ALERT MEMORANDUM

SEC Continues to Bring Actions Against ADR Lenders For Use of Uncovered Pre-Released ADRs

September 18, 2019

In what appears to be an industry-wide sweep involving American Depositary Receipts ("ADRs"), over the last few years the SEC has brought enforcement actions against 13 financial institutions – including depositary banks and brokers that borrow and lend "pre-released" ADRs. On August 16, 2019, the SEC announced the latest of these actions against two brokers – Cantor Fitzgerald & Co. ("Cantor") and BMO Capital Markets Corporation ("BMO") – for charges related to the improper borrowing and lending of "pre-released" ADRs without obtaining or locating the foreign shares purportedly underlying those ADRs.[1] The SEC's cases have targeted conduct going back as far as seven years from the date of the announced settlements, and resulted in monetary settlements in excess of $427 million.[2] While these actions may be on the wane given the apparent contraction of the pre-release market, the SEC's actions signal that it is willing to bring cases to police conduct it views as having a negative effect on markets generally, even in the absence of readily-identifiable victims.

[1] *See Cantor Fitzgerald and BMO Capital Charged for Improper Handling of ADRs*, SEC Press Release, August 16, 2019, https://www.sec.gov/news/press-release/2019-155 ("Cantor and BMO Press Release").
[2] *Id.*

Background

ADRs are securities that represent an ownership interest in a specified number of foreign shares and that can be traded on U.S. stock exchanges or over the counter. ADRs allow foreign issuers to more easily access U.S. markets and U.S. market participants to more easily access foreign securities. Typically, a depositary and a foreign issuer enter into a depositary agreement under which the depositary will issue ADRs to a market participant that delivers the corresponding number of foreign shares to the depositary's foreign custodian. The delivery of the foreign shares to the custodian removes those shares from the market such that the total number of outstanding shares, in the form of ADRs or actual shares, remains constant.

However, many depositary agreements allow for the "pre-release" of ADRs before the foreign shares are delivered to the custodian. Such situations are governed by an agreement between a broker and a depositary ("Pre-Release Agreements"). Pre-Release Agreements typically have required the broker receiving the pre-released ADRs from the depositary ("Pre-Release Broker" in the SEC's parlance) to represent that it, or the customer on whose behalf the Pre-Release Broker is acting, beneficially owns the foreign shares underlying the ADRs while the pre-release transaction is outstanding. Historically, the pre-release of ADRs was used to resolve settlement timing discrepancies between markets. Many depositary agreements seek to preclude pre-release transactions over dividend record dates. In agreements in which Pre-Released ADRs are permitted to be outstanding over a dividend record date, the Pre-Release Broker is required to ensure that the relevant dividends are passed on to the depositary (and in some cases is explicitly required to represent that an appropriate amount of non-U.S. dividend withholding taxes are being paid).

The SEC's Sweep Against Pre-release Abuses

Since 2017, the SEC has brought 13 actions against the four U.S. depositary banks that issue ADRs (JP Morgan Chase Bank, Citibank, Bank of New York Mellon, and Deutsche Bank), four Pre-Release Brokers (Banca IMI Securities Corp., Wedbush Securities Inc., Industrial and Commercial Bank of China Financial Services LLC, and ITG Inc.), and a number of downstream brokers that borrowed and lent Pre-Released ADRs pursuant to master securities loan agreements ("MSLAs"). Generally in these cases, the SEC has alleged that a depositary issued Pre-Released ADRs to a Pre-Release Broker, who in turn on-lent the ADRs to other brokers, who on-lent them to an end user customer or other brokers in the market and so on. The SEC has found that, as a result, the ADRs entered the securities market without the requisite corresponding foreign shares being deposited with the custodian or held by anyone in the chain of transactions.

The SEC's orders found that the depositary banks provided ADRs to brokers in pre-release transactions when neither the broker nor its customers held the underlying foreign shares. With respect to the Pre-Release Brokers, the SEC found that they acted as conduits and should have known that neither they nor their customers owned the requisite underlying foreign shares. Finally, with respect to the downstream brokers – including BMO and Cantor Fitzgerald – the SEC found that the MSLAs did not contain any provisions requiring the broker or their customer to hold the underlying foreign shares as required under the Pre-Release Agreement and that "securities lending personnel should have known that they were potentially receiving pre-released ADRs and that the Pre-Release Brokers would not be complying with the Pre-Release Obligations."[3] The monetary penalties

[3] *See In the Matter of BMO Capital Markets*, SEC Release No. 86693 at 5, August 16, 2019, https://www.sec.gov/litigation/admin/2019/34-86693.pdf ("BMO Settlement").

have ranged from under $1 million to as high as $135 million.

