the deposit agreement, to include ten separate points:

(1) the conversion ratio, that is, the number of deposited securities represented by one unit of ADR;

(2) the voting procedure applicable to the underlying securities;

(3) procedures for distribution of dividends;

(4) procedures for circulating notices, reports, and proxy solicitations;

(5) provisions for the sale or exercise of rights;

(6) provisions for the sale or deposit of any securities acquired or disposed of due to dividends, stock splits, or reorganization;

(7) duration, amendment, or termination of the agreement;

(8) the definition of rights of ADR holders to inspect the transfer of books of the depositary and the list of ADR holders;

(9) a description of any withdrawal restrictions applicable to the underlying securities; and

(10) any terms which limit the liability of the depositary.[105]

Item 2 requires the foreign issuer to furnish the SEC with certain public reports filed pursuant to foreign law, or in the alternative, the information which Regulation 12g3-2(b)

---

99. Forms S-1, S-2, and S-3 can be found at 2 Fed.Sec. L. Rep. (CCH) ¶¶ 7,121, 7,141, and 7,151, respectively.

100. Forms F-1, F-2, and F-3 can be found at 2 Fed. Sec. L. Rep. (CCH) ¶¶ 6,951, 6,961, and 6,971 respectively.

101. 17 C.F.R. §§ 229 et seq. (1992).

102. 17 C.F.R. §§ 210 et seq. (1992).

103. *E.g.*, "F" series filers are not subject to Items 101-103, 201, 301-304, and 401-404 of Regulation S-K. Some of the requirements of those sections are encompassed in a requirement that foreign issuers provide information required under Part 1 and Item 18 of Form 20-F. Part 1 and Item 18 of Form 20-F require that information similar to the above mentioned Reg. S-K requirements be furnished, but those requirements are much less extensive, particularly with regard to financial statements.

104. 17 C.F.R. § 229.202(f) (1992).

105. *Id.*

requires.[106] However, if the foreign issuer is subject to the periodic reporting requirements of the Securities Exchange Act, it may substitute periodic filings to satisfy the Item 2 requirements.[107] The registrant must also certify that the information filed pursuant to Item 2 is open for inspection and copying by all ADR holders.[108]

Item 3 specifies the necessary supporting exhibits, which include:

(1) copies of all applicable deposit agreements and any other related agreements or contracts entered into between the depositary and the issuer within the preceding three years;

(2) an opinion of counsel certifying the legality of the securities being registered, including a statement that the ADR holders will be entitled to the rights specified in connection with the ADRs; and

(3) the name of any dealer known to have deposited shares against the ADRs within the preceding six months or who has assisted or participated in the proposed ADR plan.[109]

Item 4, which relates to undertakings, requires the depositary to report semiannually the number of shares represented by the ADRs issued during the reporting period, the number of shares represented by ADRs retired during the reporting period, the total number of shares evidenced by ADRs still outstanding, and the total number of ADR holders at the end of the reporting period.[110] The depositary must also report all dealers who deposit shares against the ADRs during the reporting period.[111] Item 4 further requires the depositary to permit the inspection of any reports or other communications from the issuer by all ADR holders.[112] Finally, Item 4 requires notification of the depositary's fee schedule and a description of the services provided in return for the fees.[113]

2. *The Underlying Securities: Regulation 12g3-2 Exemptions*

Certain securities and qualified foreign issuers are exempt from registration requirements under Regulation 240.12g3-2.[114] The differences between ADR registration

106. *See infra* note 114 and accompanying text.
107. Fed. Sec. L. Rep. (CCH) ¶ 7003.
108. 17 C.F.R. § 229.202(f) (1992).
109. *Id.*
110. *Id.*
111. *Id.*
112. *Id.*
113. *Id.*
114. 17 C.F.R. § 240.12g3-2 provides, in relevant part, as follows:
(a) Securities of any class issued by any foreign private issuer shall be exempt from section 12(g) of the Act if the class has fewer than 300 holders resident in the United States . . . .

(b)(1) Securities of any foreign private issuer shall be exempt from section 12(g) of the Act if the issuer, or a government official or agency of the country of the issuer's domicile or in which it is incorporated or organized:

and registration of domestic securities stem from the rather tedious regulations which apply to the two forms of registration. The limited reporting requirements of ADR registrations become apparent when they are compared with the registration of the securities underlying the ADRs.

For example, F series filers are not subject to Items 101-103,[115] 201,[116] 301-304,[117] and 401-404[118] of Regulation S-K. However, a requirement that foreign issuers provide the information required under Part 1[119] and Item 18[120] of Form 20-F encompasses some

---

> (i) Shall furnish to the Commission whatever information in each of the following categories the issuer since the beginning of its last fiscal year (A) has made or is required to make public pursuant to the law of the country of its domicile or in which it is incorporated or organized, (B) has filed or is required to file with a stock exchange on which its securities are traded and which was made public by such exchange, or (C) has distributed or is required to distribute to its security holders;
>
> (ii) Shall furnish to the Commission a list identifying the information referred to in paragraph (b)(1)(i) of this section and stating when and by whom it is required to be made public, filed with any such exchange, or distributed to security holders.;
>
> (iii) Shall furnish to the Commission, during each subsequent fiscal year, whatever information is made public as described in paragraphs (b)(1)(i)(A), (B) or (C) of this section promptly after such information is made or required to be made public as described therein;
>
> (iv) Shall, promptly after the end of any fiscal year in which any changes occur in the kind of information required to be published as referred to in the list furnished under paragraph (b)(1)(ii) of this section or any subsequent list, furnish to the Commission a revised list reflecting such changes; and
>
> (v) Shall furnish to the Commission in connection with the initial submission the following information to the extent known or which can be obtained without unreasonable effort or expense: the number of holders of each class of equity securities resident in the United States, the amount and percentage of each class of outstanding equity securities held by residents in the United States, the circumstances in which such securities were acquired, and the date and circumstances of the most recent public distribution of securities by the issuer or an affiliate thereof.

17 C.F.R. § 240.12g3-2 (1992).

115. Item 101 refers to the description of the business. 17 C.F.R. § 229.101 (1992). Items 102 refers to the description of property owned by the business. 17 C.F.R. § 229.102 (1992). Item 103 refers to the description of legal proceedings pending against the company. 17 C.F.R. § 229.103 (1992).

116. Item 201 refers to the market price of the common equity shares and dividends paid on those shares. 17 C.F.R. § 229.203 (1992).

117. Item 301 refers to selected financial reports. 17 C.F.R. § 229.301 (1992). Item 302 refers to quarterly supplemental financial data. 17 C.F.R. § 229.302 (1992). Item 303 requires the submission of the management's discussion and analysis of the financial condition of the company. 17 C.F.R. § 229.303 (1992). Item 304 refers to changes in, and disagreements with, accountants on accounting and financial disclosure. 17 C.F.R. § 229.304 (1992).

