



School of Law
UNIVERSITY OF GEORGIA

Prepare.
Connect.
Lead.

Digital Commons @ University of Georgia School of Law

LLM Theses and Essays

Student Works and Organizations

1-1-1998

American Depositary Receipts As A Way For Russian Companies to Enter The U.S. Capital Market

Dmitry Gladkov

University of Georgia School of Law

Repository Citation

Gladkov, Dmitry, "American Depositary Receipts As A Way For Russian Companies to Enter The U.S. Capital Market" (1998). *LLM Theses and Essays*. 207.
https://digitalcommons.law.uga.edu/stu_llm/207

This Dissertation is brought to you for free and open access by the Student Works and Organizations at Digital Commons @ University of Georgia School of Law. It has been accepted for inclusion in LLM Theses and Essays by an authorized administrator of Digital Commons @ University of Georgia School of Law. [Please share how you have benefited from this access](#) For more information, please contact tstriepe@uga.edu.

AMERICAN DEPOSITORY RECEIPTS AS A WAY
FOR RUSSIAN COMPANIES TO ENTER
THE U.S. CAPITAL MARKET

Dmitry Gladkov

Law Library
School of Law
The University of Georgia



The University of Georgia



Alexander Campbell King Law Library

UNIVERSITY OF GEORGIA LAW LIBRARY



3 8425 00347 4827

AMERICAN DEPOSITORY RECEIPTS AS A WAY
FOR RUSSIAN COMPANIES TO ENTER
THE U.S. CAPITAL MARKET

by

DMITRY GLADKOV

Ph.D., Novosibirsk Military Academy, Russia, 1988

J.D., The Moscow State Institute of International Relations, Russia, 1995

A Thesis Submitted to the Graduate Faculty
of The University of Georgia in Partial Fulfillment of the
Requirements of the Degree

MASTER OF LAWS

ATHENS, GEORGIA

1998

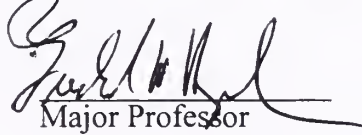
LAW LIBRARY
UNIVERSITY OF GEORGIA

AMERICAN DEPOSITORY RECEIPTS AS A WAY
FOR RUSSIAN COMPANIES TO ENTER
THE U.S. CAPITAL MARKET

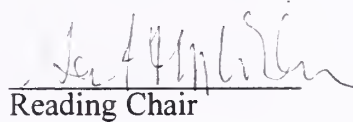
by

DMITRY GLADKOV

Approved:


Major Professor

14 May 1998
Date


Reading Chair

22 May 1998
Date

Approved:


Dean of the Graduate School

May 26, 1998
Date

TABLE OF CONTENTS

CHAPTER I INTRODUCTION.....	1
CHAPTER II GENERAL INFORMATION	3
1. How Do ADRs Work?.....	3
2. ADR Advantages for Investor	6
3. ADR Disadvantages for the Investor	11
4. Why Do Companies Launch ADR Programs?	12
5. Disadvantages for the Issuing Companies	13
6. Interest of Russian Companies in ADR Facilities	15
CHAPTER III AN OVERVIEW OF ADR REGULATION	19
1. Basic Features.....	19
2. Registration Requirement	20
3. Exchange Act Reporting.....	33
4. Rule 144(a) and Private Placements	38
CHAPTER IV TYPES OF ADR FACILITIES AND RELEVANT REGULATION REQUIREMENTS.....	42
1. General Approach.....	42
2. Unsponsored ADR Facility	44
3. Sponsored ADR Programs.....	48
4. ADR Listing Requirements	56
CHAPTER V LIABILITY.....	61
1. General Characteristics.....	61
2. Aurotek-Rogers Test.....	64
3. Rule 10b-5	65
CHAPTER VI ADRS. PROSPECTS FOR THE FUTURE	68
CHAPTER VII CONCLUSION.....	72
BIBLIOGRAPHY	73



Digitized by the Internet Archive
in 2013

<http://archive.org/details/americanposito00glad>

CHAPTER I

INTRODUCTION

The integration process of the markets began more than twenty years ago and has developed dramatically world's capital over the past few years. With the increased sophistication of the market players (borrowers, investors and financial intermediaries), rapid advances in information technology and communications, and great co-operation among financial regulators, the international capital markets are now more closely linked than before.

Depository receipts ("DRs") are an important element in the market integration process. They allow domestic investors to acquire and trade in foreign securities, while at the same time giving the issuing corporations access to the major stock markets of other countries.

In the last few years, the depository receipts concept has developed considerably. Issuers in a variety of countries have realized that there are a number advantages in making their stock available in a form convenient not only to U.S. investors but also, or alternatively, to investors in the Euromarkets or elsewhere. This has prompted the development of European Depository Receipts (EDRs)¹ and Global Depository Receipts (GDRs)².

American Depository Receipts ("ADRs") are USA dollar denominated negotiable instruments issued in the U.S. by a depository bank, representing ownership in non-U.S.

¹ The EDR accesses the Euromarket but not the U.S. market. It settles and trades through the Euromarket clearing system Euroclear and Cedel, and may be listed on a European Stock Exchange, normally London or Luxembourg; EDRs may be denominated in any currency.

² A GDR accesses two or more markets, usually the Euromarkets (like EDR) and the U.S. (like and ADR). GDRs are generally denominated in U.S. dollars, but may be denominated in any currency.

securities, usually referred to as underlying ordinary shares. ADR can also be used to represent debt securities or preferred stock. ADRs make it possible for a U.S. investor to acquire and trade in non-U.S. securities denominated in U.S. dollars without concern for the differing settlement timctables and the problems typically associated with overseas markets. ADRs also provide foreign companies with the access to the U.S. capital market, the largest and the most efficient investor base in the world.

There are several types of ADR, each of which involves a different level of disclosure of information and compliance with the requirements of the Securities and Exchange Commission ("SEC"). Depending on the ADR type, the issuer obtains a different types of access to the U.S. investors base. Some ADR structures allow the issuer to raise a capital in the U.S., while others simply provide the company with a possibility to enhance its international image and make it easy for the U.S. investors to buy and trade existing shares of the company.

Historically, it is considered that the first ADR program was developed and introduced by the Guaranty Trust Company in cooperation with several U.S. and foreign arbitrage brokers in response to a law passed in Britain which prohibited British companies from registering shares overseas without a British - located transfer agent.³ UK shares were not allowed physically to leave the UK, and so, to accommodate U.S. investor demand, a U.S. instrument had to be created. This instrument was called an American Depository Receipt. In its present form ADR came to existence in 1955, when the SEC introduced its Form S-12, for registering all depository receipts programs. Form S-12 was later substituted with Form F-6, which is still in operation today.

³ Regis Moxley, 8 Vill.L.Rev. 19, 22 (1962).

CHAPTER II

GENERAL INFORMATION

1. How Do ADRs Work?

If investor is willing to acquire shares in a foreign company, he can either buy the foreign shares in the local market through a broker in that country or, providing the foreign company in question has an ADR program, the investor can request his broker to buy ADRs. The broker may either purchase existing ADRs or, if none are available, he may arrange for a depository bank to issue new ones.

The depository receipt is issued by a U.S. depository bank, when the foreign company shares are deposited in a local custodian bank, usually by a broker who has acquired the shares in the open market. Once issued, ADRs may be freely traded in the U.S. over-the-counter market ("OTC"), in case of the Level I ADRs, or, upon compliance with U.S. Securities and Exchange Commission regulations, on one of the U.S. national stock exchanges (Level 2 and 3 ADRs). When the ADR holder sells, the depository receipt can either be sold to another U.S. investor or it can be canceled. In the latter case, the ADR certificate would be surrendered to the depository and the shares held by the custodian bank in the country of issuing corporation be released back into the domestic market, most likely sold to a broker there. The depository receipt holder is eligible to request delivery of the actual shares at any time, provided that it is allowed under the laws of the country where the shares have been issued. For example in Peru "it is

prescribed by local legal requirements that securities must be physically presented at the Lima Stock Exchange in order to finalize a trade.”⁴

Shareholder information such as annual reports, notices of general meetings and corporate actions, and official news releases are provided by the issuer to the depository and the receipt holders, either direct or through the local custodian. The investor is, thus spared the costs and difficulties often encountered when direct investment is made in local markets, where currency, settlement, and linguistic problems may be compounded by an excessive number of intermediaries.

ADR holders are entitled to all the dividends payable on the underlying foreign shares and, furthermore, to have these dividends paid in U.S. dollars.

The demand by American investors for ADR “is growing between 30 to 40 percent annually and is driven by the increasing desire of retail and institutional investors to diversify their portfolios globally.”⁵ These investors, as a general rule, do not, or cannot for various reasons which will be explored further, invest outside of the U.S. and, as a result, utilize ADRs as a means to diversify their portfolios. Investors who do have the capabilities to invest outside the U.S., usually investment banks, prefer to utilize ADRs because of the convenience, enhanced liquidity and cost effectiveness ADRs offer, as compared to acquiring and safekeeping ordinary shares in the home country of the issuer.

ADRs are issued when investors decide to acquire securities of a non-U.S. company. To achieve this they contact their brokers to make a purchase. These brokers, through their international offices or through a local broker in the company's home market, purchase the ordinary shares of the target company and order that the shares be delivered to the depository bank's designated custodian in that country. The broker who carries out the transaction will convert the U.S. dollars received from the investor into the

⁴ John T. Connor, Jr., *Russian ADRs in U.S. Capital Markets*, BNY Home Page (August 1996) <<http://www.bankofny.com/adr/aovrview.htm#what>>.

⁵ See *id.*

corresponding foreign currency and pay the local broker for the shares acquired. Purchased shares may be delivered to the custodian bank at the same day. In its turn the custodian notifies the depository bank on the results of the transaction. Upon such notification, the depository issues ADRs and delivers them to the initiating broker, who then delivers the ADRs to the investor.

As soon as ADRs are issued, in accordance with the SEC requirements, they may be traded in the United States and, just as with any other U.S. security, they can be freely sold to other investors. When an ADR is sold to another U.S. investor and the existing ADR certificate is simply transferred from one ADR holder (seller) to another one (buyer), it is known as an intra-market transaction.

An intra-market transaction is settled in the same manner as any other U.S. security purchase: in U.S. dollars on the third business day after the trade date and typically through the Depository Trust Company ("DTC"). "Intra-market trading accounts for approximately 95% of all ADR trading in the market today."⁶

When investors want to sell their ADRs, they notify their broker. The broker can either sell the ADRs in the U.S. market through an intra-market transaction or sell the shares outside of the U.S., typically into the home market, through a procedure known as a cross-border transaction. In cross-border transactions, brokers, either through their own international offices or through a local broker in the company's home market, will sell the shares back into the home market. In order to settle the trade, the U.S. broker will surrender the ADRs to the depository bank with instructions to deliver the shares to the buyer in the home market. The depository bank will cancel the ADRs and instruct the custodian to release the underlying shares and deliver them to the local broker who purchased the shares. The broker will arrange for the foreign currency to be converted into U.S. dollars for payment to the ADR holder.

⁶ John T. Connor, Jr., *Russian ADRs in U.S. Capital Markets*, BNY Home Page (August 1996) <<http://www.bankofny.com/adr/aovrview.htm#what>>.

Once ADRs are issued and there is an adequate number of ADRs outstanding in the U.S. market, usually 3% to 6% of the company's shares in Depository Receipt form, a real intra-market trading market may be established. Until this market develops, most ADR purchases result in ADR issuance versus the deposit of shares. When executing an ADR trade, brokers seek to obtain the best price by comparing the ADR price in U.S. dollars to the dollar equivalent price of the actual shares in the home market. Brokers will buy or sell in the market that offers them the best price and they can do so in three ways: (i) by issuing a new ADR, (ii) transferring an existing ADR or (iii) canceling a ADR. For example, if the price of the shares in the domestic market is \$20.12 per share, and the ADR is traded for U.S.\$20.14, the broker will buy shares and issue ADR until the price of the shares is pulled up to \$20.14, at which point the broker starts simply to buy and sell the existing ADRs which are already in the market.

The continuous buying and selling of ADRs in either market keeps the price difference between the local and U.S. markets to a minimum. As a result, about 95% of ADR trading is done in the form of intra-market trading and does not necessarily involve the issuance or cancellation of ADRs.

When a non-U.S. company completes an offering of new shares, part of which will be sold as ADRs in the U.S. stock market, the company will deliver the shares to the depository bank's local custodian at the time of the closing. The depository bank then will issue the corresponding ADRs and deliver them to the ADR purchasers.

2. ADR Advantages for Investor

U.S. investors have become increasingly interested in overseas markets as a result of their higher yields compared to the U.S. equity market over recent years. This interest is reflected in the number of ADR programs, which grew from 600 in 1984 to 1415 by the end of 1994. Total ADR trading volume on U.S. exchanges has also shown dramatic growth, moving from U.S.\$ 15.8 billion in 1984 to over U.S.\$ 200 billion in 1994.

From the investor's standpoint, U.S. investors buy ADRs for the following reasons: convenience, safety, cost, liquidity and compliance with the regulatory requirements.

2.1. Convenience and Safety

From a convenience perspective, ADR, as a vehicle for trading in a foreign securities, avoids 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.⁷ 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.⁸

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.⁹

In addition to these disadvantages, fluctuating exchange rates and high transportation costs increase the expense and delay of obtaining proceeds from the sale of foreign securities. Although efforts have been made to improve clearance and settlement practices across international borders, certain difficulties still remain. Finally, market risk, also called "position risk"¹⁰ is lower in case of ADR trading.