The SEC found that these lending practices resulted in "inflating the total number of a foreign issuer's tradeable securities," which in turn lead to "abusive practices like inappropriate short selling and dividend arbitrage that should not have been occurring."[4] In the most recent cases against Cantor and BMO, the SEC announced that it "continues to hold accountable parties that abused the ADR markets over an extended period of time."[5] The SEC brought charges under Section 17(a)(3) of the Securities Act of 1933 – a negligence-based provision that bars deceptive practices – for obtaining ADRs from Pre-Release Brokers "in circumstances where they should have known that such ADRs likely had been pre-released without compliance with the Pre-Release Brokers' obligations under the Pre-Release Agreements," and Section 15(b)(4)(E) of the Securities Exchange Act of 1934 for failure to supervise.[6]

It is not precisely clear what deceptive conduct BMO engaged in here. As to Cantor, the SEC alleges that Cantor was itself a Pre-Release Broker and, thus, represented to its depositary bank that either it or its ultimate customer owned the underlying foreign shares. There is no such allegation against BMO, which merely borrowed ADRs from other brokers and was not alleged to have made any representations in connection with such trades. Misrepresentation concerning share ownership made by brokers to the depositary banks would not itself appear to be the primary motivator of these cases since the SEC has sued the depositary banks as well. Rather, the SEC's actions may be driven by a desire to efficiently stop what it views as abusive tax arbitrage or short-selling practices by the ultimate end user; *i.e.*, the brokers' customers. Under the depositary agreement and Pre-Release Agreement, if a dividend was paid while an ADR was pre-released (such that the depositary did not hold the underlying share and the holder of the pre-released ADR still held the share), that holder of that share receiving the dividend was supposed to pay any non-U.S. dividend withholding tax as if the share were actually owned by the depositary (and then pay to the depositary the remainder of the dividend). However, the SEC alleged that in abusive tax arbitrage strategies, a non-U.S. party holding the foreign share would not in fact be subject to the dividend withholding but would pay to the custodian a reduced amount as if the foreign tax had in fact been paid. In this way, borrowing the ADR through a pre-release would enable the holder to profit from this arbitrage and obtain a larger portion of the dividend.[7] The SEC alleged that, to facilitate this strategy, BMO CMC would borrow a pre-released ADR and then convert that pre-released ADR into an ordinary share, and that because "BMO CMC could have avoided the additional complexity and expense of obtaining and converting the pre-released ADRs" by instead just obtaining the ordinary shares, it should have known that it was "engaging in transactions in which pre-released ADRs were inappropriately obtained by Pre-Release Brokers and lent to BMO CMC."[8] The SEC may simply view it as more efficient to bring cases against the brokers and depositary banks – institutional gatekeepers that both supply the ADR lending markets and may have strong incentives to settle with their primary regulator – as opposed to each customer that may have used Pre-Released ADRs in an abusive way. Indeed, this strategy appears to have worked. It appears that in recent years pre-release activity has substantially slowed, possibly owing in part to the SEC's enforcement actions against market participants throughout the borrowing and lending chain.

[4] *JPMorgan to Pay More Than $135 Million for Improper Handling of ADRs*, SEC Press Release, December 26, 2018, https://www.sec.gov/news/press-release/2018-306.
[5] Cantor and BMO Press Release.
[6] *See* BMO Settlement at 3; *In the Matter of Cantor Fitzgerald & Co.*, SEC Release No. 10672, August 16, 2019, https://www.sec.gov/litigation/admin/2019/33-10672.pdf.
[7] *See* BMO Settlement at 6.
[8] *Id.*

There is reason to think that these actions may be reaching a natural end-point in the not-too-distant future. First, as noted, it appears that the pre-release market has significantly shrunk. The conduct investigated by the SEC in many of these cases reached as far back as 2011 and 2012, typically beyond the five-year statute of limitations applicable to disgorgement claims,[9] but the routine use of tolling agreements and the willingness of investigated parties to cooperate with investigations and engage in settlement discussions may have made it easier for the SEC to bring these actions.[10] Nonetheless, the sheer number of the SEC cases to date, as well as their impact on the pre-release market, likely means that there are simply fewer attractive cases going forward. The real takeaway of this sweep appears to be that while the SEC has signaled that it is focused on preventing harm to individual victims, it is still willing to make cases to reform market structures and regulate conduct by investigating and prosecuting gate keepers.

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[9] *See Kokesh v. SEC*, 137 S. Ct. 1635 (2017) (holding that the SEC's disgorgement remedy constituted a penalty and was therefore subject to a five-year statute of limitations under 28 U.S.C. § 2462).

[10] Interestingly, such actions may remain open for longer to Self-Regulatory Organization ("SROs") such as FINRA since the SEC recently held that SROs are not subject to the same five-year statute of limitations. *See In the Matter of John M. E. Saad*, SEC Release No. 86751, August 23, 2019.