118. Item 401 requires a list of all directors, executive officers, promoters, and control persons. 17 C.F.R. § 229.401 (1992). Item 402 requires notification of any executive compensation schedule. 17 C.F.R. § 229.402 (1992). Item 403 requires a list of security ownership of certain beneficial owners and management. 17 C.F.R. § 229.403 (1992). Item 404 requires the disclosure of certain relationships and related transactions. 17 C.F.R. § 229.404 (1992).

119. Part 1 of Form 20-F sets out virtually the identical requirements as in Item 101 of the "S" series reporting forms. In addition, Part 1 of Form 20-F requires a description of the principal products and/or services rendered and a breakdown of sales and revenue for the preceding three years. 17 C.F.R. § 249.220(f) (1992).

of the requirements of those sections. Part 1 and Item 18 of Form 20-F require that information similar to the Regulation S-K requirements just enumerated be furnished, but those requirements can be much less extensive, particularly with regard to financial statements.[121]

Under certain circumstances foreign securities, and qualified foreign issuers, may be exempt from SEC registration requirements under Regulation 240.12g3-2.[122] Subpart (a) of Regulation 12g3-2 is primarily a small-issuer exemption for foreign private issuers with less than 300 U.S. shareholders of the class of securities issued.[123] Additionally, foreign private issuers are exempt from registration if the issuer or appropriate government agency furnishes to the SEC any information (1) required to be made public in accordance with the law of the home country,[124] (2) filed or required to be filed with any stock exchange on which the issuer's securities are listed or required to be made public by the rules of such exchange, and (3) distributed or required to be distributed to its shareholders.[125] At the end of each fiscal year, the foreign issuer must supply updates of the information required above.[126] The foreign issuer must also file reports, "to the extent known or which can be obtained without unreasonable effort or expense . . .," including, (1) the number of U.S. shareholders of each class of equity securities, (2) the amount and percentage of each class of outstanding equity securities held in the U.S., (3) the circumstances of how the U.S. securities holders acquired their shares, and (4) the date and circumstances surrounding the issuer's most recent public distribution.[127] Thus, the SEC's framework for registration is not a true exemption, but rather, it relies heavily on regulatory filings and distribution documentation of the home country of foreign issuers.

V. THE LIABILITY MYSTERY: WHO IS RESPONSIBLE FOR REGISTRATION AND TRANSACTION INTEGRITY?

A. *Introduction*

In order for the SEC to operate in accord with the design of the Securities Acts, the application of those acts' remedial provisions must be clear and workable. Toward this end, the securities acts provide a framework for giving investors redress against the wrongful conduct of a variety of parties who engage in the various aspects of securities transactions. However, in the ADR process, the various roles of the parties involved can be as nebulous as the ADR arrangements themselves. The identification of who may be responsible for the

120. Item 18 of Form 20-F requires the registrant to submit financial statements and accountant's certificates as would be required by Form 10 or 10-K with some sections excepted. Item 18 further requires that the financial statements disclose "substantially similar" information as U.S. financial statements prepared under the GAAP rules and Regulation S-X. The registrant may, in preparing the financial data, comport with the rules of GAAP or, in the alternative, use some other uniformly accepted accounting standards, if: (1) those standards are prominently set out at the beginning of the financial statement, and (2) a discussion is included covering the accounting principles used and the variations from GAAP and Regulation S-X. *See* 4 Fed. Sec. L. Rep. (CCH) ¶ 29,701 at 29,724.

121. *Compare* 17 C.F.R. § 229 *et seq.* (1992) *with* 17 C.F.R. § 210 *et seq.* (1992).

122. *See supra* note 114 (setting forth the relevant text of 17 C.F.R. § 240.12g3-2 (1992)).

123. 17 C.F.R. § 240.12g3-2(a) (1992).

124. *I.e.*, where the issuer is organized.

125. 17 C.F.R. § 240.12g3-2(b)(1)(i) (1992).

126. 17 C.F.R. § 240.12g3-2(b)(1)(ii)(1992).

127. 17 C.F.R. § 240.12g3-2(b)(1)(v) (1992).

accuracy and integrity of the registration of ADRs, and for the ADR transactions, depends on a two-factor standard: reliance and causation.

The approach of using such a two-factor standard arguably retreats to the common law fraud proofs employed before the passage of the Securities Acts. Indeed, the 1933 Act was designed, in part, to eliminate the necessity of proving reliance, privity, and causation. However, as will be discussed, the Securities Acts, as interpreted by the courts, place liability on six main groups of participants in securities registration and subsequent transactions:[128]

---

128. Under the 1933 Act, several sections provide civil remedies that could be applicable in the ADR case setting. Particularly, Sections 11 and 12(2) have provisions that may well stem to the ADR arrangement, however, these provisions are by no means clear or all encompassing. Section 11 of the Securities Act provides a civil right of action against a variety of participants in the registration process, including issuers, non-issuers who sign the registration statement, experts participating in the registration, and underwriters. Section 11 provides, in relevant part, as follows:

> (a) . . . In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue —
>
> (1) every person who signed the registration statement;
>
> (2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
>
> (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;
>
> (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or having prepared or certified any report on valuation which is used in connection with the registration statement, with respect to the statement, in such registration statement, report, or valuation, which purports to have been prepared or certified by him;
>
> (5) every underwriter with respect to such security.

15 U.S.C.S. § 77k(a) (Law. Co-op. 1991).

Section 17 of the Securities Act, 15 U.S.C.S. 77q, also outlines liability provisions regarding fraud in securities. Section 17(a) provides that:

> . . . It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly —
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission, to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C.S. 77q(a) (Law. Co-op. 1991).

However, a great controversy surrounds whether a private right of action exists under this section. There is no express right granted in Section 17, and there is a vast split whether an implied right exists. The generally

(1) issuers, (2) officers and directors, actual and potential,[129] (3) persons who sign the registration statement, (4) experts,[130] (5) underwriters, and (6) collateral participants. Analysis of where liability affixes in ADR transactions therefore requires placing the participants in these categories.

Various approaches to the formation of the ADR arrangement are possible. For the purposes of this discussion, two are of primary importance. The first is the situation where the foreign issuer participates simultaneously in the U.S. registration and distribution of the underlying securities, and the second is where there is not simultaneous U.S. registration and distribution. In the first situation, the foreign issuer logically and reasonably should be required to sign the registration as issuer of the ADR. In this case, issuer liability inevitably attaches to the foreign issuer with regard to the registration of the securities underlying the ADR. However, liability for the ADR registration itself may or may not apply. In the second situation where there is no simultaneous registration of the underlying securities, the foreign issuer may not be involved with the ADR registrations. In this situation, the depositary bank assumes the role of primary manager of the ADR arrangement. The liability confusion surfaces under both these ADR arrangements.

To find a viable means of protecting investors and affixing liability in the ADR arrangement, the importance of the ADR registration statement and the particular relevance of the reliance and causation standards must be recognized. Where there is no simultaneous U.S. registration of the securities underlying the ADR, investors rely even more on the information in the Form F-6 ADR registration statement. However, the imposition of strict liability for the contents of the F-6 registration statement on the depositary bank solely on the basis of the bank's participation appears overreaching,[131] and it would discourage banks from further participation. By imposing the burden of proving causation, depositary banks would be subject to liability only for misstatements or omissions linked directly to the investor's injury. An analysis of the various approaches to liability under the Securities Acts should superimpose the role of the depositary bank over the various approaches to liability that may apply to the ADR arrangement. This Article addresses such an analysis.