⁷ 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).

⁸ See *id.*

⁹ In case of direct investing in Russian securities, the investor may be required to obtain a Russian Central Bank ("RCB") license for operations connected with movement of capital (RCB Instruction No.352). Transfer of dividends or proceeds from the sale of securities is allowed only upon presentation of the RCB license and evidence that the investor has paid income tax on receipt of dividends, or in the event the tax treaty in force exempts dividends from taxation, the investor will be required to prove that he is a resident in the country - party to the treaty.

¹⁰ "Position risk is a risk of adverse movement in a security's price. For, example, the market value of security purchased by a firm may fall before it can be resold." HAL S. SCOTT, PHILIP A. WELLONS, *INTERNATIONAL FINANCE*, 292, (The Foundation Press, Inc. 4th ed. 1997).

In June 1989, Federal Reserve Board Chairman Alan Greenspan addressed members of the Senate Banking Subcommittee on the subject of trends in globalized securities market. Greenspan noted that there is a systemic risk¹¹ in clearance and settlement delays.¹² "In the U.S., the maximum clearance and settlement window period is five days."¹³ Greenspan warned that any float period in excess of five days introduces significant threats to investment in securities.¹⁴ Systemic and failed trade risks are substantially lower if the investor acquires ADRs. Because ADRs settle according to U.S. principles and they settle in U.S., the trade fails very rarely. Trade failure, or "settlement risk"¹⁵ means nondelivery of ADRs on the settlement date. "The failed trade rate in the United States for ADRs is less than 0.5%"¹⁶ If the investor buys shares directly in the country of the issuer, the failed trade rate is substantially higher.

There is also some inconvenience in bearer form certificates, issued by the foreign corporations as evidence of stock ownership. Bearers of these certificates have no direct contact with the foreign corporation, no information relating directly to corporate activities such as meetings, dividend declarations, merger and takeover quests, and potential reorganizations. In this situation the investor may rely only on trade publications of foreign origin, hoping that he receives them in time and provided that he does not have problems with foreign language and understanding of the investment data format. By contrast, by using the ADR facility the investor promptly accesses the information

¹¹ "systemic risk is a risk that a disturbance could severely impair the working of the financial system and, at extreme, cause a complete breakdown in it. For example, collapse of securities prices could lead to the default of one or more large securities firms. Because of financial interrelationships, this could lead to further defaults of securities firms and banks", HAL S. SCOTT, PHILIP A. WELLONS, INTERNATIONAL FINANCE, 292, (The Foundation Press, Inc. 4th ed. 1997).

¹² *Global Markets' Interdependence Makes Them More Vulnerable, Greenspan Warns*, 21 Sec.Reg. & L.Rpt. (BNA) 877 (June 16, 1989).

¹³ *See id.*

¹⁴ *See id.*

¹⁵ "Settlement risk is a risk that a firm's trading partner will be either unwilling or unable to meet its contractual obligations." HAL S. SCOTT, PHILIP A. WELLONS, INTERNATIONAL FINANCE, 292, (The Foundation Press, Inc. 4th ed. 1997).

¹⁶ Joseph Valli, *American Depository Receipts: An Overview*, Fordham International Law Journal, 3 (January 1994).

disseminated by the depository banks and their affiliates. Moreover, ADR registration requires that the depository specify in the registration statement those provisions which relate to voting procedures, dividend distributions, and circulation of notices and proxy solicitations, along with the other information of similar interest to an equity holder.¹⁷

ADRs trade and settle like any other U.S. security. There is no difference between buying shares of Glaxo ADRs and buying Microsoft or Lucent technologies securities. It works exactly the same way and investor pays the same commission rates.

As the legal owner of the deposited securities, the depository is also able to facilitate the transfer of shares by ADR holders. The holder of an ADR certificate can transfer the certificate in the United States through endorsement and delivery to the depository, which, in turn, transfers the ownership of the underlying deposited securities by making an entry on the depository's books. Without this transfer mechanism, a U.S. owner of foreign securities would be required to transfer securities pursuant to the transfer procedures of the foreign jurisdiction where the foreign private issuer is incorporated. In addition, upon surrender of ADR certificates to the depository, the ADR holder may elect either to (in the case of SEC-registered and the most of privately placed ADR issues) sell the deposited shares in the foreign market, in which case, the foreign shares would be released to the designee of the ADR holder for delivery against payment to close the foreign sale, or surrender ADR certificates to the depository, in which case the holder may receive the deposited shares represented by the ADR certificate.¹⁸

2.2. Cost Efficiency

On the cost side, in contrast to the "direct investing" (buying shares on the local market of issuer) there are some cost advantages from the U.S. investor standpoint.

¹⁷ Douglas B. Spoors, *Exploring American Depositary Receipts: The International Augmentation of U.S. Securities Market*, 6 Transnational Lawyer, at 181 (1993).

¹⁸ In some jurisdictions, cross-border transfer of securities may be restricted. In the Russian Federation for example, securities denominated in local currency may not be exported. Foreign currency denominated securities are subject to the customs declaring.

- Custodian fees are avoided. In case of “direct investing” the investor has to appoint a custodian to hold his shares in the country of issue. Custodian fees may vary “from ten to forty basis points annually”¹⁹
- ADRs simplify the collection of dividends. As a general rule dividends on bearer securities are declared through publication in newspapers in the country of the issuer location. The owner of the bearer securities would collect the dividend by presenting the security certificates to a paying agent. Thus, in case of direct investing, a U.S. securities holder has to monitor foreign newspapers and then attempt to collect their dividend through the international mails. Although big corporate issuers have websites on Internet, thus, obviating the problem of keeping their shareholders informed on corporate actions, the problem of cross-border dividend payments still remains. The ADR facility eliminates both problems (i) information transfer and (ii) dividend payment.
- Foreign exchange rates on dividends are better on ADR dividends. As a general rule, when the depository bank pays dividends and converts into U.S. dollars large sums of money, it is able to provide a customer with an exchange rate, that is better than is available from a non-depository bank.
- The direct investor also may face some obstacles with protection of his investments on international markets, as remedial measures are generally very obscure. ADRs to some extent, resolve this problem for the investor, as one of the purposes of issuer’s registration is to make him liable for whatever defaults may occur with securities.

2.3. Compliance With Regulatory Requirements

Depository receipts mitigates the obstacles that mutual funds, pension funds and other institutions may have in purchasing and holding securities outside of their local

¹⁹ Joseph Valli, *American Depositary Receipts: An Overview*, Fordham International Law Journal, 2 (January 1994).

market, due to the legislative and charter limitations on their ability to invest in foreign securities.

2.4. Liquidity

ADR programs open the issuer's stock to a wider investor base, and in the case of American market this base may be substantially bigger than the issuer's local one. This fact enhances the liquidity of the underlying securities.

3. ADR Disadvantages for the Investor

It would fair to disclose some disadvantages that the potential investor may encounter while investing in ADRs.

- An unsponsored ADR holder and a holder of Level I ADRs may face a problem of the ADR liquidity on U.S. market, due to restrictions on transfer of these securities imposed by SEC;
- Disclosure of information and reconciliation of financial statement requirements imposed on issuers by SEC for unsponsored ADR programs and Level I ADRs are minimal. Thus, the investor, sometimes is deprived of the possibility to make a correct judgment on his investment. Only big institutional investors, like investment funds, insurance companies and pension funds may be able enough to collect all necessary information on the issuer's market, based on which they may take the risk of investing in these ADRs.
- Also, the costs associated with establishing an unsponsored ADR facility is born fully by the investor and may be relatively high.
- It would be, however, naive to believe that all those advantages the ADR facility provides, compared with direct investments, are free of charge. The depository bank which undertakes to eliminate all the obstacles for the U.S. investor periodically charges the unsponsored ADR holders fees for its services. In case of sponsored ADR

facility, however, all expenses associated with maintenance of ADR program are born by the issuing corporation.

- Although investing in ADRs is much safer for the U.S. investor, certain risk still remains. U.S. issuance of ADRs creates an image of stability and security which is belied by the reality of foreign exchange risk and political risk inherent in buying any equity issued in a foreign market, especially an emerging market with insufficient regulatory standards and enforcement. Even though obtaining a favorable court decision confirming an ADR holder's rights may be relatively easy, the enforcement procedure, which should take place in the country of issuer may be burdensome for the small corporate or individual investor.

4. Why Do Companies Launch ADR Programs?

ADR programs are becoming more attractive to non-U.S. corporations, as the most effective means of entering the important U.S. market. Furthermore, certain types of ADR programs permit capital raising in the U.S., and the amount of new capital raised through ADRs have risen dramatically, from U.S.\$ 2.5 billion in 1990 to over U.S.\$ 19 billion in 1994. ADR has also taken on increasing importance in cross border mergers and acquisitions. There are several reasons why non-U.S. companies establish ADR programs. Most of the companies establish ADR programs as a way of entering the U.S. market to tap some demand for their securities. They also provide a simple means of diversifying a company's shareholder base. The U.S. investment community, which is especially sophisticated in industries like telecommunications may more highly value the underlying shares or price/earning ratio on foreign firms in this sector.

ADRs may increase the liquidity of the underlying shares of the issuer and, moreover, it may be the reason for the price appreciation of the underlying securities. For example, shares in Russian companies with programs for foreign investors to trade their shares abroad through the ADR, have outperformed the bullish Russian market.

Observing this, Russian investors have started active purchasing of the shares of firms, that are likely to launch an American Depositary Receipt. Salomon Brothers calculated that shares of companies with ADRs outperformed the Russian market by 37 percent in 1996 and the market itself rose 156 percent (according to the International Finance Corporation).²⁰ Thus, the simple fact that a non-U.S. company establishes an ADR in U.S., enabling U.S. investors to buy its shares, usually pushes the company's stock into a higher price range.

Companies may establish ADR programs as a means of raising a capital in the United States. In many cases, when a big company is making an offering, their home market cannot absorb it. For example, in 1993 YPF an Argentine oil company did a U.S.\$ 3 billion global offering that was part of privatization. YPF was able to raise only U.S. 500 million in the Argentine market. The rest of the needed funds was raised in Europe U.S.\$500 million and U.S.\$2 billion in the United States through the ADR facility.²¹

Companies may also establish ADR programs for some other reasons. Roche, the Swiss pharmaceutical company established its ADR program to enable 40,000 of its U.S. based employees to invest in the parent company. It also provided the company executives in U.S. with stock options.

Another obvious advantage of ADR is that it increases the issuer's visibility and name recognition in the international markets, which may enhance knowledge of its products and ease the path of future capital raising exercises.

5. Disadvantages for the Issuing Companies

An ADR facility is a very expensive method of entering the U.S. market, and it is not a particularly efficient mode of entry. The issuer can expect that on ADR public

²⁰ Peter Handerson, *Local Demand Sparks Rise of Russian Pre-ADR Shares*, Reuters (January 30, 1997) <<http://www.nd.edu/~astrouni/zhiwriter/97/97013003.htm>>

²¹ Joseph Valli, *American Depositary Receipts: An Overview*, Fordham International Law Journal, 2 (January 1994).

offering may cost to him anywhere between U.S.\$500,000 to U.S.\$1 million in fees to the legal firms and stock market advisers.²² In case of issuance of an ADR for a Russian company, the expenses may be twice or three times as much, due to the complexity of accounting reconciliation and difficulties associated with work of the issuers' legal advisor.

The lead-in time may also be prohibitive. As a general rule, only registration takes at least two months in case of Rule 144(a) offering and six month for public offering. Collection of documents, filling up forms and due diligence investigation may take years. For example, it took several months for the Russian telecommunications giant Rostelecom, which was stating its Level 2 ADR program, to resolve only one issue, whether Rostelecom's small independent registry - which the company was required to enlist, particularly in light of its hopes for a Level -1 ADR program - should be financially liable for shareholder claims of compensation from registry.²³

Internet and electronic means of trading represent a serious alternative to an ADR facility. Computer networks of securities exchanges located in major financial centers are gradually replacing national securities exchanges. 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 real time basis has progressed, such systems are extremely expensive.²⁴ Further development of these systems will depend heavily on integration of local financial markets, mutual confidence in regulatory agencies, and reciprocity in enforcement procedures.²⁵

²² Joseph Valli, *American Depositary Receipts: An Overview*, Fordham International Law Journal, 4 (January 1994).

²³ Erin Arvedlund, *Rostelecom To Get Its Disputed ADR*, Moscow, Reuters (1997) <<http://www.nd.edu/~astrouni/zhiwriter/97/97013004.htm>>.

²⁴ *Global Markets' Interdependence Makes Them More Vulnerable, Greenspan Warns*, 21 Sec.Reg. & L.Rpt. (BNA) 877 (June 16, 1989).

²⁵ Beck, *International Trading: Trading Links Between Toronto Stock Exchange and Midwest Stock Exchange, Current Developments in International Securities, Commodities and Financial Futures Markets*, 111-119, Singapore Conferences on International Business Law, Faculty of Law, National University of Singapore, (1987).

We should not, however, underestimate the current capacity of Internet trading, where all the world's stock exchanges and big corporate issuers already have their websites and have established electronic facilities for trading in listed securities and supplying investors with all necessary on-line information. Internet trading has already attracted the attention of European Governments which have reported losses associated with the tax collection. Thus, an ADR facility, which is supposed to fill an informative gap between the foreign issuer and American investor may some time in the near future be replaced with Internet trading. In this event, the protection measures established by SEC will become ineffective since the issuer may obtain unrestricted access to the U.S. market.

