Ten banks, brokerages stop pre-release American Depositary Receipts amid broad SEC probe

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In Brief

At least 10 of the 13 financial institutions charged with improper handling of pre-release American Depositary Receipts have exited that activity in recent years amid a long-running US Securities and Exchange Commission investigation that has covered much of the industry. Firms that have discontinued the practice include depositary banks and brokerages at some of the world's largest banks, including JPMorgan Chase, Bank of America, Deutsche Bank, Citigroup and Industrial and Commercial Bank of China. The SEC has levied fines totaling $427 million since early 2017 as its investigation continues. "You might say that by increasing the compliance cost, the SEC is lowering the likelihood of people doing this type of activity," Cornell law professor Charles Whitehead said.

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"You might say that by increasing the compliance cost, the SEC is lowering the likelihood of people doing this type of activity," Cornell business law professor Charles Whitehead said in an interview.

"There is an argument that the ADR market has outlived its usefulness. In a 24-hour trading cycle, when people in the US can directly trade overseas, and are sophisticated enough to do so, we do not necessarily need something like an ADR," he added.

ADRs are US-traded securities that represent shares of foreign-listed companies.

First created in the late 1920s, they allow US customers to invest in foreign companies without the complexity and costs of directly owning shares overseas. Foreign companies, in turn, get an opportunity to expand their investor base in the US.

— SEC actions —

The biggest SEC fines have been paid by depositary banks owned by JPMorgan Chase, which surrendered $135 million; Deutsche Bank, $75 million; BNY Mellon, $54 million; and Citibank, $38 million.

"Those are big penalties," said Cleary Gottlieb partner Nicolas Grabar. "Those are not just a slap on the wrist."

Some prominent brokerages — including Bank of America's Merrill Lynch, Societe Generale's SG Americas Securities, and Deutsche Bank Securities — also have been fined.

The largest brokerage penalty was paid by Banca IMI Securities, a US unit of Italian bank Intesa Sanpaolo, which agreed to pay $35 million. The most recent case was brought last month against Cantor Fitzgerald and BMO Capital Markets brokerages, which agreed to pay a total of $4.5 million to settle charges.

"The SEC's actions involving pre-released ADRs have revealed industry-wide abuses," Stephanie Avakian, the SEC's co-enforcement chief, has said. "Failures at each institutional link in the chain of these transactions, from depositary bank to broker-dealer, left the markets for those ADRs ripe for potential abuse at the expense of ADR holders."

— 'Pre-release' ADRs —

ADRs are supposed to have a matching number of foreign shares in bank custody. But they can be "pre-released" to brokerages if a broker or customer owns the underlying stock.

The SEC alleged in some cases that the ADRs weren't backed by foreign shares. They amounted to "phantom securities" used for improper short-selling and dividend arbitrage by the firms, the agency said.

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“They are front-running,” Duke law professor James Cox said. “This is not an 'oops, I made a mistake.’ These are purposeful violations.”

SEC orders in the cases of the four depositary banks and five brokerages said the institutions had discontinued pre-release of ADRs. A Merrill spokesman said the firm has stopped the activity.

Neither Societe Generale nor BMO would say whether they have stopped pre-releasing ADRs. Cantor Fitzgerald brokerage declined comment.

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