---

accepted view is that no private right of action exists under Section 17. Because of the controversial nature of Section 17 liability in domestic securities actions, potential liability under that section, as it could possibly apply to the ADR arrangement, is not discussed in this article. It is the author's belief that such a discussion would be inconsequential.

129. Since a foreign issuer would be subject to issuer liability if the underlying securities are simultaneously issued in the United States, and there is no "issuer" liability with regard to the ADR registration, the focus of the liability discussion is on the depositary bank. Assuming that the depositary bank is not an officer or director of the foreign issuer, officer and director liability is not discussed.

130. 15 U.S.C.S. § 77k(4) provides for liability where experts certify portions of the registration statement. However, a careful reading of that section indicates that a depositary bank is probably not within the definition of experts for the purpose of this section. Therefore, expert liability is not discussed.

131. Part of the underlying problem of the issuer dilemma described above is not so much in finding a remedy where misinformation is disseminated or fraud is perpetrated, but in the strictness of the provisions and how they are applied. The root of the question is in the primary difference between issuer and non-issuer liability. For example, in the traditional sense, Section 11 liability under the Securities Act focuses on issuer liability and provides for secondary liability for conduct of non-issuers as well. Where issuers are generally held to strict liability standards, non-issuers are subject to lesser standards. Thus, although there may be a variety of collateral defendants subject to liability under Section 11, only the issuer is held to the high standard of strict liability. Laven v. Flanagan, 695 F.Supp. 800, 811 (D.N.J. 1988); In re Worlds of Wonder Securities Litigation, 694 F.Supp. 1427, 1434 (N.D. Cal. 1988), *citing*, Herman & MacLean v. Huddleston 459 U.S. 375, 381, 103 S.Ct. 683, 687, 74 L.Ed.2d 548 (1983).

B. Non-Issuers Who Sign the Registration Statement

Section 11 of the Securities Act provides a civil right of action against a variety of participants in the registration process, including non-issuers who sign the registration statement, experts who participate in the registration, and underwriters. Anyone who signs the registration statement may be held liable for false or misleading statements in, or omissions from, the registration statement.[132] When a depositary bank signs on behalf of the fictitious entity created by the ADR arrangement, the bank logically should be subject to liability under this clause. However, this appears to directly conflict with the SEC's position on issuer status. The bank signs the registration statement merely as a ministerial function and should therefore be free from liability based on that function. Acceptance of the issuer status policy requires acceptance of the signature non-liability theory, too, a result which further restricts a private right of action and decreases available remedies.

C. Underwriters

Section 11 extends liability to underwriters who participate in ADR registration.[133] The question arises whether a depositary bank can, or should, be considered an underwriter for the purposes of liability. The term underwriter means any person who purchases securities from an issuer with a view to distribution or who offers or sells securities for an issuer, or who participates directly or indirectly in any such undertaking or the underwriting of any such distribution. The term issuer, relative to underwriters, includes any person directly or indirectly controlling or controlled by the issuer or any person under direct or indirect common control with the issuer.

Although the definition of underwriters is broad,[134] the peculiar role of depositary banks must be considered in light of these definitions. For example, underwriters have been held to be persons who sell securities for the issuer,[135] registration participants,[136] and distribution managers.[137] The definition of underwriter is truly a situational definition: it is not a definition based on an entity's general business activity. Rather, the essence of the relationship between the parties illuminates their status.[138] For example, dealers who dispose of stock and have particular knowledge of the background of the transactions may be subject to underwriter status.[139] Moreover, it is not necessary to establish that every participant in the underwriting function had knowledge of all the facts and circumstances

132. 15 U.S.C.S. § 77k(a)(1) (1992).

133. 15 U.S.C.S. § 77k(5) (Law. Co-op. 1991).

134. 15 U.S.C.S. § 77b(11) (Law. Co-op. 1991).

135. In *Securities & Exch. Comm'n. v. Chinese Consol. Benev.*, 120 F.2d 738 (1941), members of a Chinese benevolent society who gratuitously undertook to solicit orders for the purchase of Chinese government bonds were held to be underwriters.

136. Although participation in the sale is an indirect approach to applying underwriter status to others who may be involved in the transaction, liability is not necessarily dependant on underwriter status. The "participation theory" is discussed more fully *infra*, at notes 145-58, and accompanying text.

137. Dealers are generally exempt from underwriter status, and thus not generally subject to underwriter liability. However, if a dealer crosses that line between dealer and underwriter by managing the distribution, the dealer is also classified as an underwriter. *See* Section 2(11), 15 U.S.C.S. § 77k (Law. Co-op. 1991).

138. 2 LOSS & SELIGMAN, *supra* note 12, at 1109.

139. Securities & Exch. Comm'n. v. Micro-Moisture Controls, Inc., 167 F.Supp. 716 (D.C.N.Y. 1958), *aff'd.* 270 F.2d 241 (2d Cir. 1959).

surrounding the distribution.[140] Both direct and indirect participation, without such detailed information, do not relieve a participant from underwriter status for the purposes of liability.[141] Mere participation through coordinating listings of the distribution on behalf of the underwriter has been held to subject the participant to underwriter liability,[142] and SEC policy potentially subjects even affiliated bookkeepers of the issuer who perform strictly administrative functions to liability as underwriters.[143]

Looking more closely at the depositary bank in the ADR arrangement, it is questionable whether the bank is purchasing from an issuer with a view to distribution of the security so that underwriter liability can attach. The bank's acceptance of the deposits of the foreign securities and subsequent issuance of the depositary receipts may theoretically qualify as a sales transaction on behalf of the issuer for underwriter status. However, although various exchanges of stock have been held as qualifying transactions, the transaction is too far removed from the contemplated purchase and sale arrangements to investors to fall within the framework of this section. Thus, the status of underwriter, based upon the purchase with a view to distribution theory, should not apply to bank depositaries.

McFarland v. Memorex Corp.[144] lends support to this conclusion. In this case, warrant holders who never owned the underlying shares but who also sold their unexercised warrants to underwriters were held not to be underwriters. The *McFarland* court reached this holding because the warrant holders bore no risk in the particular arrangement and because there would have been no recourse against them if the underwriters could not subsequently sell the warrants. With ADR arrangements, such as with the warrant holders, the depositary is a behind the scenes participant and should not be subject to underwriter liability.

D. Collateral Participants

As the judicial definition of underwriter sometimes considers participants in sales transactions to be underwriters of sellers for application of Section 11 liability,[145] courts have also broadened the scope of liability under Section 12 by applying the participation theory. This theory subjects anyone who participates in some significant way in the sales effort of securities to liability.[146] The authority broadening liability to participants derives from a long line of cases involving Section 12 liability.[147] The participation theory at first appears to provide an ample basis to impose liability on depositary banks who participate in the ADR transaction between the depositor, the depositary, and the investor, but applying this theory poses problems.