6. Interest of Russian Companies in ADR Facilities

The Russian market economy emerged only a few years ago. However, from the beginning, it was clear that without integration into the global market Russia would not be able to develop its national economy to a reasonably sophisticated level.

Recognizing the significance of participation in the global market economy, Russian companies initiated their presence in the capital markets of Europe, Asia and U.S.. This was followed by the establishment of ADR programs. More than dozen of major Russian companies now have begun to enter U.S. markets by employing Level I ADR Programs, including: LUKoil, one of the Russian largest oil companies (date of SEC registration: December 27, 1995); Seversky Tube Works, a major producer of pipelines facilities for Russia's oil and gas industry (Feb. 5, 1996); Torgovy Dom GUM, which operates one of the oldest Moscow's department stores (June 7, 1996); Tatneft, a Tatarstan Republic oil company (June 3, 1996); INKOMBANK, the first Russian Bank established ADR program (May 28, 1996); Chernogorneft, another oil company (March 22, 1996). Rostelecom, the biggest Russian telecommunication company has become the first Russian company which has established a Level 2 ADR program and started to trade

ADRs on the NYSE on February 17, 1998. Other Russian companies in the process of obtaining SEC approval are Menatep Bank, United Energy of Russia, the nationwide electric energy utility, Purneftegaz, NIKoil, Norilsk Nickel and Bank Vozrozhdenie.

Because foreign portfolio investment in Russian firms is occasionally restricted, an important characteristic of the ADR programs is that Russian concerns over foreign ownership are addressed when the shares are first reregistered in the name of the depository institution. In fact, ADR programs for Russian companies can only be created with their active support.

While Russian firms have not yet raised large amounts of capital with ADRs, they are gaining important experience and exposure that will allow them to in the future. As already mentioned, several such ADRs are currently trading in the Pink Sheets over the counter in the U.S., and more are in the SEC registration process:

- "LUKoil, with 1994 gross revenues of \$4.3 billion, offers an ADR representing 4 ordinary shares, started trading at \$17.5 and currently (July, 1996) trades in the \$37 - \$47 range.
- Seversky Tube Works, with 1994 sales of \$279 million, offers an ADR representing 10 ordinary shares, started trading at \$4.17 and currently trades in the \$19 - \$23 range.
- Chernogorneft, with 1995 sales of \$465 million, offers an ADR for one ordinary share, and starting trading at \$5.86 and currently trades in the \$9 - \$12 range.
- GUM, with 1995 sales of RR 900 billion, offers an ADR representing 2 ordinary shares, and started trading at \$32.75; currently trades \$39 - \$44 .
- Tatneft, with 1995 sales of \$2 billion, offers an ADR for one ordinary share, but has not yet come to market.

- INKOMBANK, with total assets as of December 31, 1995 of \$2.6 billion, will offer one ADR representing 15 ordinary shares, has received SEC approval, but not yet the approval of the Central Bank of Russia."²⁶
- Rostelecom, telecommunications company started trading of Level 2 ADR on NYSE, on February 17. Each ADR represents six underlying shares. Each ADR is reportedly traded for U.S.\$ 20.20-20.25. Merrill Lynch is a financial advisor.

After the "original issues," generating additional depository receipts can be done incrementally, in response to U.S. demand, with the process taking about three days (initiating a new ADR program takes considerably longer). Shares traded as ADRs are effectively taken off the local market, and trade in the United States at the same price as home-country shares.

Most Russian securities traded the United States are Level-1 ADRs. Level I ADR programs are limited to the over-the-counter market (OTC) and can not be used to raise new capital. However, this program has proved to be relatively inexpensive and does not require detailed disclosure of company financial and business data.

Economic reforms and big industrial projects that are carried out in Russia require significant financial resources. One of the ways to obtain the necessary financing is to raise capital through public offerings of stock. Russia's emerging capital market, however, is not able currently, to absorb big offerings because of the absence of institutional investors like pension funds and insurance companies, as well as undeveloped securities market regulations, offering/trading facilities and investor protection mechanisms. Because of the numerous frauds that have occurred in the Russian capital market, like activity of "financial pyramids," Russian individual investors have lost much of their interest in investment operations. Thus, apart from borrowings,

²⁶ John T. Connor, Jr., *Russian ADRs in U.S. Capital Markets*, BNY Home Page (August 1996)
<<http://www.bankofny.com/adr/aovrvview.htm#what>>.

the only way to obtain financing, is to raise capital on international capital markets. The ability of Russian "public" companies to directly raise equity capital in U.S. markets, however, will be severely restricted for years to come given their absence of audited financial statements and an understanding of the "disclosure to the financial markets" regime that we take for granted.

CHAPTER III

AN OVERVIEW OF ADR REGULATION

1. Basic Features

All ADRs are classified as securities and, therefore, are subject to the federal regulations and close attention of the SEC. Two federal statutes provide the primary federal regulation of ADR issuance and trading. The first one is the Securities Act (1933),²⁷ regulates public placement of the foreign securities in the United States issued by a foreign private issuer. The second statute, the Exchange Act,²⁸ originally adopted in 1934, governs secondary trading in ADRs in U.S. capital markets. Although there are certain differences in regulation of domestic and foreign securities issuers in both statutes, the framework for both categories is essentially the same.

The Securities Act, which is now sixty five years old still remains one of the most important regulatory documents of the securities market. It was passed just after the crash in the 1920s, as a reaction of Congress to the abuses on securities market that took place during the 1920s, which severely harmed investors. "After giving the matter a great deal of thought, Congress determined that the best method to regulate the sale of securities in the United States was by means of full disclosure."²⁹ The U.S. system of securities regulation is not aimed at determining the fairness and attractiveness of the securities offered to the general public. Frode Jensen, III, the author of "The Attraction of

²⁷ Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1988).

²⁸ Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78ll (1988).

²⁹ Frode Jensen, III, *The Attraction of the U.S. Securities Markets to Foreign Issuers and the Alternative Methods of Assessing the U.S. Markets: From a Legal Perspective*, 17 Fordham International Law Journal, 25 (January 1994).

the U.S. Securities Markets to Foreign Issuers and the Alternative Methods of Assessing the U.S. Markets: From a Legal Perspective” represents this idea as follows:

It is not, in general, a matter of concern to the SEC whether or not particular stock is a good to buy at U.S. \$30 or U.S.\$20, or whether a debt security is properly priced. The focus of our securities law is on full disclosure. The theory is that business prospects, management, and the financial condition of a company are fully and properly disclosed in a registration statement and in the accompanying prospectus, then the investor can make up his own mind regarding the appropriateness of the price and fairness of the transaction.³⁰

2. Registration Requirement

The major cornerstone of the federal securities regulation is the registration requirement. Every issue, offer and sale of a security, unless statutory exempt³¹, is subject to SEC registration.³² That means that all ADRs, being securities separate and apart from the deposited foreign securities they represent, must be registered under the Securities Act before they may be publicly distributed within the United States.

When a foreign private issuer wants to establish an ADR facility in the U.S. market, such issuer generally proceeds in a manner similar to that of U.S. domestic issuer registering securities. For the purposes of the Securities Act, ADRs and the deposited underlying securities are considered separate securities, each subject to the registration with the SEC unless a relevant exemption is available. The foreign private issuer is required to file with the SEC two registration statements: (1) Securities Act Form F-6, to have authority to register the depository receipt³³, and (2) Forms F-1, F-2, F-3 or F-4, to register the deposited shares. The requirement to register both depository and deposited

³⁰ Frode Jensen, III, *The Attraction of the U.S. Securities Markets to Foreign Issuers and the Alternative Methods of Assessing the U.S. Markets: From a Legal Perspective*, 17 Fordham International Law Journal, 27 (January 1994).

³¹ See 15 U.S.C. §77c (1988) (providing exemptions for certain securities), See also 15 U.S.C. §77d (1988) (providing exemption for certain transactions).

³² See 15 U.S.C. §77e(a) (1988) “unless a registration statement is in effect as to a security”.

³³ Please note that the SEC regulations sometimes use the term “depository share”. “[depository share is] a security, evidenced by American Depositary Receipt, that represents a foreign security or multiple of a fraction thereof deposited with depository” Regulation C, 17 C.F.R. §230.405 (1992).

shares, however, is not clearly provided in any rule established by the SEC or statute. The requirement stems from an interpretation of the conditions precedent to the use of Form F-6, which provide that this form may be used only if "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 United States..."³⁴

If the U.S. investor purchases the securities of the foreign issuer on a secondary market, the transaction is usually exempted from the registration requirement in accordance with section 4 of the Securities Act.³⁵ Therefore, as long as deposited shares may be purchased in a secondary market transaction without registration, only Form F-6 must be filed to comply with the instructions relating to use of the form. In contrast, when the foreign private issuer makes a public offering of ADRs, both depository receipts and the underlying deposited securities must be registered.

Three conditions precedent to the use of Form F-6 must be satisfied by the registrant. The Securities Act has established them as follows:

(a) The holder of the ADRs is entitled to withdraw the deposited securities at any time subject only to (1) temporary delays caused by closing transfer books of the depository 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, (2) the payment of fees, taxes, and similar charges, and (3) compliance with any laws or governmental regulations relating to ADRs or to the withdrawal of deposited securities;

(b) 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 United States; and

(c) 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) (§ 240.12g3- 2(b) of this chapter) unless the issuer of the deposited

³⁴ Securities Act Form F-6, 17 C.F.R. § 239.36 (1992).

³⁵ 15 U.S.C §77d(2)(1988) Section (2) of the Securities Act exempts "transactions by an issuer not involving any public offering."

securities concurrently files a registration statement on another form for the deposited securities.³⁶

The withdrawal right condition mentioned above, as a general rule, is met by the terms of the depository agreement or by the terms of the certificate issued to investors to evidence ADR.

The second and third conditions precedent to the use of Form F-6, in the event of public offering, may be satisfied by registering the deposited securities via a second registration, typically Form F-1. If ADRs are traded on a secondary market without public offering the issuer, in order to satisfy the second and third conditions, must qualify for the exemptions provided by the Securities Act. In many situations the foreign private issuers establish the Rule 12g3-2(b) exemption before the ADR arrangement is created.³⁷

2.1. Form F-6. Registration of the Depository Shares

It has been established that Form F-6 is a basic document for the registration of ADRs, which must be filed by the issuer with the SEC. The Form F-6 registration statement basically consists of two parts. Part I provides a list of the information which must be mentioned by the issuer in the prospectus. Certain disclosure is required with regard to the depository obligations, the depository mechanism and the rights of the ADR holder. Part I may also require to describe the effect of the foreign laws and regulations on the ADR holders.

Part II of the Form F-6 provides a list of exhibits which must be filed as a part of the registration statement. The exhibits are the following:

(a) A copy of the Deposit Agreement or Deposit Agreements under which the securities registered hereunder are issued. If the Deposit Agreement is amended during the offering of the Depository Shares, such amendments shall be filed as amendments to the registration statement.

(b) Any other agreement, to which the depository is a party relating to the issuance of the Depository Shares registered hereby or the custody of the deposited securities represented thereby.

³⁶ Securities Act Form F-6, 17 C.F.R. § 239.36 (1992).

³⁷ Securities Act Release No.6459, 48 Fed.Reg. 12,346 (March 18, 1983).

(c) Every material contract relating to the deposited securities between the depository and the issuer of the deposited securities in effect at any time within the last three years.

(d) An opinion of counsel as to the legality of the securities being registered, indicating whether they will when sold be legally issued, and entitle the holders thereof to the rights specified therein.

(e) Furnish the name of each dealer known to the registrant or depository who (1) was deposited shares against issuance of ADRs within the past six months, (2) proposes to deposit shares against issuance of ADRs, or (3) assisted or participated in the creation of the plan for the issuance of the ADRs or the selection of the deposited securities. As to each such person indicate the number of securities proposed to be deposited to the extent known. The information furnished pursuant to this item is not to be deemed 'filed' as part of the registration statement...

Part II also provides a list of undertakings to be furnished by the depository:

(a) The depository undertakes to furnish promptly the following information to the Commission semi-annually, beginning on or before six months after the effective date of the registration statement:

(1) The following information in substantially the tabular form indicated: (i) number of depository shares evidenced by receipts issued during period covered by report; (ii) number of depository shares evidenced by receipts retired during period covered by report; (iii) total amount of depository shares evidenced by receipts remaining outstanding at the end of six-month period; (iv) total number of holders of receipts at the end of six-month period.

(2) The name of each dealer known to depository depositing shares against issuance of ADRs during the period covered by the report.

(b) The depository hereby undertakes to make available at the principal office of the depository in the United States, for inspection by holders of the ADRs, any reports and communications received from the issuer of the deposited securities which are both (1) received by the depository as the holder of the deposited securities; and (2) made generally available to the holders of the underlying securities by the issuer.

(c) If the amounts of fees charged are not disclosed in the prospectus, the depository undertakes to prepare a separate document stating the amount of any fee charged and describing the service for which it is charged and to deliver promptly a copy of such fee schedule without charge to anyone upon request. The depository undertakes to notify each registered holder of an ADR thirty days before any change in the fee schedule.³⁸

Form F-6 does not require information about the issuer, other than identity, to be

³⁸ Securities Act Release No.6459, 48 Fed.Reg. 12,346 (March 18, 1983).

disclosed. However, Form F-6 obligates the issuer of the deposited securities be reporting under the Exchange Act or furnishing to the Commission certain information which is made public in the country of the issuer's incorporation. (Reporting obligations of the issuer is discussed further.)

