

## Consultant's Corner

### American Depositary Receipts (ADRs):

### What You Need To Know

By Elizabeth Howard

American Depositary Receipts were invented by J. Pierpont Morgan and first issued through Morgan Guaranty Trust in 1927, when the London retailer, Selfridge's Ltd., wanted to make it easier for Americans to invest in their company. Or so the story goes. The concept was simple. An ADR was designed to allow an American investor to buy the actual receipts for a foreign security, with the shares deposited in the foreign branch of an American bank. The American bank would convert the dividends into dollars and the investor would not have to handle the conversion of a foreign currency. In 1927 this also meant that an American did not have to embark on a long ocean voyage to handle the transaction in person.

Edward S. Davis, a partner in the corporate department at Hughes Hubbard & Reed, points out that ADRs present an opportunity to invest in a foreign security through the U. S. market.

For example,

- The dividends, interest, and principal are paid in U.S. dollars.
- The ADR is traded in U.S. dollars.
- The trades are settled according to U.S. Rules (five days) whether on the NASDAQ or other exchanges.

*Elizabeth Howard is the principal of Elizabeth Howard & Company, a New York based corporate communications and marketing firm. The firm specializes in working with law firms. Ms. Howard is the Publisher and Editor-In-Chief of Observations, a letter that covers issues and trends. Her articles have appeared in Investor Relations, Law Firm Marketing & Profit Report, Communications Arts and Public Relations Journal among others.*

- The depository bank will assist in obtaining refunds or a tax credit with respect to foreign taxes withheld on dividends or interest.
- Significant information relating to the issuer can be furnished by or through the depository bank.

Jim Waddington, a securities law expert with Whitman Breed Abbott & Morgan, notes that "ADRs are basically a convenient way for U.S. investors to invest in other markets. The U.S. investor does not worry about converting local currency dividends, opening a brokerage account in the foreign jurisdiction, paying foreign capital gains taxes or obtaining information on the issuer."

In 1960 a representative from Morgan Guaranty traveled to Japan to discuss ADRs. The Japanese were afraid the ADR would breach the nation's capital controls. However, the Ministry of Finance warily consented to an ADR for Sony, the first ever for a Japanese stock. Setsuya Tabuchi, the Chairman of Nomura Securities, later commented: "If there was a single milestone in the internationalization of the Japanese market, it was in 1961 when Sony issued American Depositary Receipts in the United States."

As interest in investing in foreign markets grew and the economy became internationally oriented, there was phenomenal growth in the ADR market. *Business Week* Magazine in a cover article published in the September 19, 1994 issue pointed out that: "...American investors -- from individuals to multi-billion-dollar pension and mutual funds -- have fallen in love with global stocks," and many foreign companies are bringing their offerings to the market in the form of ADRs<sup>2</sup>. The article went on to describe the burgeoning investment in ADRs. In 1993, the Bank of New York reported

that in the first six months of that year, ADRs were traded totaling 2.8 billion shares, and valued at \$84 billion. The Bank of New York estimated that \$266 billion of ADRs would trade on the New York, American and NASDAQ exchanges in 1994. The actual figures January 1 through 30 June, 1994 were \$128.5 billion, with the total number of listed depository receipt programs at 1,031 and a total estimate for 1994 at 1,096. The breakdown by country:

UK	19.4%
Australia	16.1%
Japan	14.3%
South Africa	8.2%
Hong Kong	5.8%
Mexico	5.3%
France	2.7%
Netherlands	2.5%
Italy	2.4%
Germany	2.4%
Ireland	2.0%
Other	18.9%

*Why is it important for American companies to understand how an ADR functions and to follow the ADR market when offerings are made for foreign companies?*

"Every lawyer representing a U.S. corporation should know about ADRs because their client's foreign competitor will use ADRs to make tax-effective acquisitions in the United States and to raise capital here," comments Edward Davis, Hughes Hubbard & Reed.

Monte Wetzler, a partner at Whitman Breed Abbott & Morgan and an expert in securities law, also points out that "the wholly owned foreign subsidiary of an American company can use an ADR if they intend to go public or if they want to raise money in the American market."

"ADRs are also used in employee benefit plans so it is important for in-house counsel to understand how they function," comments Ann Fisher, a partner at Sullivan & Cromwell. She also points out that "while the ADR is a more convenient way to invest in a foreign stock, an ADR is not risk free, because you cannot eliminate the country risk."