140. *Id.*
141. *Id.*
142. *Id.*
143. Securities Act of 1933, Rel. No. 5515, July 22, 1974, Fed. Sec. L. Rep. (CCH) ¶ 79,907.
144. 493 F.Supp. 631 (N.D. Cal. 1980).
145. 15 U.S.C.S. § 77k (Law. Co-op. 1991).
146. Canizaro v. Kohlmeyer & Co., 370 F.Supp. 282, 287 (E.D. La. 1974).
147. For the statutory provisions of Section 12(2) liability, see note 128. For a complete historical and legislative analysis of the participation theory, see Abrams, *The Scope of Liability Under Section 12 of the Securities Act of 1933: "Participation" and the Pertinent Legislative Materials*, 15 FORDHAM URB. L.J. 877, 878 (1987).

The innate difficulty in the participation theory lies in defining its parameters. In *Wonneman v. Stratford Securities Co.,*[148] the court succinctly posed the riddle:

> What constitutes "participation?" Does one who supervises the selling operations "participate" in an individual sale? Does one who composes advertising material "participate" in the sale? Does a director or an officer "participate" in the sale?[149]

Opposing decisions split on the basis of function versus construction further complicate the application of the participation theory. On the one hand, courts have held that "the securities laws are remedial and are to be construed liberally in order to achieve the congressional purpose."[150] On the other hand, some courts, following the lead of the Supreme Court, have held that generic necessities underlying interpretation of the "remedial purposes" of the Securities Acts do not justify overbroad application of the language and the statutory scheme.[151]

Somewhere between these two poles, the participation theory was redefined and received general acceptance as a principle based on a substantial factor test.[152] In 1973, the Fifth Circuit adopted the substantial factor test,[153] shifting from the but-for standard

---

148. [1957-1961 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 90,923 (S.D.N.Y. June 26, 1959), ¶ 91,034 (S.D.N.Y. June 7, 1961).

149. Wonneman v. Stratford Sec. Co., [1957-1961 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,923, at 92,963.

150. Freed v. Szabo Food Serv., Inc., [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,317 (N.D. Ill. Jan. 14, 1964); *see also* Lannerth v. Mendenhall, 234 F. Supp. 59, 64 (N.D. Ohio 1964).

151. McFarland v. Memorex Corp., 493 F.Supp. 631 (N.D. Cal. 1980), *citing* Securities and Exch. Comm'n v. Sloan, 436 U.S. 103, 116, 98 S.Ct. 1702, 1711, 56 L.Ed.2d 148 (1978); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200, 96 S.Ct. 1375, 1384, 47 L.Ed.2d 668 (1976, *reh'g. denied.* 425 U.S. 986, 96 S.Ct. 2194). The *McFarland* court further stated that "[t]he ultimate question is one of congressional intent, not one of whether [the] Court thinks that it can improve upon the statutory scheme that Congress enacted into law....", *citing* Touche Ross & Co. v. Redington, 442 U.S. 560, 99 S.Ct. 2479, 2490, 61 L.Ed.2d 82 (1979). Moreover, the court noted that the Supreme Court has instructed that "the securities acts are not to be interpreted as a federal common law of securities and that traditional rules of strict construction apply." *McFarland,* 493 F.Supp. 631, *citing* Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 100 S.Ct. 242, 62 L.Ed.2d 146 (1974); *Touche Ross,* 442 U.S. 560; *Sloan,* 436 U.S. 103; Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977); *Ernst & Ernst,* 425 U.S. 185; Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975).

152. In 1964, *Lannerth,* 234 F.Supp. 59, was decided. Refining the participation approach, the *Lannerth* court noted that the proper application must lie somewhere between the narrow view that only the actual parties to the sale would be subject to liability, i.e., strict privity, and the "too-liberal view" that anyone who "remotely participated in the events leading to the transaction" would be subject to liability. The *Lannerth* court described the standard in terms of tort law:

> [w]e think that the line of demarcation must be drawn in terms of cause and effect: Two borrow a phrase from the law of negligence, did the injury to the plaintiff flow directly and proximately from the actions of this particular defendant? If the answer is in the affirmative, we would hold him liable. But for the presence of the defendant ... in the negotiations preceding the sale, could the sale have been consummated? If the answer is in the negative, and we find that the transaction could never have materialized without the efforts of [the] defendant, we must find him guilty.

Id. at 65. Stated another way, "[t]he hunter who seduces the prey and leads it to the trap he has set is no less guilty than the hunter whose hand springs the snare." *Id. See* Hill York Corp. v. Amer. Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971).

153. Lewis v. Walston, 487 F.2d 617 (5th Cir. 1973).

applied in earlier cases.[154] This approach subjects any participant whose conduct was a substantial factor in consummating a transaction to liability.[155]

The Supreme Court in *Pinter v. Dahl*[156] specifically rejected the substantial factor test with regard to Section 12 claims. In rejecting the test's application to Section 12 actions, the Court noted, however, that collateral participation liability is not inappropriate in all securities actions. In the Court's view,

> Congress knew of the collateral participation concept and employed it in the Securities Act and throughout its unified program of securities regulation. Liabilities and obligations expressly grounded in participation are found elsewhere in the Act.[157]

The Court reasoned that Congress designed Section 12 specifically as a strict liability provision aimed at controlling sellers by its rigid application. The difficulty in applying the test in Section 12 actions existed because the test was too expansive and opposed the strict definition of seller intended by Congress. The Court believed that application of the test in Section 12 actions would subject securities professionals

> whose involvement is only the performance of their professional services, to [Section] 12(1) strict liability . . . [while the] buyer does not, in any meaningful sense, purchas[e] the security from such person.[158]

Notwithstanding the Supreme Court's rejection of the substantial factor test for Section 12 claims, the test remains a workable standard in other securities actions.

Although the depositary bank in the ADR arrangement does not fit perfectly into the framework of the participation theory, the overall application of the theory could be reasonably workable. Where the depositary coordinates the efforts and resources of the depositor to effect the F-6 registration, it serves as a direct link between the depositor and the investor. Inasmuch as the underwriter is a necessary link in accomplishing domestic

---

154. *Hill York Corp.*, 558 F.2d 680; *Lannerth*, 234 F.Supp. 59.

155. *Lewis*, 487 F.2d at 621-22. *See* Swenson v. Engelstad, 626 F.2d 421, 426-27 (5th Cir. 1980); Pharo v. Smith, 621 F.2d 656, 667 (5th Cir. 1980); *Hill York Corp.*, 558 F.2d at 692-93; Adalman v. Baker, Watts & Co., 807 F.2d 359, 363 (4th Cir. 1986) (Section 12 liability extends to any person who "is a 'significant participant' in, or one who 'proximately caused,' a sale of securities . . . . Whether a participant is "a 'seller' of securities should be determined by whether the [participant's conduct] was a 'substantial factor' in the sale of securities."); Davis v. Avco Fin. Servs., Inc., 739 F.2d 1057, 1067 (6th Cir. 1984). Some courts have narrowed the application of the test by also requiring proof of scienter on the part of the collateral participant [Akerman v. Oryx Communications, Inc., 810 F.2d 336, 344 (2d Cir. 1987); Mayer v. Oil Field Sys. Corp., 803 F.2d 749, 756 (2d Cir. 1986)] or that some special relationship exist between the collateral participant and the purchaser [Collins v. Signetics Corp., 605 F.2d 110, 113 (3rd Cir. 1979)].