One of the legal issues related to the use of Form F-6 deals with the question of which entity signs the form. This issue arises from the general registration exemption for the securities issued by U.S. banks. As a general rule, the registration must be signed by the issuer. In the case of an unsponsored ADR facility, however, the issuer is not involved in the facility establishing process and, therefore, may not be liable for the ADR issuance. Who must sign the statement then? This issue will be discussed in detail in the section describing an unsponsored ADR facility.

2.2. Registration of the Underlying Securities³⁹

As it was already mentioned above the underlying securities are also subject to the SEC registration under the Securities Act, in the event, the foreign private issuer enters the U.S. market to raise funds through the public offering of the ADRs. A public offering under the U.S. securities laws requires the filing of a registration statement⁴⁰ which includes the prospectus.⁴¹

A prospectus is an integral part of the registration statement. This part solely, without any other information must be delivered to the investor, the offeree or purchaser of the securities to be issued.

The issuer is not required to deliver a registration statement to the investor, but it must be filed with the SEC in order to effect registration. The registration statement is subject to the close examination of the SEC. Only after it has been confirmed and approved by the SEC, may the issuer initiate trading.

³⁹ The scope of detailed analyses of the registration forms provided in this thesis is limited to the Form F-1.

⁴⁰ 15 U.S.C § 77e (1988).

⁴¹ 15 U.S.C § 77j(b) (1988).

For all foreign private issuers, other than foreign governments, the Securities Act assigns appropriate registration forms: Forms F-1, F-2, F-3 or F-4.⁴²

As a general rule Form F-1 is used for the initial public offerings of ADRs.⁴³ Forms F-2 and F-3 are primarily used by the foreign private issuers that previously have already registered securities under the Securities Act or Exchange Act.⁴⁴ Forms F-2 and F-3 allow the issuer to effect registration by reference of reports filed under the Exchange Act. Registration of Form F-2, however, requires delivery of the reports filed earlier with the prospectus.⁴⁵ Additional requirements for the use of Form F-3 are that the foreign private issuer (i) must be reporting for at least thirty-six months⁴⁶ and (ii) be so-called "world class issuer"⁴⁷. A "world class issuer" is defined as an issuer, whose voting stock held worldwide by non-affiliates, has an aggregate market value equivalent to U.S. three hundred million dollars or more. The aggregate market value of the stock is computed by use of the last sales price of the stock or the average of the bid and asked prices of the stock in the principal market for such stock within 60 days prior to the date of filing of Form F-3.⁴⁸

The Form F-3 may be used for (i) certain primary offerings, (ii) offerings of investment grade debt securities, (iii) securities issued in exchange of certain rights and warrants, (iv) securities issued pursuant to a dividend reinvestment plan or conversion of outstanding securities, or (v) securities issued in a secondary offering.⁴⁹

Form F-4 is used, as a general rule, for various business combinations like reclassifications, mergers, consolidations, transfers of assets and exchange offers.⁵⁰

⁴² Securities Act Form F-1, F-2, F-3 and F-4, 17 C.F.R. §§ 239.31-34 (1992).

⁴³ Securities Act Form F-1, General Instructions reprinted in 2 Fed.Sec.L.Rep. (CCH) 6952, at 6061(1992).

⁴⁴ Securities Act Form F-2, General Instructions reprinted in 2 Fed.Sec.L.Rep.(CCH) 6963, at 6071(1992).

⁴⁵ See *id.* at 6074.

⁴⁶ Securities Act Form F-3, General Instructions reprinted in 2 Fed.Sec.L.Rep.(CCH) 6972, at 6082(1992).

⁴⁷ See *id.* at 6082-83.

⁴⁸ See *id.*

⁴⁹ Mark A. Saunders, *American Depositary Receipts: an Introduction to U.S. Capital Markets for Foreign Companies*, 17 Fordham International Law Journal, 48, 69 (1993).

⁵⁰ Securities Act Form F-4, General Instructions reprinted in 2 Fed.Sec.L.Rep.(CCH) 6982, at 6091, 17 C.F.R. §230.145(a)(1992).

Form F-1 is a full-disclosure, long-form registration statement, which requires the highest extent of disclosure in comparison with other registration forms and, therefore, is the most expensive and time-consuming document to prepare.

The main requirements of the Form F-1 are:

- Information relating to the terms of the issued securities, the plan of the securities distribution, terms of the offering, plan of the use of the raised funds;
- A detailed description of the issuer's business. This information is to provide
 - a discussion of the general developments of the business during the preceding five years;
 - basic products produced and services provided by the issuer, principal markets for these products, methods of product distribution to these markets;
 - three years income and cash flow statements, with breakdown by category of activity and by geographical markets. Financial information must be supported by discussion of material differences between relative contributions to operating profit as compared to relative contributions to revenues;
 - special data relating to the registrant's operations or industry, which may cause a material impact on future financial performance of the issuer. The registrant must furnish information about any material risks unknown to the investors, including dependence on major customers, suppliers, governmental regulation, terms of the material contracts, unusual competitive conditions, anticipated raw material or energy shortages (additional disclosure requirements may be set forth in the special guides adopted by the SEC for the companies of the oil and gas industries, banks and insurance companies). Registrant must furnish additional information about operations which have not given revenues for the three preceding years.
- a description of the location and conditions of the registrants' assets and production facilities and other materially important physical properties. In the case of enterprise involved in extracting of mineral resources business, material information about

production, reserves, locations, developments and the character of the registrant's interest must be provided (generally, only proven oil or gas reserves and confirmed or probable other reserves may be disclosed).

- selected financial information for each of the five years preceding the registration, including revenues, income, assets and long-term obligations.
- a management discussion over the financial conditions of the registrant, material changes in financial conditions and results of operations for each year for which financial statements have been provided (three years), including detailed information about general trends, commitments and other material events regarding to capital resources, liquidity and results of operations.
- information about pending legal proceedings, control of the registrant by a parent or other entity and 10 per cent shareholders. Describe the nature of the markets where the registrants securities are traded. Information about exchange control, governmental, legal or charter restrictions and limitations which may affect non-resident holders of the registering securities. Disclose holders obligations and liability with regard to the taxes due in accordance with the laws of the country where the registrant is incorporated. Disclose information about the directors and executive offices of the registrant, aggregate compensation paid them for services in the last year. Options made available to the registrant's management in a stock subject to registration. Information about the interest of management, controlling shareholders, certain associated persons in material transactions with the registrant.
- a description of the securities to be registered;
- registrant's balance sheets as of the end of the two most recent fiscal years, confirmed by outside auditor. Audited income statements and changes in financial position for each of the three most recent fiscal years.

Requirements of the U.S. securities laws and the SEC to the form and content of the financial statements provided by the registrant are established by the Regulation S-X. These requirements may be summarized as follows:

- (i) the registrant must provide interim unaudited financial statements, if on the effective date of the registration the last audited balance sheet is dated more than six month;
- (ii) As a general rule statement must be presented in the currency effective in the registrants country;
- (iii) the statements must disclose an informational content in a manner similar to statements which comply with U.S. generally accepted accounting principles ("GAAP") and Regulation S-X.
- (iv) the statements may be prepared according to U.S. GAAP or, alternatively, the registrant may provide statements prepared in accordance with identified comprehensive body of accounting principles together with a discussion and quantification of all material variations from U.S. GAAP and Regulation S-X, with regard to the accounting principles, practices and methods used in preparing financial statements.
- (v) the statements and notes should include various supporting information required by U.S. GAAP and Regulation S-X, such as registrant' business segmentation, pension information. The registrant may be excused form presentation of this information in the event of registration of securities are to be offered pro rata to all existing shareholders, pursuant to dividend or interest reinvestment plan or upon conversion of outstanding convertible securities or exercise of outstanding warrants.⁵¹

⁵¹ Securities Act Form F-1, General Instructions reprinted in 2 Fed.Sec.L.Rep. (CCH) 6952, at 6061(1992).

2.2.1. Registration and Financial Statements Preparation

The preparation of the registration statement by a non-U.S. private issuer usually requires a significant commitment of management resources to achieve the result which satisfies all the requirements of the U.S. securities regulations and properly presents the issuer to U.S. investors for commercial and marketing purposes.

There are a number of areas that have caused and continue to cause concern for the foreign issuers. Therefore, it is strongly recommended to the foreign issuer to have assistance of an accountant firm which is expert in U.S. accounting principles and practices. Typically it is one of the big international accounting firms with substantial U.S. practice. It is also essential that the issuer has established a relationship with knowledgeable U.S. legal advisers, specialized in the securities business. The bankers which will establish an ADR facility may play an active role in providing legal and investment advice, as well as necessary assistance in preparation, filing of the required documents.

The issuing company represented by its directors, officers, U.S. agents, underwriters, experts, legal advisors, auditors and accountants involved in preparation of the registration statement may have liabilities under the U.S. securities laws for false or misleading statements in or omissions from the filings. Thus, the importance of careful and accurate preparation of the filing must be clearly understood by all participants of the registration process. Preparation of the filing includes (i) "due diligence" investigation, usually conducted by the outside legal advisor, (ii) audit of the financial information provided by the accounting firm, (iii) outside experts' conclusions. Liability of each person mentioned above will be analyzed in more detail further in the Liability chapter.

2.2.2. Registration Disclosure Requirements

The disclosure requirements for the foreign private issuers under Form F-1 are similar to those for domestic United States issuers. Mark A. Saunders, a partner with Haight, Gardner, Poor & Havens, however, in his article *American Depositary Receipts: an Introduction to U.S. Capital Markets for Foreign companies*,⁵² distinguishes four principal differences:

1. The content of the financial statements of the foreign private issuers must be substantially similar to that required of domestic registrants. There is no need to prepare them in accordance with the U.S. GAAP, however, they must comply with accounting principles generally accepted in the domicile country, and must be supported with a reconciliation of significant variations from U.S. GAAP in the accounting principles applied. In the event establishing an ADR facility for the underlying shares the reconciliation of the differences in the measurement items (income statement and balance sheet amount) is required only in annual reports of the registrant.
2. As a general rule a full reconciliation of the financial information provided in the registration statement is required only in very specific cases, depending on the nature of the securities to be offered. On most occasions, however, only revenue information need be separated into categories of activity and geographical markets, unless the total operating profit from each segment substantially differs from their respective contributions to total sales and revenue. In the latter case the registrant's disclosure is required.
3. Compensation of directors and officers need be disclosed only in the aggregate unless, as a matter of policy, the issuer discloses this kind of information to its shareholders or makes it otherwise open to the public.

⁵² Mark A. Saunders, *American Depositary Receipts: an Introduction to U.S. Capital Markets for Foreign Companies*, 17 Fordham International Law Journal, 48, 69 (1993).

4. Information regarding transactions with management must be reflected in the registration statement to the extent the registrant discloses such information to its shareholders or otherwise makes it public.

These notes do not relate to the Canadian issuers, which are allowed to offer their securities in the U.S. on the basis of documentation which is primarily complies with Canadian, rather than U.S. requirements⁵³ The SEC also has adopted Rule 144(a) under the Securities Act, which provides less strict disclosure standards to the issuers due to the limited number of investors able to enter the Rule 144(a) market (see the discussion further).

There are some areas of the concern which nearly all the foreign issuers face while preparing a registration statement.

The financial statements required in the Securities Act registration statement of a non-U.S. private issuer must either be prepared according to U.S. GAAP or in accordance with an identified comprehensive body of accounting principles together with a discussion and quantification of material variations from U.S. GAAP in the accounting principles applied. All financial statements must be audited by accountants who are considered to be independent under the strict requirements of the SEC.

One of the most burdensome requirements is extensive disclosure of the executives compensation⁵⁴ and all issuer's transactions with officers, directors, and shareholders.⁵⁵ Although the regulations provide a threshold for disclosure of the transactions, which is U.S.\$60,000, it is too low, to benefit most issuers.⁵⁶

⁵³ Exchange Act Rel. No.29,354.

⁵⁴ Regulation S-K, 17 C.F.R. §229.402(1993)

⁵⁵ See *id.* at §229.404.

⁵⁶ Regulation S-K, 17 C.F.R. §229.404(1993). Item 404 provides (a) Transactions with management and others. Describe briefly any transaction, or series of similar transactions, since the beginning of the registrant's fiscal year, or any currently proposed transaction, or series of similar transactions to which the registrant or any of its subsidiaries was or to be a party, in which the amount exceeds \$60,000 and in which any of the following persons had, or will have, a direct or indirect material interest... *Id.*

Another area of the issuer concern is business segment disclosure. In contrast to the European disclosure standards the U.S. securities regulations require separate lines of business to be described separately.⁵⁷ For example, a German company may run several businesses and never disclose the profitability of each of the business segments in the home market or make this information public. In the U.S. it has to do so in order to obtain the SEC approval for the registration. For some big European producers that was an obstacle they could not get over, as this kind of information is considered one of a biggest company's secrets and would be harmful if made available to competitors.

Material contracts is another traditional area of concern for the foreign private issuers.⁵⁸ If the issuing company is dependent upon one or two suppliers and this dependency is based on the contractual relationship, the issuer will have to disclose the terms and conditions of these contracts to the SEC. Confidential treatment of this information, however, may be requested from the SEC. On some occasions the SEC has granted the confidential treatment to certain issuers' information, that otherwise would be disclosed.⁵⁹

Very often foreign issuers encounter a problem with identifying who the competitors are and what is the competitive balance in the industry.⁶⁰ Issuers also find it complicated to draft Management Discussion and Analyses ("MD&A").⁶¹ The SEC views MD&A as a means of providing investors with management's views of the future and the prospects for the company and industry. The SEC also requires disclosure of negative trends in a business which may affect the company, or information which may help the

⁵⁷ Regulation S-K, 17 C.F.R. §229.101(b).