ADRs trade in dollars and the dividends are paid in dollars; however, the value is tied to the currency and the market in a particular country. An example of an ADR that attracted the attention of investors and sold millions of shares was Telefonos De Mexico. TelMex had a 52 week high of \$74.88 and dropped to \$34.00 when the peso collapsed on December 19, 1994. It is currently trading at \$29.50 (16 February, 1995). According to Eric Frank, Vice President, ADR Department, J.P. Morgan, "this was an offering that attracted publicity and interest among investors who were unfamiliar with investing in the international market. In many cases individuals didn't do the research that should be done before making this kind of investment." While the ADR

ments.

South Africa, on the other hand, is described by Andrew Levine, a Vice President of The Bank of New York, as a reemerging market. "When the sanctions against South Africa were lifted, the sponsored ADR market began to open up." South Africa is described as reemerging because it has a strong and sophisticated market in place. In a number of the emerging countries in South America and in Asia, the financial and other systems supporting an ADR market are still developing. There are 30 sponsored ADR programs in South Africa.

*What do lawyers need to counsel companies coming to the United States to set up an ADR?*

The reason most companies set up an ADR program is to expand their investor base and increase the liquidity of the underlying shares. According to Jim Waddington, "Most companies coming to the United States markets are unfamiliar with U.S. market practices, legal requirements and liability concerns. As a result, the U.S. counsel needs to be much more involved in advising these companies and guiding them through the ADR process."

*Will interest in creating ADRs be sustained?*

In recent years, many countries have adopted a free market model and moved toward a system based on capitalism; however, most of these countries do not yet have fully developed capital markets. As a result, companies in those countries will turn to developed capital markets like the United States to raise funds. Therefore, it seems likely that the ADR market will be sustained "as long as the regulation in the United States works in their favor," says Ann Fisher, Sullivan & Cromwell.

For the foreign issuer one of the first steps in the ADR process is the selection of legal counsel and a depositary bank. "During that process," says Ms. Fisher, "one can learn about the fundamentals of the U. S. securities market -- what is involved in an offering, what the fees will be." Although there are a select number of law firms who are active in the ADR market, Ms. Fisher comments that the competition among law firms is fierce and that one should take time to interview a number of firms and "be selective". Fisher counsels company representatives to "ask a lot of questions and to push for specifics during these presentations, before they plunge into the process."

A former Vice President of J. P. Morgan in New York, in discussing ADRs stresses the importance of retaining the services of a U. S. law firm, as well as investor relations counsel, with recognized expertise in the securities market. He points out that the CEO and the CFO of a foreign company coming to the United States, perhaps for the first time, must understand the time commitment necessary to complete an offering, adding that they should plan at least two annual visits to the United States.

Charles Engros, a partner at Morgan, Lewis & Bockius, has handled a number of ADRs. "The attorney representing a foreign company considering an ADR listing must act as both an advocate and educator. It is important that the company select a lawyer who is an expert in U.S. securities law and is someone who has familiarity with both the cultural standards and legal requirements of the issuer's home country. In essence, the lawyer must have the ability to efficiently negotiate those points that are negotiable and to recognize and accept those standard provisions which are generally not negotiable and the sensitivity to educate the client about the distinction between those points." He also underlines the need to work with a firm which has handled ADRs and has the experience in handling the next offering. "One does not want to retain the services of a firm that has never handled an ADR offering. The education process is lengthy and expensive and the waters can be treacherous." In most cases law firms are recommended by investment bankers or the depositary bank. While disclosure and other SEC requirements may be less stringent for non-U.S. issuers than for domestic companies, it is no less important for foreigners to keep abreast of, and in line with, the current rules.

Daniel Bushner, of the London Office of Rogers & Wells, notes that one prominent feature of U.S. securities laws is their severe provisions regarding civil and criminal liability. "The most stringent of these regulations is the liability for misstatements in, or omissions from, registration statements for public offerings," he says. Bushner warns that anyone who buys securities on the basis of statements which are misleading -- because of misstatements or omissions -- can recover their losses "from the issuer of the securities, from every person who



Elizabeth Howard

is a simple concept, Maureen Brundage, a partner in the corporate department at White & Case, believes that many American Lawyers still view it as a mystery. "An ADR offering is just a method for foreign issuers to raise equity capital in the United States."

The boom in the ADR market in the first two quarters of 1993 was sparked by an interest in investing in emerging markets, particularly Latin America and Asian countries. Ms. Brundage believes American investors are "spooked" by what happened in the Hong Kong and Asian markets midway through 1994 and with the collapse of the peso on December 19, 1994 in Mexico. "Some deals are not getting done as a result," she com-