156. 486 U.S. 622, 108 S.Ct. 2063, 2079-81, 100 L.Ed.2d 658 (1988), *vacating* Dahl v. Pinter, 787 F.2d 985 (5th Cir. 1986). Although *Pinter* specifically involved claims under Section 12(1), i.e., offers or sales of securities in violation of Section 5 of the Securities Act, it has been uniformly held by lower courts that *Pinter* applies to Section 12(2) actions as well. Mercer v. Jaffe, Snider, Raitt & Heuer, P.C., 713 F.Supp. 1019, 1024 (W.D. Mich. 1989), *citing* Wilson v. Saintine Exploration & Drilling Corp. 872 F.2d 1124, 1126-27 (2d Cir. 1989); Schlifke v. Seafirst Corp., 866 F.2d 935, 940 (7th Cir. 1989); Abell v. Potomac Ins. Co., 858 F.2d 1104, 1115 (5th Cir. 1988).

157. Pinter v. Dahl, *supra* note 156, at 2080 n.26.

158. *Id.* at 2081.

offerings, the depositary must function in a similar role whose absence would make the ADR arrangement impossible. The depositary's role is a substantial one and, although the depositary is not the immediate and direct seller of the underlying security, it functions as the trading liaison between depositor and investor. Moreover, the depositary is both a benefactor and beneficiary in the ADR arrangement: it acts as a facilitator in the exchanges of deposited securities and receipts issued, and it receives fees for performing those functions. Therefore, it would not be unreasonable to apply the participation model to the ADR arrangement and require the depositary bank to adhere to appropriate standards of responsibility for that participation.

E. *Section 12(2)*

The focal point of Section 12(2) liability is the offer or sale of securities by means of a prospectus or oral communication that includes an untrue statement or omits a material fact.[159] Liability under Section 12(2) extends to brokers, dealers, and others who participate in the sales transactions of securities. Notwithstanding the Supreme Court's holding in *Pinter*, liability under Section 12(2) can nevertheless apply under some non-traditional circumstances. Section 12 typically applies to broker-dealers, and the all-important offer or sale is the liability trigger. Further, the Supreme Court's analysis tends to address the potential liability of far-removed defendant participants in the offer or sale of securities. However, certain applications of the section could include depositary banks within its liability umbrella.

The definition of broker-dealer is broad enough to expose a depositary bank to liability under Section 12(2).[160] The Supreme Court's reasoning in *Pinter*, rejecting the substantial factor test, was an effort to protect remote participants in securities sales transactions. The Court clearly identified the problems of accurately defining the parameters of the substantial factor test, arguing that

> [t]he test affords no guidelines for distinguishing between the defendant whose conduct rises to a level of significance to trigger seller status and the defendant whose conduct is not sufficiently integral to the sale. None of the courts employing

---

159. 15 U.S.C.S. § 77*l*(2) (Law. Co-op. 1991) provides:

> Any person who: . . . .
> (2) offers or sells a security (whether or not exempted by the provisions of section 3 [15 U.S.C.S. § 77c], other than paragraph (2) of subsection (a) thereof, by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Id.

160. 15 U.S.C.S. § 77b(12) (Law. Co-op. 1991) defines a dealer as "any person who engages either for all or part of this time, directly or indirectly, as agent broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person."

the approach has articulated what measure of participation qualified a person for seller status, and logically sound limitations would be difficult to develop.[161]

The Court creates another judicial cliff-hanger, however, by rejecting the substantial factor test. The Court states in its conclusion that "merely a substantial factor in causing the sale of unregistered securities is not sufficient in itself to render the defendant liable...,"[162] but it offers no suggestion on what standard may be appropriate or what participants may be tested under such a standard. In declining to offer even a trace of advice about the proper analytical approach, the Court fails to acknowledge that, under certain circumstances, the test could be adequately defined. By applying the substantial factor test in terms of the closely scrutinized role of a participant, coupled with statutory definitions of collateral participants, the result would be a workable standard adequate to accommodate most circumstances. The role of the depositary bank in the ADR arrangement, coupled with the statutory definition of dealer, is such a circumstance. When a depositary bank accepts a deposit of foreign securities and subsequently issues the corresponding receipts, it fits well within the statutory framework of dealers who are subject to Section 12(2) liability. When the role of a depositary bank is scrutinized under the rubric of participation, there should be little question that Section 12(2) applies.

In 1985, the Ninth Circuit fashioned its own version of the substantial factor test. In *Anderson v. Aurotek*,[163] the court imposed Section 12 liability on participants in the sales of securities whose "acts are 'both necessary to and a substantial factor in the sales transaction.'"[164] The same principle was further defined in 1986 as a two-prong test in *SEC v. Rogers*.[165] The first prong of the test requires that the participation be a but-for cause in the outcome;[165] the second prong requires that the participation be more than de minimis.[167] The *Rogers* court explained that substantial participation was a standard without precise bounds, but it proceeded to clarify the two-prong test; giving additional substance to the prior standard.

Applying the combined concepts of *Aurotek* and *Rogers* to the ADR participation arrangement leaves little room for error in finding potential liability with regard to the role of the depositary banks. First, as discussed above, the banks' participation is clearly within the statutory definition of dealer because the bank acts at least indirectly as the agent or broker of the depositor, whether a foreign issuer or other shareholder, by accepting the deposits and subsequently offering the corresponding depositary receipts. Second, the ADR arrangement could not function but for the participation of the bank. Finally, although the bank's participation is, arguably, only a ministerial function, in reality that participation is far more than merely de minimis: the bank's role is central to the ADR arrangement. Therefore, applying the modified *Aurotek-Rogers* test to the ADR circumstances results in a workable and predictable model.

---

161. Pinter v. Dahl, *supra* note 156, at 2081 (citations omitted). It may be fitting to apply Justice Stewart's famous test for obscenity, "I know it when I see it. . . ." Jacobellis v. Ohio, 378 U.S. 184, 197, 84 S.Ct. 1676, 1683, 12 L.Ed.2d 793 (1964).

162. Pinter v. Dahl, *supra* note 156, at 2082.

163. 774 F.2d 927 (9th Cir. 1985).

164. 774 F.2d at 930, *citing* SEC v. Murphy, 626 F.2d 633, 649-50 (9th Cir. 1980).

165. 790 F.2d 1450, 1456 (9th Cir. 1986).