⁵⁸ *See id.* at §229. 601(b)(10).

⁵⁹ Regulation C, 17 C.F.R. §230.406(a)(1993) Item 406(a) of Regulation C provides for confidential treatment of certain information:

"Any person submitting information in a document required to be filed under the Act may make written objection to its public disclosure by following the procedure in paragraph (b) of this section, which shall be the exclusive means of requesting confidential treatment of information included in any document required to be filed under the Act..."

⁶⁰ Regulation S-K, 17 C.F.R. §229.402 (1993).

⁶¹ *See id.* at §229.303(1993).

investor to determine whether or not there are negative trends in the industry. This disclosure must be accurately written by the issuer and its counsel.

The risk factors section of the registration statement may also be a difficult undertaking for the issuer. The issuing company must in this section present its view, as to what are the risks in making investments and why the investor may lose money.⁶²

The prospectus, on the other hand, may be viewed not only as a selling document, but also as an “insurance policy”. This is because as long as it fully discloses all material facts it may not be challenged subsequently by investors on the grounds that it failed to fully disclose material facts about the company, its business and its prospects. Due to the very high level of investor protection in the U.S. and very efficient legal mechanisms it may be more important for the issuer that the prospectus be an insurance policy than it is to be a selling document.

3. Exchange Act Reporting

When a foreign private issuer intends to list ADRs on a national securities exchange or quoted on NASDAQ⁶³, it becomes subject to the periodic reporting requirements under the Exchange Act. Such an issuer will be required to file annual reports in accordance with the SEC Form 20-F⁶⁴ and to submit other information to the extent this information is required to be prepared pursuant to the home market regulations.

⁶² Regulation S-K, 17 C.F.R. §229.503(c)(1993). Item 503(c) of the regulation S-K requires disclosure of certain risk factors:

(c) Risk factors. Registrants, where appropriate, shall set forth on the page immediately following the cover page of the prospectus ... a discussion of principal factors that make the offering speculative or one of high risk; these factors may be due, among other things, to such matters as an absence of an operating history or the registrant, an absence of profitable operations in recent periods, the financial position of the registrant, the nature of the business in which the registrant is engaged or proposes to engage, or, if common equity or securities convertible into or exercisable for common equity are being offered, the absence of a previous market for the registrant's common equity. *See id.*

⁶³ Exchange Act §12(b), 15 U.S.C. §781(a)(1988).

⁶⁴ 17.C.F.R. §249.220(f)(1993).

When a foreign private issuer has ADRs traded in the OTC market, it may either comply with the periodic reporting requirements or establish and maintain an exemption provided the Exchange Act.

In 1967 the Congress amended the Securities Exchange Act with the section 240.12g3-2 "Exemptions for American Depository", which is known as a rule 12g3-2(b). This amendment provides certain exemptions from the registration requirement under Section 12(g):

(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. This exemption shall continue until the next fiscal year end at which the issuer has a class of equity securities held by 300 or more persons resident in the United States...⁶⁵

A foreign issuer may be also exempt from registration requirements of the Exchange Act, if on the last day of the previous financial period the value of the foreign issuer assets not exceeded U.S.\$5 million and the foreign private issuer's securities were not quoted on NASDAQ.⁶⁶

Another way, authorized by the SEC, for the foreign issuer to avoid the registering requirement under section 12(g) of the Exchange Act is to supply the SEC with certain minimum information required from the issuer by its home regulatory authorities:

(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:

(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 if 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

⁶⁵ Exchange Act Rule 12g3-2(a), 17 C.F.R. §240.12g3-2(a)(1992).

⁶⁶ Exchange Act Rule 12g-1, 17 C.F.R. §240.12.g-1 (1992).

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 (A), (B) or (C) of paragraph (b)(1)(i) 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..., 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.

(2) The information required to be furnished under paragraphs (b)(1)(i) and (b)(1)(ii) of this section shall be furnished on or before the date on which a registration statement under section 12(g) of the Act would otherwise be required to be filed...

(3) The information required to be furnished under this paragraph (b) is information material to an investment decision such as: the financial condition or results of operations; changes in business; acquisitions or dispositions of assets; issuance, redemption or acquisitions of their securities; changes in management or control; the granting of options or the payment of other remuneration to directors or officers; and transactions with directors, officers or principal security holders.

(4) Only one complete copy of any information or document need be furnished under paragraph (b)(1) of this section... Press releases and all other communications or materials distributed directly to security holders of each class of securities to which the exemption relates shall be in English. English versions or adequate summaries in English may be furnished in lieu of original English translations. No other documents need be furnished unless the issuer has prepared or caused to be prepared, English translations, versions, or summaries of them. If no English translations, versions, or summaries have been prepared, a brief description in English of any such documents shall be furnished...⁶⁷

Hal S. Scott and Philip A. Wellons, in their text book on International Finance⁶⁸

⁶⁷ Exchange Act Rule 12g-1, 17 C.F.R. §240.12.g3-2(b)(1992).

⁶⁸ HAL S. SCOTT, PHILIP A. WELLONS, INTERNATIONAL FINANCE, 292, (The Foundation Press, Inc. 4th ed. 1997).

mention three reasons which encouraged the Congress to adopt this rule. "(1) SEC was relatively satisfied in 1967 with the level of information being disclosed by non-U.S. companies in their home markets; (2) there was no reason to believe a significant U.S. shareholder base would develop for issuers relying on the rule; (3) the world's capital markets were not nearly as integrated as they are today."

It must be mentioned, however, that not all qualifying foreign issuers may enjoy the registration exemption. The Rule excludes from this category:

(1) Securities of a foreign private issuer that has or has had during the prior eighteen months any securities registered under section 12 of the Act or a reporting obligation (suspended or active) under section 15(d) of the Act...; (2) Securities of a foreign private issuer issued in a transaction ... to acquire by merger, consolidation, exchange of securities or acquisition of assets, another issuer that had securities registered under section 12 of the Act or a reporting obligation (suspended or active) under section 15(d) of the Act; and, (3) Securities quoted in an "automated inter-dealer quotation system" or securities represented by American Depositary Receipts so quoted...⁶⁹

Thus, the Rule clearly discriminates between OTC trading on Pink Sheets and trading on stock exchanges, like NYSE, AMPEX and NASDAQ, by providing that securities trading on organized stock markets are fully subject to the reporting requirements of the Exchange Act of 1934, but such reporting requirements are not applicable so long as ADRs are not listed on a U.S. securities exchange or quoted on NASDAQ. Thus, so long as issuer maintains its exemption under rule 12g3-2(b), a sponsored ADR facility will not trigger the obligation of the issuer to comply with the periodic reporting requirements.

In the event the foreign private issuer fails for some reason to establish the exemption from the reporting requirement it incurs the obligation under the Exchange Act to file with the SEC annual reports on Form 20-F mentioned above and periodic reports on Form 6-K.

⁶⁹ Exchange Act Rule 12g-1, 17 C.F.R. §240.12.g3-2(d)(1)(1992).

Form 20-F must be filed within six months following the end of the foreign private issuer's fiscal year.⁷⁰ In essence, the requirements for the information to be provided in the Form 20-F is not that different from those of the Form F-1, which is used for public offering registration. The registrant must disclose information relating to the business properties, management, securities and finances of the issuer.⁷¹

Although the content of the financial statements required to be filed with Form 20-F must provide the information similar to that required for domestic issuers, the financial statement, need not be prepared in accordance with U.S. GAAP. The statements, however, must comply with the accepted accounting principles of the foreign issuer's domicile. Reconciliation of the differences in measurement items must also be provided.⁷²

The periodic report on Form 6-K requires the foreign private issuer to furnish the SEC with the information similar to that required by Rule 12g3-2(b) under the Exchange Act.⁷³ The report must include information which:

- (i) is required to be made public in the country of the issuer domicile or in which it is incorporate or organized pursuant to the laws of the country: or
- (ii) has filed with a foreign stock exchange on which its securities are traded and which was made public by that exchange: or has distributed to its securities holders.⁷⁴

These reports must be filed with the SEC immediately after the required materials have been made public in the issuer's country.

Typically, depository shares (ADRs) registered on Form F-6 (unsponsored ADRs and ADRs of the Level I) are exempt from Section 12(g) of the Exchange Act⁷⁵ and

⁷⁰ 17 C.F.R. §249.220(8)(b)(1993).

⁷¹ Form 20-F, 17 C.F.R. §249.220(f)(1993).

⁷² *See id.*

⁷³ Exchange Act Form 6-K, General Instructions reprinted in 4 Fed.Sec.L.Rep. (CCH) 30,971, at 21,951.

⁷⁴ *See id.*

⁷⁵ 17 C.F.R. §240.12g3-2(c)1992.

accordingly no annual (Form 20-F) or other periodic reports (Form 6-K) must be filed with the SEC under the Section 15 of the Exchange Act.⁷⁶

4. Rule 144(a) and Private Placements

To encourage access to the U.S. capital markets of the foreign private issuers and increase the liquidity of their privately placed securities on the secondary market, the SEC adopted Rule 144(a) ("the Rule") under the Securities Act, on April 19, 1990. The Rule provides a non-exclusive exemption from the registration requirements of the Securities Act for the resale of certain securities, including ADRs, to qualified institutional buyers ("QIB").⁷⁷ The offering of securities under the Rule 144(a) is also known as a private placement.

Non-exclusive exemptions means that if a transaction satisfies all requirements set forth by the Rule, it falls within the "safe harbor" (exempted) category defined by the SEC.

4.1. "Non-Fungibility"

Only resale of "non-fungible" securities ("Rule Securities") may qualify for the Rule's exemption. "Non-fungible" means that the same class of securities have not been listed on a U.S. securities exchange or quoted on NASDAQ, at the moment of the Rule 144(a) securities issuance. The "Non-fungibility" condition is not applicable to securities which are traded already on OTC market and their quotations are available on the current "Pink Sheets" of the National Quotation Bureau.

The "non-fungibility" condition was designed to prevent the development of dual markets for the same security, when securities traded on a stock exchange for the market price could be sold on retail private market for a lower price by bypassing exchange intermediaries. "Non-fungibility", however, is determined only at the moment of the

⁷⁶ 17 C.F.R. §240.15d-3(1992).

⁷⁷ See *id* at §230.144(a)(1993).

securities issuance. If later on the issuer lists the same class of securities on a U.S. stock exchange or quotes them on NASDAQ it is eligible for resale exemption under the Rule.

In order to prevent issuer evasion of the “non-fungibility” condition, the Rule establishes that the securities are deemed of the “same class” if their terms are substantially similar to the Rule Securities. Substantial similarity for the purpose of the Rule may include equal rights and privileges, liquidation preferences and convertibility. With regard to the debt instruments it may include similar interest rates, maturity, redemption, subordination, call and convertibility conditions.

4.2. Qualified Institutional Buyer

In order to qualify for the Rule’s exemption the securities may be offered or sold only to “qualified institutional buyers” or to the persons acting on behalf of QIB. QIBs must acquire the traded securities for their own account or the account of another QIB. The Rule defines QIB to be (i) any institution that owns and invests on a discretionary basis not less than U.S.\$100 million in securities of issuers that are not affiliated with the QIB or (ii) an entity all the owners of which are QIBs. The Rule sets forth an additional qualification requirement of net worth U.S.\$25 million for the Banks and thrifts, and aggregate of U.S.\$10 million in securities investments being managed for any broker-dealer.

In order to determine whether the investor meets the QIB test, the seller may use publicly available information appearing (i) in the buyer’s most recently published financial statements, (ii) the most recent publicly available documents filed with the SEC or any other self-regulatory organization, (iii) foreign governmental organization or foreign self-regulatory agency, (iv) “recognized securities manual,”⁷⁸ or (v) certification by an executive officer of the purchaser.

⁷⁸ HAL S. SCOTT, PHILIP A. WELLONS, INTERNATIONAL FINANCE, 81, (The Foundation Press, Inc. 4th ed. 1997).

Under the terms of the Rule the seller must take reasonable steps to make sure that the buyer is aware that the seller relies on the Rule 144(a) exemption.

4.3. Process of Private Placement Under the Rule 144(a)

The process of doing private a placement involves the drafting of an offering circular which in general has the same content as a prospectus. It is to provide information about the company and the issuing securities. As the offering circular is not subject to the SEC registration, the disclosure of the financial information provided therein must comply only with accounting principles of the issuer's home country and is primarily product of negotiations of the issuer and the investment banker.

Typically, the issuer includes in the offering circular a set of financial statements which, although are prepared in accordance with the accounting principles of the issuer's home country, are "Americanized" in terms of style and presentation. In addition, the issuer may provide reconciliation to the U.S. GAAP of the most significant financial data. The circular also may include a SEC-style Management and Discussion Analyses (see Prospect of Registration Form F-1).⁷⁹

Following the adoption of the Rule 144(a) the SEC has adopted the rules of the National Association of Securities Dealers, Inc. (the NASD) implementing its PORTAL trading system⁸⁰(the PORTAL Rules). The PORTAL market thus, has began to provide a means for QIBs to execute and settle transactions in Rule 144-elegible U.S. and non-U.S. securities, including ADRs, which have been approved by NASD for trading through the

⁷⁹ Frode Jensen, III, *The Attraction of the U.S. Securities Markets to Foreign Issuers and the Alternative Methods of Assessing the U.S. Markets: From a Legal Perspective*, 17 Fordham International Law Journal, 39 (January 1994).

⁸⁰ PORTAL stands for Private Offerings, Resales and Trading through Automated Linkages and consists of computer and communication facilities that are used for dissemination of securities quotations, for clearance and settlement of domestic and foreign debt and equity securities through designated PORTAL clearing and depository organizations. Market participants may access PORTAL through their personal computers or a NASDAQ work station. HAL S. SCOTT, PHILIP A. WELLONS, INTERNATIONAL FINANCE, 83, (The Foundation Press, Inc. 4th ed. 1997).

PORTAL system. PORTAL Rules, was supposed to establish an effective system for secondary trading of unregistered securities.

CHAPTER IV

TYPES OF ADR FACILITIES AND RELEVANT REGULATION REQUIREMENTS

1. General Approach

There are a variety of ADR programs. They may be distinguished in accordance with the functional criteria of capital rising (Level III ADRs) and non-capital rising facilities (Unsponsored ADR and Level I and 2 ADRs). In accordance with market entry criteria, there are two basic ADR facilities - sponsored (voluntary entry) and unsponsored (Non-voluntary entry). Some ADR experts classify them in accordance with placement method criteria as (i) public offerings, (ii) private placements, and (iii) rule 144(a) offerings. The type of the program used depends mostly on the financial and legal capability of the issuer, his willingness to establish one or another ADR program and investor attitude.

Difference between voluntary and non-voluntary entry results from the SEC's recognition of fact that special problems related to the foreign securities do exist. The approach set forth in the Securities Act is that foreign private issuers should be treated the same as domestic issuers, because of necessity to provide equal competitive opportunities for foreign and domestic issuers and ensure investor protection. Section 5 of the Securities Act specifically requires that, absent of exemption, all offers and sales of securities must be registered with the SEC.⁸¹ To satisfy the registration requirements of section 5, a registration statement must be filed with the SEC. The registration along with other SEC requirements made it very complicated for the foreign issuers to enter the U.S.

⁸¹ See 15 U.S.C. §77e (1988).

market. At some point in securities market development the SEC recognized that there was a necessity not only to ensure protection of the domestic investors, but also to provide them with an opportunity to invest in foreign securities and participate in global investment projects.⁸²

The SEC has admitted that “protection” and “foreign investment opportunities” policies competed each other. If all foreign private issuers were required to meet fully the requirements of the U.S. securities regulations, only a few foreign issuers would be able to enter the U.S. market, with the result that U.S. domestic investors would be deprived of the opportunity of the overseas investing.⁸³ Moreover, if very strict registration requirements were imposed and if foreign securities were totally restricted from trading in U.S., U.S. investors would channel their foreign investments through foreign securities exchanges, where disclosure requirements for the issuers are not so difficult to comply with. Thus, an unreasonably strict regulation policy would undermine the primary SEC objective - to protect domestic investors.

In order to pursue both policies, the SEC has come up with the “voluntary” principle. Under this principle “the more voluntary steps a foreign company has taken to enter the U.S. capital markets, the degree of regulation and amount of disclosure more closely approaches the degree of regulation of domestic registrants.”⁸⁴

Although the “voluntarism” principle has few defined parameters, it is explicitly applied to those cases where a foreign issuer is not involved in the depository arrangement and a U.S. investor (dealer or shareholder) deposits acquired securities and requires the depository to issue depository receipts. It is obvious that if the foreign issuer of the securities entered the U.S. market unvoluntarily, registration of securities relating to this entry must be more lenient than for those issuers who actively sponsor the establishment of the ADR facility with the objective of stock exchange listing of ADRs

⁸² Securities Act Rel. No.6360, *supra* note 56, at 84, 645.

⁸³ *See id.*

⁸⁴ *See id.*

or a public offering. In order to give some shape to the "voluntarism principle" the SEC has come up with guidelines, which provide the following parameters:

A distinction is made between foreign issuers that voluntarily enter the United States securities markets and those companies whose securities are traded in the United States without any significant voluntary acts or encouragement by the issuer. Currently, this distinction is accomplished by deeming all foreign companies having either securities listed on a United States exchange or having made a public offering of securities registered under the Securities Act as having voluntarily entered the United States market. Other foreign companies whose securities are traded in the United States through no direct act of the issuers are deemed not to have taken any voluntary acts to enter the United States markets.⁸⁵

In addition, the SEC having exercised its authority to issue regulations under the Exchange Act, clearly acknowledged that quotation of securities on NASDAQ fell within the meaning of the voluntary entry principle.⁸⁶ The SEC based its decision on the fact that mere application for NASDAQ quotation and consent to pay a fee may be considered as voluntary action on the side of the issuer.⁸⁷

2. Un-sponsored ADR Facility

In accordance with the "voluntarism principle" two basic types of ADRs, sponsored and un-sponsored,⁸⁸ may be distinguished. If the ADR facility is established without the active participation on the issuer's side and thus, the issuer is not a reporting issuer under the Securities Exchange Act of 1934,⁸⁹ although he may explicitly express his agreement with ADR placement in U.S., this ADR program is considered un-sponsored. Registration exemption for the issuing corporation does not mean that the ADR issue is also exempted from registration. In this case the obligation to file a registration statement under the Securities Act of 1933 is imposed on the depository,

⁸⁵ Securities Act Rel. No.6360, *supra* note 56, at 84, 643.

⁸⁶ See Exchange Act Rule 12g3-2(d)(3), 17 C.F.R. §240.12g3-2(d)(3) (1992).

⁸⁷ Foreign Securities, Securities Act Release No. 6433, Fed.Sec.L.Rep. (CCH) 83, 272 (Oct.28, 1982).

⁸⁸ See 1991 SEC Report, *supra* note 7, at 81, 588 (distinguishing between sponsored and un-sponsored ADRs).

⁸⁹ Securities Exchange Act of 1934, 15 U.S.C. §§78a-78ll (1988).

which must submit an application under Rule 12g3-2(b) to the SEC seeking an exemption from the full reporting requirements of the Securities and Exchange Act of 1934. Having obtained a SEC approval for the application of the exemption, the depository files a Securities Act Form F-6.⁹⁰ Upon receipt of the SEC approval the depository issues ADR for the underlying shares of the foreign issuer and distributes ADRs to the holders.

Because unsponsored ADR programs are exempt from the SEC's reporting requirements, they can only be traded in the U.S. on the over-the-counter market and listed in the "Pink Sheets." The only obligation of the issuer of this type of ADR facility is that all material public information published by the issuer in his home country be provided to the SEC and made available to the U.S. investors. There are no specific requirements as to the format, language and accounting information of these materials.

2.1. Advantages of Unsponsored ADRs

- This type of ADR provides the easiest and relatively inexpensive way of expanding the issuer's investor base in the U.S.;
- All costs associated with establishment of an unsponsored ADR program are born by the investor;
- SEC registration and reporting requirements are minimal;
- The issuer is not a party to the depository agreement, or a registration applicant and therefore is not subject to any U.S. liability arising in connection with the ADR program.

⁹⁰ 17 C.F.R. §239.36 (1992).

2.2. Disadvantages of Un-sponsored ADRs

- Since the ADR facility was established by the investor on the basis of the depository agreement to which the issuer is not a party, the issuer has little, if any, control over the activity of the unsponsored ADR program;
- Once established, the unsponsored program may be easily duplicated by other depository banks (which only need to file a Form-6 with the SEC) without any consent on the issuer's side;
- Although there is an opportunity for the issuer to convert an unsponsored ADR program into a sponsored one, such a conversion may be very expensive, as it requires a payment of the cancellation fees for outstanding unsponsored ADRs;
- Experts view unsponsored programs as obsolete since they are associated with a number of hidden problems and costs. Within the period from 1983 to 1994 only three new unsponsored ADR programs were established;⁹¹
- Unsponsored ADRs' liquidity is very low, as they are restricted from being traded on U.S. stock exchanges or quoted on NASDAQ.

2.3. Bank Exemption

The Securities Act Form F-6 must be signed by the issuer. However, in the case of an unsponsored facility, the actual foreign issuer is not involved in issuance of ADRs, thus it may be implied that this obligation is imposed on the depository establishing this facility. Under the Section 3(a)(2) of the Securities Act of 1933, U.S. banks may enjoy limited registration exemptions with regard to the certain securities, including securities issued by the banks.⁹² Although a depository receipt is a security issued by the bank, it

⁹¹ Joseph Valli, *American Depositary Receipts: An Overview*, Fordham International Law Journal, 4 (January 1994).

⁹² 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 governmental functions."

was unclear whether an ADR falls within this statutory exemption or not.⁹³ The issue triggered two practical questions. First, whether the bank is considered an issuer of ADRs for the SEC registration purpose and second, who will be responsible for the Section 11 issuer liability, if the bank is not issuer. Even if the bank is deemed to be an issuer it is unrealistic to demand that it be responsible for the defaults of the actual issuer.

The SEC has ruled that the depository may not be an issuer, but it still ⁹⁴ “lacked a party to tag with issuer’s responsibilities. Under this dilemma, ADR would have become an independent exempt security with no detectable issuer identity, which obviously would be contrary to the very fiber of SEC policy.”⁹⁵

In 1995 after having held an intensive discussions with a number of banks involved in the ADR establishing process, the SEC confirmed its position that a bank was not considered to be an issuer of the ADRs for the SEC registration and the Section 3(a)(2) of the Securities Act may not be used as an exemption for ADRs registration. In its report to the Congress the SEC stated:

Section 3(a)(2) was intended to provide an exemption only for a bank 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 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 purchases the protection intended by that section.⁹⁶

Finally, the SEC solved this problem by adopting the fictional entity theory, also known as “the double entity theory.” Under this theory the bank assumes the issuers responsibility to file a registration documents with the SEC:

The legal entity created by the agreement for the issuance of ADRs is

⁹³ Douglas B. Spoors, *Exploring American Depositary Receipts: The International Augmentation of U.S. Securities Market*, 6 Transnational Lawyer, at 181, 195 (1993).

⁹⁴ The instruction to Form F-6 indicates that “the depository for the issuance of ADR itself shall not be deemed to be an issuer...” Form F-6, 2 Fed.Sec.Reg.L.Rep. (CCH) at 6161 (1988).

⁹⁵ Douglas B. Spoors, *Exploring American Depositary Receipts: The International Augmentation of U.S. Securities Market*, 6 Transnational Lawyer, at 181, 196 (1993).

⁹⁶ SEC Securities Act Release No. 3593, Fed.Sec.L.Rep.(CCH), 76,372; 22 SEC Ann.Rep. 43 (1956).

required to sign a registration statement on Form F-6, although the depository may sign on behalf of such entity. Two commentators disagreed with the proposal that the entity sign the registration statement even for sponsored arrangements because in those situations the foreign issuer and various officers and directors must sign the registration statement. The Commission believes that the signature of the depository on behalf of the entity is necessary because the depository must undertake to submit certain information to the Commission and must determine the effective date under Rule 466.⁹⁷

The theory, however shielded the bank and its officers from any liability under section 11, arising from the content of the registration document. "Signatures of the foreign issuer and its representatives would not bind the depository."⁹⁸

3. Sponsored ADR Programs

This type of facility is created jointly by a foreign private issuer and a depository. In contrast to the unsponsored ADR, sponsored programs are initiated by the issuer.

The foreign private issuer signs the Form F-6 registration statement and sets up a contractual relationship with depository on the basis of an agreement with depository. The agreement stipulates the rights and responsibilities of the parties and allocates expenses. The agreement, as a general rule, sets forth an obligation of the depository to provide notice of shareholder meetings and other information about the foreign private issuer so as to enable the ADR holders to exercise their shareholders rights through the depository (voting, receipt of dividends, etc.) The foreign private issuer pays administration fees to the depository for the services and for maintaining the ADR facility.

On the other side the depository establishes the contractual relationship with the holders of ADRs, by virtue of the depository agreement.

⁹⁷ Securities Act Release No. 6459, 48 Fed.Reg. 12,346 (March 18, 1983).

⁹⁸ *See id.*

3.1. Level I ADR

A Level I sponsored ADR program is considered by specialists to be the easiest and the least expensive way for a company to initiate trading of its shares in ADR form. In order to establish this program the issuer files Form F-6 and obtains the Rule 12(g)3-2(b) reporting exemption. All the issuer has to do is to supply the SEC with any material information the issuer produces and distributes locally in his home country. Under this type of arrangement the issuer has a certain amount of control over the ADRs issued, since an agreement with the depository is initiated and executed between the issuer and one selected depository bank. A sponsored Level I ADR may be traded only over-the-counter in the United States on the Pink Sheets. As the issuer is not fully registered with the SEC Level I program can not be listed on an exchange or used as a means of raising capital. Many companies have found that by establishing a Level I program, they have a chance to gain the necessary experience on the working of the U.S. capital market and to build-up a core group of U.S. investors. It must be noted, however, that the success of a Level I ADR primarily depends on its ability to attract market makers. Because the "pink sheet" through which ADRs are typically traded, are not as visible as trading on exchanges would be, issuers need expert depository banks, investment banks, and investor relations firms to take care of the investor's interest in the traded ADRs.