166. *Id.*

167. *Id.*

The modified *Aurotek-Rogers* test arguably introduces principles of causation and reliance into the securities liability framework, but such a proposal is contrary to the sentiments of the Supreme Court. In *Pinter*, the Court repudiated Congress' intent to incorporate principles of tort law doctrine, that is, reliance and causation, into Section 12 liability,[168] arguing that such an incorporation would create too much uncertainty and produce unpredictable results.[169] However, taking the analysis of the modified *Aurotek-Rogers* test a step further, the concept is equivalent to causation and reliance, but with a stronger foothold. When an ADR holder relies on the ADR registration information coordinated by the depositary bank with the depositor, and when the bank permits the disclosure of untrue statements or omits material facts from that registration, the requirements of reliance and causation are established, with the modified *Aurotek-Rogers* test also satisfied. The introduction of reliance and causation would therefore pinpoint liability, rather than create the abstract standard that the Supreme Court warned against.[170]

F. *Aiding and Abetting Under Section 18 of the Securities Act and 10(b) of the Securities Exchange Act*

Aiding and abetting liability is probably the most promising remedial theory to apply to participants in the ADR arrangement. A plaintiff must prove three elements to establish aiding and abetting in a securities action: (1) that an underlying securities violation has been committed, (2) that the aider and abettor had knowledge of the violation, and (3) that the aider and abettor substantially and knowingly participated in the violation.[171] The potential liability of depositary banks under Sections 18 and 10(b) under the aiding and abetting theory is discussed next.[172]

---

168. Pinter v. Dahl, *supra* note 156, at 2081.

169. *Id.*

170. A second area of ambiguity in application of Section 12(2) liability is whether liability extends only to initial distributions or also to secondary issues. *See generally* DAVID LIPTON, 15 BROKER-DEALER REGULATION 3-201 (1989) (Rel. #1, 9/89). The language of the statute is broad in that liability extends to any person who "offers or sells a security" without any reference to whether Congress contemplated only primary distributions or whether secondary trading was also within the intended class of transactions. In analyzing the intent of Congress on this point, some courts believe that the Securities Exchange Act of 1934 deals specifically with "post distribution trading" and that Section 12(2) of the Securities Act should be restricted to primary distribution. *See* Strong v. Webber, Inc., 700 F. Supp. 4 (S.D.N.Y. 1988). Apparently there are no cases that have been decided on this precise issue. The question prompts an analysis of the ADR arrangement in terms of classification as a primary or secondary issue. The issuance of the depositary receipts could be argued both ways. This issue is, however, beyond the scope of this article.

171. Staffin v. Greenberg, 509 F.Supp. 825, 833 (E.D. Pa. 1981), *citing* Monsen v. Consol. Dressed Beef Co., Inc., 579 F.2d 793, 799 (3rd Cir. 1978), *cert. den. sub nom.*, [First Pennsylvania Bank N.A. v. Monsen] 439 U.S. 930, 99 S.Ct. 318, 58 L.Ed.2d 323; Keller v. Coyle, 499 F.Supp. 1031, 1033 (E.D. Pa. 1980).

172. Aiding and abetting claims have arisen on numerous occasions in Section 11 and 12 actions with varied success. Although there have been decisions that have allowed aiding and abetting claims under Sections 11 and 12, the trend, particularly in Section 11 claims, is contrary. *See* Ahern v. Gaussoin, 611 F.Supp. 1465, 1482 (D.C. Ore. 1985) (holding plaintiff cannot use aiding and abetting theory in connection with Section 11 claims); In re Flight Transp. Corp. Sec. Litigation, 593 F.Supp. 612, 616 (D. Minn. 1984) (the Supreme Court has adopted a narrow construction of Section 11..., an aiding and abetting theory under Section 11 must fail); *see also* In re Worlds of Wonder Securities Litigation, *supra* note 131; In re Equity Funding Corp. of Amer. Sec. Litigation, 416 F.Supp. 161 (C.D. Cal. 1976); McFarland v. Memorex, *supra* note 144; Bresson v. Thomson, 641 F.Supp. 338 (S.D.N.Y. 1986); In re Elsinct, Ltd., Securities Litigation, 674 F.Supp. 374 (D. Mass. 1987); *but see* Laven v. Flanagan, *supra* note 131, at 808; Zatkin v. Primeth, 551 F.Supp. 39 (S.D. Cal. 1982).

1. Aiding and Abetting: Section 18

Section 18 of the Securities Act extends liability to any person who makes false or misleading statements in any application, report, registration, or other document filed pursuant to securities registration and reporting requirements.[173] Due to Section 18's broad language, aiding and abetting liability is compatible with the rudiments of Section 18. At least one court has held that Section 18 "is the catch-all civil liability provision for all of the reporting requirements of the Exchange Act . . . ."[174]

Although few cases are litigated under Section 18, any liability arising in connection with false or misleading statements in an ADR registration would appear to fit precisely within the conceptual framework of Section 18. The ADR registration statement clearly lies within the statutory requirements of a Section 18 claim. Moreover, the breadth of Section 18's language is sufficiently broad to subject a depositary bank participating in the collection of data, the coordination of data, or both for an ADR registration to liability as a principal participant in the registration.[175] Even when it may not be the principal participant, ADR investors rely on the bank as having the means, if not the motivation, to reasonably ensure the integrity of the registration statement. As the coordinator of the ADR registration, that is, the liaison between depositor and investor, the depositary sits in a prime position for aider and abettor liability under Section 18 upon the establishment of its defined elements.

Although Section 18 claims can be difficult to prove, the peculiar circumstances of the ADR relationship between parties may help overcome the difficulty. A key element of a Section 18 action is the requirement of reliance.[176] Although the required quantum of

---

Aiding and abetting under Section 12 claims has also met with scattered success. The first case approving Section 12 aiding and abetting liability was in re Ceasar's Palace Securities Litigation, 360 F.Supp. 366 (S.D.N.Y. 1973). That decision was followed by several circuits approving aider and abettor liability under Section 12. *See generally* Sandusky Land, Ltd. v. Uniplan Groups, Inc., 400 F.Supp. 440 (E.D. Wis. 1977); Stern v. American Bankshares Corp., 429 F.Supp. 8181 (E.D. Wis. 1977); Kilmartin v. H.C. Wainwright & Co., 637 F.Supp. 938 (D. Mass. 1986). However, several other courts have rejected Section 12 aider and abettor liability. *See generally* In re Activision Securities Litigation, 621 F.Supp. 415 (N.D.Cal. 1985); Beck v. Cantor, Fitzgerald & Co., 621 F.Supp. 1547 (N.D. Ill. 1985); Collins v. Signetics Corp. 605 F.2d 110 (3rd Cir. 1979).

In *Pinter v. Dahl* the Supreme Court noted the disparity of Section 12 application with regard to aiding and abetting but did not consider that issue in reaching its decision. Pinter v. Dahl, *supra* note 156, at 2079 n.24. Because of the inconsistency in decisions considering aider and abettor liability under Sections 11 and 12, the present discussion passes on further consideration here and focuses on Section 18 and 10(b) claims.

173. 15 U.S.C.S. § 78r (Law. Co-op. 1983 & Supp. 1992) provides in part:

> (a) Persons liable; persons entitled to recover; defense of good faith; suit at law or in equity; costs, etc. Any person who shall make or cause to be made any statement in any application, report, or documents filed pursuant to this title or any rule or regulation thereunder, or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title [15 U.S.C.S. § 78*o*(d)], which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction.