3.1.1. Advantages of Level I ADR Program

- The issuer is eligible for the SEC reporting requirement exemption;
- By working with a single depository bank, the issuer has greater control over its ADR program that it would be in the case of an unsponsored program. This happens because (i) only one U.S. depository, as a general rule, sponsors an ADR program, while unsponsored ADR programs may be duplicated without foreign private issuer's consent, (ii) the depository is bound by a contractual obligation to the foreign private issuer, allowing the issuer to require the depository to undertake certain tasks;

- The depository operates as a communication channel between the issuer and its U.S. shareholder base. Dividend payments, financial statements and details of corporate actions are passed on to U.S. investors via the depository;
- The depository bank is responsible for maintenance of the shareholder records for the issuer and may, upon a special arrangement with the issuer, monitor large stock transactions and report them to the issuer;
- Costs of establishing this type of ADR facility are minimal, although higher than in the case of an unsponsored facility. All transaction costs are absorbed by the ADR holders;
- There is the possibility to upgrade relatively easily Level II or III program as the issuer and depository bank do not have to negotiate cancellation of unsponsored ADRs with several depositories, as it would be the case when upgrading an unsponsored program;
- Establishing of Level I ADR facility provides the issuer with valuable experience in the U.S. marketplace;
- With a sponsored ADR, the depository does not deduct a fee from dividends distributed to the ADR holders, while in the case of unsponsored ADR the fees are generally deducted. Thus, a sponsored facility is more attractive for the holders as they receive a higher yield on their dividends than in the case of unsponsored facility.

The advantages mentioned in this paragraph relate to all sponsored ADR facilities.

3.1.2. Disadvantages of Level I ADR

- It can not be listed on any of the national exchanges in the U.S., which may result in low liquidity of ADRs. Low liquidity, obviously, reduces attractiveness of this securities for the investor, which in its turn limits the issuer's ability to enhance its name recognition in the U.S.;
- Capital raising is not permitted under a Level I program;

- The effect of this type of facility is very limited in terms of increasing the shareholder base. The issuer may expect to obtain about three to six percent of its shareholder base through such a program;⁹⁹
- Trading on “Pink Sheets” is limited, in terms of volume. Very often big institutional investors, such as pension funds, can not invest in Level I ADRs due to the inadequacy of disclosure.

3.2. Level II ADR Program

A sponsored Level II ADR program is primarily used by the issuers when they decide to list ADRs on one of the U.S. stock exchanges. A Level II ADR program must comply with the SEC's full registration and reporting requirements. In addition to filing a Form F-6 registration statement, the issuer is also required to file with the SEC Form 20-F, which means full disclosure of all information about the company, including the annual report prepared in accordance with the U.S. GAAP (see previous above) .

Registration enables the issuer to list its ADRs on one of the three major national stock exchanges (New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), the National Association of Securities Dealers Automated Quotation (NASDAQ) Stock market). Each of these exchanges has its own requirements regarding a company's eligibility to list its shares as well as reporting and disclosure obligations.

Level II ADR programs are typically initiated by foreign private investors to give U.S. investors access to their stock. As in the case of Level I, a depository agreement is signed between the issuer and depository bank.

⁹⁹ Joseph Valli, *American Depositary Receipts: An Overview*, Fordham International Law Journal, 45 (January 1994).

3.2.1. Advantages of Level II ADR Program

- It is more attractive to U.S. investors than a Level I program because the ADRs may be listed on one of the U.S. stock exchanges and as a result it becomes a more liquid asset;
- Listing and registration also enhance the issuer's name recognition in the U.S. capital market;
- U.S. disclosure regulations for large investors enable the issuer to monitor the ownership of its shares in the U.S.

3.2.2. Disadvantages of a Level II ADR Program

- More detailed disclosure is required than for a Level I program;
- SEC regulations do not permit a public offering of ADRs under a Level II program, which means that this facility may not be used for raising a capital;
- This program is much more expensive and time consuming to establish and to maintain, due to the necessity to comply with more stringent disclosure and reporting requirements which entails higher legal, accounting and financial expertise costs.

3.3. Sponsored ADR Program - Level III

A Level III sponsored ADR program is similar in many aspects to Level II ADR. The issuer initiates the program, establishes a relationship with a depository bank and lists Form F-6 and 20-F registration statements with the SEC. The most significant difference is that the issuer may raise capital through a public offering of ADRs in the U.S.. This, however, requires the issuer to file a Form F-1 with the SEC.

In addition to the advantages of a Level II ADR Program, Level III program enables the issuer to make public offerings to finance various transactions or establish an Employee Stock Ownership Plan (ESOP) for the employees of the issuer's U.S. subsidiary.

3.3.1. Advantages

- Level III ADR facility allows the issuer to raise a capital in U.S.;
- The issuer obtains access to the fullest possible investors base;
- There are no restrictions on the resale of the Level III ADRs in the United States.

3.3.2. Disadvantages

- Registration and reporting requirements are more onerous than for ADRs of lower levels;
- Establishing this type of facility requires much more time than for all other ADR programs. Joseph Velli Executive vice-president of the Bank of New York estimates that it takes six months to set up a Level III ADR program, while a Rule 144(a) ADR program may not take more than 2 months;¹⁰⁰
- The setting-up and maintenance costs are substantially higher than for other ADR programs. The issuer may expect that the costs to be anywhere between U.S.\$500,000 to U.S. \$1 million.¹⁰¹

3.4. Rule 144(a) ADRs

Rule 144(a) has lifted certain restrictions governing resale of privately placed securities and thus, added liquidity to these securities and increased their secondary market. It is estimated that more than 3000 qualified institutional buyers (QIBs) operate now in the U.S. securities market and it is expected that the SEC may broaden the definition of QIB to allow a larger number to participate in the Rule 144(a) market.¹⁰²

Under the Rule foreign private issuers now have easy access to the U.S. equity private placement markets and may this way raise capital through the issue and private

¹⁰⁰ Joseph Velli, *American Depositary Receipts: An Overview*, Fordham International Law Journal, 45 (January 1994).

¹⁰¹ See *id.*

¹⁰² *Depositary Receipts Handbook*, Bankers Trust, Corporate Trust & Agency Group (August 1997) <<http://www.bankerstrust.co/ms/dreceipt/handbook.htm>>.

placement of restricted ADRs, avoiding the complications associated with the full SEC registration and reporting requirements. This also makes the private placement considerably cheaper when compared with the public placement of Level III ADRs.

Having introduced the PORTAL rules in June 1990, the SEC has established a means for creating a secondary market for Rule 144(a) securities.

3.4.1. Advantages of Rule 144(a) ADRs

- Rule 144(a) ADRs represent a cheaper means of raising equity capital than through a public offering (Level III ADRs);
- Rule 144(a) ADRs may be issued more easily and quicker than other ADR's facilities due to the available SEC exemptions from registration and reporting requirements;
- They can be effectively traded through the NASD's PORTAL;
- ADR holders can cancel the ADR and sell the actual shares back into the home country in the event the ADR's liquidity on the U.S. market is limited for some reasons;
- Rule 144(a) substantially simplified the procedures for the transfer of privately placed securities. Under the former private placement procedure, in order to transfer a security an opinion of counsel had to be delivered, since it was assumed that privately placed securities tended to be held indefinitely;
- Once an issuer does a 144(a) offering, it can either, at a later stage, upgrade through listing to a different ADR program on a U.S. stock exchange, or it can do an exchange offer, where it registers its privately placed securities with the SEC, thus making them freely tradable on one of the exchanges.¹⁰³

3.4.2. Disadvantages of Rule 144(a) ADRs

- Rule 144(a) ADRs can not be created for shares already listed on a U.S. exchange;

¹⁰³ Joseph Valli, *American Depositary Receipts: An Overview*, Fordham International Law Journal, 54 (January 1994).

- Rule 144(a) ADRs' market is limited by the QIB's restriction. Although the number of the potential qualified participants of the market is relatively high, it is not so liquid as the U.S. public equity market. Frode Jensen III, a partner with Winthrop, Stimson, Putnam & Roberts, points out in his article "The Attraction of the U.S. Securities Markets to Foreign Issuers and the Alternative Methods of Assessing the U.S. Markets: From a Legal Perspective",

We found in the 1970s and 1980s an increasing number of U.S. issuers going abroad and foreign issuers not coming to the United States because, on the one hand, the public offering alternative was too onerous and expensive, and on the other hand, the private placement alternative was too cumbersome, and while cheaper, because it does not involve registration, involved higher issuance costs, higher coupons, lower prices for equity, and was generally unsatisfactory.¹⁰⁴

- Secondary trading of the Rule 144(a) securities involves substantial paperwork, associated with the necessity of proving eligibility of securities for the Rule 144(a) exemption and eligibility of the buyers to participate in the transactions.¹⁰⁵
- Rule 144(a) allows the issuer to raise only a relatively small amount of money. "The practice indicates that the "small amount of money" be anywhere from U.S.\$30 to U.S.\$50 million. It happens very rare that the foreign private issuer may raise more than U.S.\$50 million under the Rule 144(a)."¹⁰⁶

Joseph Velli, vice-president of the Bank of New York, participating in the symposium "Entering the U.S. Securities Markets: Opportunities and Risks for Foreign Companies expressed an interesting opinion with regard to the prospects of the Rule 144(a) ADRs:

In 1993 the 144(a) market basically died. In 1991 and 1992 it was pretty substantial. In 1992, about U.S.\$3.8 billion was raised in equity under 144(a) ADR offerings. This year it is probably going to be somewhere

¹⁰⁴ Frode Jensen, III, *The Attraction of the U.S. Securities Markets to Foreign Issuers and the Alternative Methods of Assessing the U.S. Markets: From a Legal Perspective*, 17 Fordham International Law Journal, 60 (January 1994).

¹⁰⁵ Joseph Velli, *American Depositary Receipts: An Overview*, Fordham International Law Journal, 35 (January 1994).

¹⁰⁶ *See id.* at 53.

around U.S.\$500 million. The reason is that companies are learning that if they really want to take advantage of the U.S. markets, they have to do a public offering. There are some companies for whom it still makes good sense to do a 144(a) offering, but more and more companies are realizing that, "Yes, we could raise some money in the United States, but we are not going to be able to build a liquid market for our shares here under 144(a)." So they are doing public offering instead.¹⁰⁷

4. ADR Listing Requirements

The foreign private issuer of ADRs at some point in establishing an ADR facility, will have to decide where to list its ADRs. In making this decision, the issuer will have to take into account such factors as share liquidity, visibility, listing costs and funding requirements. Summarizing below are the listing differences among the "over-the-counter" market and the major U.S. stock exchanges.

4.1. The Over-The-Counter Market

The results of the trades outside the three major exchanges on so called OTC market are listed in the "Pink Sheets" - daily publication of the National Quotation Bureau. In 1994, 869 of the 1415 established ADR programs were traded on the OTC market.¹⁰⁸

The broker-dealer willing to participate in OTS trading must file a National Quotation Form 211 which includes updated financial and other relevant information of the company. Listing fees are paid by the broker-dealer who seeks the listing.

Listing on the "Pink Sheets" may be used for Level I and unsponsored ADR programs, while Level II and III sponsored ADR programs may be listed only on NASDAQ, AMEX or NYSE.

¹⁰⁷ Joseph Valli, *American Depositary Receipts: An Overview*, Fordham International Law Journal, 54 (January 1994).

¹⁰⁸ *Depositary Receipts Handbook*, Bankers Trust, Corporate Trust & Agency Group (August 1997) <<http://www.bankerstrust.co/ms/dreceipt/handbook.htm>>.

4.2. National Exchanges

As already mentioned, the issuer of Level II and III ADRs may have substantial benefits from listing its ADRs on one of the U.S. national stock exchanges. National stock exchanges provide the issuer with easy access to automated trading and efficient market pricing. Exchanges' listing fees for ADRs are generally less expensive than for ordinary shares in the U.S..

Each of the national stock exchanges has its own standards concerning corporate governance. Non-U.S. issuers, however, may be exempted from these requirements upon a special application.

4.2.1. NASDAQ

National Association of Securities Dealers Automated Quotation (NASDAQ) is an electronic stock market, which operates a system of competing market makers linked with the investors through telecommunication networks.

NASDAQ provides two options for listing: (i) the Small Cap Market which is available for small companies, and (ii) the National Market System where the majority of NASDAQ securities are listed. ADR listing charges for both Markets are very similar, while access criteria substantially differ (see the table¹⁰⁹):

	NASDAQ Small-Cap Market	NASDAQ National Market	
		Alternative I	Alternative II
Net Tangible Assets	US\$ 4,000,000	US\$ 4,000,000	US\$ 12,000,000
Total Stockholders Equity	US\$ 2,000,000	N/A	N/A
Net Income (in latest fiscal year or 2 of last 3 fiscal years)	N/A	US\$ 400,000	N/A
Pretax Income (in latest fiscal year or 2 of last 3 fiscal years)	N/A	US\$ 750,000	N/A

¹⁰⁹ *Depository Receipts Handbook*, Bankers Trust, Corporate Trust & Agency Group (August 1997)
<<http://www.bankerstrust.co/ms/dreceipt/handbook.htm>>.

	NASDAQ Small-Cap Market	NASDAQ National Market	
		Alternative I	Alternative II
Public Float (Shares)	100,000	500,000	1,000,000
Operating History	N/A	N/A	3 years
Market Value of Float	US. 1,000,000	US\$ 3,000,000	US\$ 15,000,000
Minimum Bid	US\$ 3	US\$ 5	US\$ 3
Shareholders	300		
-if between 0.5 and 1 m. shares publicly held		800 400	400 400
-if more than 1 m. Shares publicly held		400	400
-if more than 0.5 m. Shares held and average daily volume in excess of 2,000 shares			
Number of Market Makers	2	2	2

NASDAQ also operates PORTAL, the market for securities issued under Rule 144(a).

4.2.2. AMEX

American Stock Exchange (AMEX) operates an auction market system, intended to facilitate trading between buyers and sellers with minimum intervention from the professional dealers.