Id.

174. In re Penn Central Securities Litigation, 347 F.Supp. 1327, 1340 (D.C. Pa. 1972).

175. The relevant language is "any person who shall make or cause to be made. . . ." *Id.* § 78r(a) (Law. Co-op. 1983).

176. 15 U.S.C.S. § 78r(a) (Law. Co-op. 1983).

reliance which an investor must prove is not entirely clear, proof of some reliance is essential.[177] Thus, although constructive reliance based on Section 11 and 12 may be insufficient,[178] the relationship between an ADR investor and the depositary bank makes adequate reliance almost inevitable. The uniqueness and complexity of any aspect of international investment compels investors to rely heavily on their depositary banks. Therefore, what may be a problematic vehicle for liability in domestic securities actions may be the preferred theory in ADR liability actions.

2. *Aiding and Abetting: Section 10(b) and Rule 10b-5*

In 1934, Congress passed the Securities Exchange Act of 1934.[179] One of the milestones of that Act is Section 10(b)[180] and the corresponding Rule 10b-5.[181] The rule prohibits a vast spectrum of roguish behavior.[182] Of primary importance in the ADR arrangement is that portion of the rule directed toward liability in circumstances where the defendant is not directly involved with any purchase or sale of securities. The portions of the rule that trigger liability in such circumstances are the phrases (1) "any person," (2) "directly or indirectly," and (3) "in connection with the purchase or sale of any security."

---

177. Cramer v. General Tel. & Elec. Corp. 582 F.2d 259, 269-70 (3rd Cir. 1978), *cert. den.* 439 U.S. 1129 (1979); Mutual Shares Corp. v. Genesco, Inc., 266 F. Supp. 130, 133 (S.D.N.Y. 1967), *aff'd. in part and rev'd. in part on other grounds*, 384 F.2d 540 (2d Cir. 1967).

178. Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968), *cert. den.* 395 U.S. 903 (1969) (reliance in Section 11 action can be established "without proof of the reading" of the document); Mitchell & Co. v. Wachovia Bank & Trust Co., N.A. 452 U.S. 954 (1981); Beebe v. Pacific Realty Trust, 99 F.R.D. 60, 70 (D. Ore. 1983).

179. 15 U.S.C.S. §§ 78a to 78hh-1 (Law. Co-op. 1983 & Supp. 1992).

180. 15 U.S.C.S. § 78j provides, in relevant part, as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality or interstate commerce or of the mails, or of any facility of any national securities exchange - . . .
> (b) To sue or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for protection of investors.

Id.

181. 17 C.F.R. § 240.10b-5 provides as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) To employ any device, scheme, or artifice to defraud,
>
> (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

182. The Exchange Act is the foundation of 10(b) actions, but the Rule is the "workhorse" of 10(b) claims. For this reason, discussion centers around the Rule rather than the authorizing legislation. Even separate categories of 10b-5 violations have been identified: (1) misrepresentations and omissions by the defendant in trading securities; (2) misstatements and concealed facts when the defendant i snot involved in the purchase or sale transaction; (3) mismanagement by officers and directors; (4) market manipulation; (5) tipping; (6) tender offers and exchange offers; and (7) activities of brokers and fiduciaries. 5 JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 1-4, 2d Ed. (1990) (Rel. #24, 3/89).

a. The "Any Person" Clause

The words any person, coupled with the tenets of aiding and abetting liability, demonstrate Congress' intent to reach peripheral participants in fraudulent schemes.[183] The role of banks in potential securities actions reveals that they are squarely within the scope of the clause as peripheral participants. For example, in *Affiliated Ute Citizens of Utah v. United States,*[184] a bank was subject to 10(b) liability because its employees actively encouraged the marketing of securities for which the bank was the registered transfer agent.[185] The bank employees' misrepresentation of various aspects of the securities and the bank's collateral participation in the transaction formed the bases of liability.[186]

In another action, *Mercer v. Jaffe, Snider, Raitt and Heuer, P.C.,*[187] the court extended liability under Section 10(b) and the rule to those who "furnish information which contains a material misstatement or omission . . ., so long as he or she is not so far removed from the transmission of the misleading information that liability would necessarily become vicarious."[188] Attorneys acting on behalf of their clients lied to a state securities enforcement bureau about their client's unlawful activities,[189] and they additionally approved or assisted in the preparation of false and misleading advertising and promotional circulars used by their clients.[190] The *Mercer* court held that the attorneys' participation "certainly qualifies as 'furnishing' or 'supplying' information to potential investors in a sufficiently direct manner to impose 10b-5 primary liability."[191] In the ADR arrangement, the depositary bank is a necessary link between depositor and investor: it furnishes information by coordinating the ADR registration and facilitates the transfer of the depositary receipts. In this respect, the bank's role places it well within the group of qualifying defendants for Section 10(b) liability.

b. The "Directly or Indirectly" Clause

Both Section 10(b) and Rule 10b-5 include the phrase directly or indirectly. The import of the phrase is clear: it extends liability to behind the scenes players.[192] The extensive scope of the clause makes it the primary activator of aiding and abetting liability under the rule. Aiders and abettors have been held liable under the rule in an assortment of situations

---

183. *See generally Id.* at 2-391 (Rel. #14, 9/87).

184. 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972), *reh'g. denied,* 407 U.S. 916, 92 S.Ct. 2430, 32 L.Ed.2d 692 (1972), *reh'g. denied,* 408 U.S. 931, 92 S.Ct. 2478, 33 L.Ed.2d 345 (1972).

185. *Id.*

186. *Id.*

187. 713 F.Supp. 1019 (W.D. Mich. 1989).

188. *Id.* at 1025, *citing* SEC v. Washington Co. Utility Dist., 676 F.2d 218, 223-24 (6th Cir. 1982).

189. *Id.* at 1025.

190. *Id.*

191. *Id. citing* SEC v. Washington Co. Utility Dis. at 223-24. The court also noted that these facts would support "an alternative basis for imposing aider and abettor liability..." *citing* Moore v. Fenex, Inc., 809 F.2d 2297 (6th Cir. 1987), *cert. den. sub nom.* [Moore v. Frost] 483 U.S. 1006, 107 S.Ct. 3231, 97 L.Ed.2d 737 (1987).

192. *See generally* 5A JACOBS, *supra* note 182, at 2-433 (Rel. #14, 9/87).

because application of the rule extends to ancillary participants.[193] At least one court has held that direct communication between defendants, who were indirect participants in the securities scheme, and the plaintiffs, is not necessary to impose 10b-5 liability. Rather, anyone who knowingly assists another in making false or misleading statements is also subject to liability.[194] Thus, a depositary bank's indirect participation by accepting the deposits and subsequently issuing depositary receipts should bring it within the framework of the directly and indirectly clause of the rule based on the depositary's constructive knowledge of the registration contents.

c. *The "In Connection With" Clause*

The final piece of the triangle is the rule's in connection with clause. One of the fundamental purposes of the clause is to define the perimeters of the rule.[195] A long line of cases establishes the requirement of some nexus, albeit a loose association, between the fraudulent conduct and the ultimate offer or sale.[196] Although no authority sets forth a definitive test for determining what this proximal nexus requires,[197] some lower courts have agreed that the connection requirement is satisfied if the fraudulent scheme "touches" the transaction.[198] On the basis of a somewhat subtle lead of the Supreme Court, it follows inferentially that no direct or close relationship between the plaintiffs and the participants need be shown.[199]

Using the flexible nexus standard as a yardstick, collateral participants in ADR registration should be subject to liability under the rule. For example, where a depositary

---

193. In *Epprecht v. Delaware Val. Machinery, Inc.* 407 F.Supp. 315 (E.D. Pa. 1976), the court expressed its view that:

> It must be emphasized that liability under Rule 10b-5 is not confined to those direct participants who are primarily liable. Often, when an underlying securities fraud is proven, there are actors on the fringe of the transaction who, depending on the degree of their involvement, may be secondarily liable as either aiders or abettors or as co-conspirators.

Id. at 320. The court further noted that "liability may also be premised on an even more attenuated relation with the underlying violation" where conspiracy is involved. *Id.*

194. Jubran v. Musikahn Corp., 673 F.Supp. 108, 113 (E.D.N.Y. 1987), *citing* Freschi v. Grand Coal Venture, 767 F.2d 1041, 1049 (2d Cir. 1985) (reversing lower court's holding that liability could be established even where there was neither "knowing assistance" to another in communicating a misrepresentation nor direct communication), *vacated on other grounds*, 478 U.S. 1015, 106 S.Ct. 3325, 92 L.Ed.2d 731 (1986), *modified on other grounds*, 800 F.2d 305 (2d Cir. 1986).

195. *See generally* 5A JACOBS, *supra* note 182, at 2-41 (Rel. #13, 6/87).

196. Abrams v. Oppenheimer Gov't Sec., Inc., 737 F.2d 582, 593 (7th Cir. 1984); United States v. Newman, 664 F.2d 12, 18 (2d Cir. 1981); Arrington v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 651 F.2d 615, 619 (9th Cir. 1981); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1028 (6th Cir. 1979); Davis v. Davis, 526 F.2d 1286, 1290 (5th Cir. 1976).

197. One commentator has compiled a series of seven questions that should be considered in determining whether the nexus requirement is satisfied: (1) whether the purchase or sale preceded the fraud; (2) did the alleged fraud occur in the transaction the plaintiff is attacking or did it arise in some other transaction; (3) did the fraud concern the terms of the securities transaction; (4) was the plaintiff a party to the fraudulent transaction sale or purchase; (5) was plaintiff's loss closely connected to the fraud; (6) to what extent was the transaction an integral part of the fraud; and (7) was the fraud calculated to lead to a securities transaction. 5A JACOBS, *supra* note 182, at 2-47 to 2-49 (Rel. #13, 6/87).

198. Alley v. Miramon, 614 F.2d 1372, 1378 n.11 (C.A. La. 1980); Valente v. PepsiCo., Inc., 454 F. Supp. 1228, 1236 (D.C. Del. 1978).

199. Alley, 614 F.2d at 1378 n.11, *citing* Superintendent of Ins. of St. of N.Y. v. Bankers L. & C. Co., 404 U.S. 6, 92 S.Ct. 165, 30 L.Ed.2d 128 (1971).

bank has knowledge that the registration statement contains false or misleading information, the nexus linking the deception and the sale of the ADRs is both clear and significant. Because the bank's role in the arrangement is central to the success of the undertaking, if the bank has knowledge of an underlying deception, not only does its collateral and passive participation touch the transaction, it likely reinforces the deception. The bank's unique position may make it the final buffer between potential deception and a foiled attempt to defraud.[200]

G. *From There to Here: The Search for a Workable Model Continues*

A chief concern behind attempting to define a liability model for ADR participants is the difficult task of fitting the remedy to the source of the problem it attempts to cure, that is, identifying who should be accountable for the accuracy of the registration statements. In this sense, the ADR holder is in a peculiar situation: it may look to a foreign issuer that may or may not be involved in the ADR arrangement, or it may look only to a local bank, the affiliated depositary bank, or both as the entities responsible for assembling the information required in the F-6 registration form. If the foreign issuer does not participate in the ADR arrangement, and if there is no simultaneous U.S. registration of the underlying securities, there is an even greater importance placed on the accuracy of the information in Form F-6. Thus, because issuer liability appears not to exist under the dual entity theory discussed above, some remedy should be available to ADR investors who place so great a reliance on the F-6 registration statement.

As discussed above, the SEC has taken the position that the depositary bank may sign the ADR registration without incurring issuer status on behalf of the fictitious entity created by the ADR arrangement. Therefore, issuer liability is inapplicable in the arrangement. However, a close look at the role of the depositary bank suggests at least two possible models of liability. First, a modified *Aurotek-Rogers* test, including the elements of reliance and causation, fit the peculiar factual pattern of the ADR arrangement. Second, the broad standards of Rule 10b-5, applied alone or through an aiding and abetting theory, clearly encompass potential depositary liability. Both models would be workable and predictable. The underlying fact that triggers liability under either test is whether the depositary bank played a significant role in coordinating the registration information and in the registration efforts. If the answer is affirmative, either test would result in the imposition of liability. If the answer is negative, the depositary bank is free from registration liability to the ADR participants.

VI. CONCLUSION

An understanding of the future of American Depositary Receipts demands a search of some mysterious paths of regulation. If ADRs are to become a dynamic tool of international finance, the banking industry and the securities industry must break the confusing regulatory molds and seek to create better defined parameters. In relation to the regulations of banks which issue ADRs, ADRs in theory compare to the discount brokerage service at issue in the

200. This is not to say that every participant in a securities transaction is obligated to police the participation of every other player, but it is not too extreme to charge the parties involved with the responsibility of prudence.

Bank of America case. Much like discount brokerage services, ADRs are restricted to the transfer of receipts for third parties. They implicate no issue, flotation, underwriting, or distribution of securities. Likewise, the subtle hazards which *Camp* set forth do not exist. Although ADRs implicate other risks, the risks are not the sort that should prevent banks from handling the administrative functions of maintaining a registry of ADR holders.

A commentator recently stated that an analysis of the changes in the financial services industry could well be titled "What in Heaven's Name Has Happened to Banking and Why Are We Talking So Much About It?"[201] The changes in the banking industry, considered with changes in international finance and investment, are remarkable. Now, the banking and securities institutions should serve international finance by a natural meld of their talent, knowledge, and experience. By this combination, American investors will be able to grasp opportunities previously unavailable. The ADR will then become a vehicle for international investors to seek and realize financial gains, while participating banks expand their services and attain their own growth. The coordinated efforts of the securities and banking industries can protect investors from the pitfalls of unregulated offerings while satisfying their customers' personal investment goals in the international markets. Finally, the flow of capital beyond international boundaries will enhance multidirectional economic growth.

201. John D. Hawke, Jr., *Introduction: Implications of Change in the Financial Services Industry*, 8 ANN. REV. BANKING L. 325 (1989).