There are special listing requirements for non-U.S. issuers. AMEX also has established special listing requirements ("Alternate") for the issuing companies which are financially sound but which, due to the nature of their business can not qualify under the "Regular" requirements. The tables¹¹⁰ hereunder provide financial and distribution requirements, which the companies seeking listing on AMEX under the "Regular" or "Alternative" scheme must comply with:

¹¹⁰ *Depository Receipts Handbook*, Bankers Trust, Corporate Trust & Agency Group (August 1997) <<http://www.bankerstrust.co/ms/drecept/handbook.htm>>.

Financial Guidelines	Regular	Alternative
Pre-tax income	US\$ 750,000 latest fiscal year or 2 of most recent 3 years	—
Market value of shares publicly held worldwide	US\$ 3,000,000	US\$ 15,000,000
Stockholders' equity	US\$ 4,000,000	US\$ 4,000,000
History of operations	-	3 years

Distribution Guidelines (applicable to regular and alternate guidelines)	Standard			
	1	2	3	4
Public float, U.S.	500,000	1,000,000	500,000	-
Public float, worldwide	-	-	-	1,000,000
Stockholders, U.S.	800	400	400	-
Stockholders, Worldwide	-	-	-	800
Average Daily Volume, U.S.	-	-	2,000	-

4.2.3. NYSE

New York Stock Exchange (NYSE), operates auction-type market system similar to AMEX, where stock prices are determined on the basis of the competing public orders. Based on the volume of trading the NYSE, is considered to the largest stock exchange in the United States.

A foreign private issuer willing to list his ADRs on the NYSE can choose to qualify either under the "Alternate Listing Standards", designed specifically for non-U.S. corporations, or under the "Original" or "Alternate Original" standards which apply to the U.S. domestic issuers. The table¹¹¹ hereunder provides general information about various listing standards:

¹¹¹ *Depository Receipts Handbook*, Bankers Trust, Corporate Trust & Agency Group (August 1997)
<<http://www.bankerstrust.co/ms/dreceipt/handbook.htm>>.

	Original Listing Standards	Alternate Original Listing Standards	Alternate Listing Standards for Non-U.S. Corporations
Round-Lot Holders (number of holders of a unit trading - generally 100 shares)	2,000 US	N/A	5,000 Worldwide
Total Shareholders	N/A	2,200 US	N/A
Market Value of Public Shares	US\$ 18,000,000 U.S.	N/A	US\$ 100,000,000 Worldwide
Net Tangible Assets	US\$ 18,000,000	N/A	US\$ 100,000,000
Pre-Tax Income:		-	-
- most recent year	US\$ 2,500,000	-	-
- two preceding years	US\$ 2,000,000	-	-
- aggregate for last three years	N/A	U.S.\$ 6,500,000	N/A
- aggregate for last three years together with minimum in most recent year	N/A	US\$ 4,500,000	-
- aggregate for last three years	N/A	N/A	US\$ 100,000,000
- aggregate for last three years together with minimum in most recent year	N/A	N/A	US\$ 25,000,000

CHAPTER V

LIABILITY

1. General Characteristics

ADRs are becoming a dynamic tool of international finance. However, the securities regulations regarding to the liability of the parties involved in establishing of the ADR programs remain confusing and need to be better defined. In several sections the Securities Act of 1933 provides civil remedies that may be used in an ADR case. Particularly, these remedies may be found in Section 11 and 12(2).¹¹² Section 11 of the Act sets forth a civil right of action against a vast number of ADR arrangement participants. It reads as follows:

- (a) ...In case any part of the registration statement, when such part become 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

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

- 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.¹¹³

Section 17 of the Securities Act also introduces certain liability provisions with regard to the fraud in securities, which may be applicable in the case of ADRs. It 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 statement made, in the light of 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.¹¹⁴

Although the provisions of the Section 17 of the Act seem to be clearly spelled out and very protective for the investor, Douglas B. Spoors, the sole practitioner in Sacramento, California, expresses the view that there is a great amount of controversy about the possibility to apply these provisions in practice. In particular he doubts the existence of a private right of action under the Section 17 of the Act. "There is no express right granted in Section 17, and there is a vast split whether an implied right exists. The generally accepted view is that no private right of action exists under Section 17".¹¹⁵

Section 11 cited above sets forth a civil right of action against various participants of the ADR arrangement. Court interpretation recognizes that the liability may be placed on six main groups of participants in ADR registration and subsequent transactions. These groups are (i) issuers, (ii) officers and directors, (iii) persons who sign the registration statement, (iv) experts, (v) underwriters, and (vi) collateral participants.

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

¹¹⁴ See *id.* at §77q(a) (Law.Co-op.1991).

¹¹⁵ Douglas B. Spoors, *Exploring American Depository Receipts: The International Augmentation of U.S. Securities Market*, 6 Transnational Lawyer, at 181, 217 (1993).

As previously noted two approaches to the ADR arrangement may be distinguished. The first is where the foreign private issuer takes an active role in establishing an ADR facility, including the U.S. registrations with the SEC and distribution of the underlying securities to the depository. The second one is where the foreign issuer agrees on ADR issuance, but does not participate simultaneously in the process of ADRs registration (unsponsored ADR program). Anyone who signs the registration statement may be held liable for omissions from the registration statement, and for false or misleading statements.¹¹⁶ It is quite obvious that in the first situation the active foreign issuer is required to sign a registration statement as an issuer of the ADR. In doing so, he inevitably incurs liability with regard to the registration of the securities underlying the ADR. However, certain experts express the opinion that liability for the ADR registration itself may or may not apply.¹¹⁷ In the second situation, the registration of the underlying securities is not required under the "involuntary entry theory" and the foreign private issuer is not involved in the ADR registration process at all. In this case, the only party which can assume liability for the ADR issuer is the depository bank - the primary manager of the ADR arrangement. This liability, however, seems to offer very limited protection to the ADR holder as the depository bank is not in control of the activity of the actual issuer.¹¹⁸

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 depository bank solely on the basis of the bank's participation appears overreaching and it would discourage banks from further participation.¹¹⁹

This approach is fully supported by the SEC which has invented a "fictitious entity theory", under which the depository bank signs the registration statement on behalf

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

¹¹⁷ Douglas B. Spoons, *Exploring American Depositary Receipts: The International Augmentation of U.S. Securities Market*, 6 Transnational Lawyer, at 181, 217 (1993).

¹¹⁸ See *id.* at 204

¹¹⁹ See *id.*

of the entity created by the ADR arrangement merely in a ministerial function and therefore, is free from liability for this function. This approach further restricts a private right of action of the investor.

Thus, the investor trying to identify a party accountable for the accuracy of the registration statements may find himself in a situation where a foreign private issuer is not involved in the ADR arrangement and the depository is protected by the SEC's ruling. The issuer's liability does not exist in this case. However, some remedy must be available to ADR investors who to the most extent relied on the F-6 registration statement when making their investments. Legal experts in this field have proposed at least two possible models of liability. First, a Aurotek-Rogers test may be applied to the ADR arrangement, provided that certain modifications have been made. Second, the depository liability may be encompassed by the broad standards of Rule 10b-5,¹²⁰ applied alone or through an aiding and abetting theory.

2. Aurotek-Rogers Test

In 1985 in the case *Anderson v. Aurotek*,¹²¹ the Ninth Circuit court imposed Section 12 liability on participants in the sales of securities based on the conclusion that their "acts are both necessary to and substantial factor in the sales transactions."¹²² This principle was further defined in *SEC v. Rogers*.¹²³ The Rogers court pointed out that participation must be more than de minimis and be a but-for cause in the outcome.

The Aurotek-Rogers test may be easily applied to the ADR participation arrangement and result in imposing liability on the depository banks. The bank participation clearly fall within the statutory definition of a dealer, because the bank acts at least indirectly as the agent or broker of the depositor, by taking deposits and offering

¹²⁰ 17 C.F.R. §240.10b-5

¹²¹ 774 F.2d 927 (9th Cir.1985).

¹²² See *id.* at 930.

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

subsequently the issued receipts. An effective ADR arrangement requires the active participation of the bank, especially in the event of foreign issuer involuntary entry. And finally, despite the SEC's "fictitious entity" theory, which assigns the depository bank only a ministerial signing function, the bank's participation in practice is far more than merely de minimis. Therefore, there is a big chance that the Aurotek-Rogers test applied to the ADR arrangement may be a workable model for protection of the investors' interest.

3. Rule 10b-5

Rule 10b-5 is a provision corresponding to the Section 10(b) of the Securities Act.¹²⁴ It 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 fraud or deceit upon any person, in connection with the purchase or sale of any security.¹²⁵

With regard to an For the ADR arrangement Rule 10b-5 may be of primary importance when the depository bank is not directly involved in the process of purchase or sale of securities. Rule 10b-5 phrases "any person", "directly or indirectly", and "in connection with the purchase or sale of any security" may be successfully used by the damaged investor to trigger the depository bank liability.¹²⁶

By inserting the words "any person" into the Rule 10b-5, Congress intended to reach peripheral participants in fraudulent schemes. Banks by carrying out the depository

¹²⁴ 17 C.F.R. §240.10b-5.

¹²⁵ *See id.*

¹²⁶ Douglas B. Spoor, *Exploring American Depositary Receipts: The International Augmentation of U.S. Securities Market*, 6 Transnational Lawyer, at 181, 213 (1993).

functions, clearly fall within the scope of the clause as peripheral participants, as they are a necessary link between depositor and investor.¹²⁷

The importance of the Rule 10b-5 phrase is also clear; it extends liability to "behind the scenes" players. A depository bank's participation in taking deposits and issuing depository receipts, even indirect in nature, may be also construed under the Rule as knowledgeable assistance in making false or misleading statements, since the bank is supposed to know the content of the registration statement.¹²⁸

The phrase "in connection with" of the Rule 10b-5, although untested in practice, may give additional strength to the application of abovementioned clauses.¹²⁹ Moreover, some lower courts have held that the "in connection with" requirement may be satisfied if the fraudulent scheme "touches" the transaction.¹³⁰

Thus, the conclusion may be made that under the either Aurotek-Rogers or the Rule 10b-5 test, depository bank liability may be triggered by the fact that the bank plays a significant role in the ADR arrangement.

The issuers liability in the case of "involuntary entry" to the U.S. market through the ADR facility remains questionable in two aspects: theoretical possibility to impose the liability under the current regulations and practical enforceability of the judicial decision.

Greater clarity in this area may further contribute to the expansion of ADR programs, as investors would be able to obtain adequate protection of their interests,

¹²⁷ Douglas B. Spoors, *Exploring American Depository Receipts: The International Augmentation of U.S. Securities Market*, 6 Transnational Lawyer, at 181, 214 (1993).

¹²⁸ See *id.* at 215.

¹²⁹ See *id.*

¹³⁰ *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).

banks would have more predictability with regard to their participation liability in ADR facilities and issuers may benefit from the reduced costs of the depository banks' services.

CHAPTER VI

ADRS. PROSPECTS FOR THE FUTURE. CONCLUSION.

The statistics for the last decade clearly indicate that investors in the United States more and more increasingly diversify their portfolios with foreign equity to capture higher returns and reduce risk through international diversification. The appetite of pension funds for increasing their foreign equity holding is expanding rapidly, and the absolute amount of money flowing out of U.S. to the foreign markets, as a consequence, is enormous. The London Stock Exchange has already made significant strides in becoming a transnational equity market for Europe and accounts now for 30% of the trading in the European equities.¹³¹ U.S. security market players are, thus, desirous of regulatory changes in current securities regulations that will allow U.S. exchanges and investors to fully participate in the growth of international trading and preserve U.S. securities market leading position in the world. The critical focus of these desired changes is easier access by foreign issuers to U.S. listings. More specifically, this means that the SEC needs to find some compromise with regard to the U.S. GAAP reconciliation. In 1994 only forty foreign issuers went ahead with a NYSE listing, while about 2,000 foreign world-class companies eligible for listing preferred to stay on the over-the counter market because of difficulties associated with the SEC disclosure and reconciliation requirements.¹³² Exemption from the U.S. GAAP quantitative reconciliation requirements granted to the foreign private issuers will not harm U.S. investors. The following argument can be made to prove this point:

¹³¹ James L. Cochrane, *Are U.S. Regulatory Requirements For Foreign Firms Appropriate?* 17 Fordham International Law Journal, 58 (January 1994).

¹³² *See id.*

1. More and more retail investors go to the OTC market to purchase the foreign world class companies' equity, and it is quite obvious that they do not benefit from the reconciliation and protection device, as this device is not set up in OTC market.
2. Institutional investors now, prefer to buy foreign company's securities in the issuer's home market or in London. They have enough resources to retain advisors to evaluate the issuer's performance through the foreign accounting. Financial analysts of the big institutional investors rely more on financial statements based on home country accounting.¹³³
3. If the foreign private issuer would be eligible for the less stringent disclosure and reconciliation requirements, that would not be very unfair to the U.S. issuers, as currently U.S. companies can issue shares and list them for trading in most major foreign markets without having to comply with foreign financial, disclosure, and accounting rules.
4. Listing of world-class foreign companies shares on U.S. stock exchanges will make the U.S. capital market much stronger.

How may the issue of listing standards for the foreigners be resolved? Financial experts propose to introduce a specific quantitative criteria in order to distinguish "world class" foreign companies and make them eligible for disclosure and reconciliation exemptions. The second approach focuses the solution on placing foreign issuers on a separate list and limiting access of the potential investors to those of them who can meet specific criteria. This approach resembles Rule 144(a) and doubtfully may create a market equal to an existing public market for regular issuers. The third approach attempts to compromise on accounting changes. This approach is based on the following factors:

1. U.S. GAAP is most often accepted by the issuers from the emerging markets as the main one due to the absence of the sophisticated domestic accounting system. Chinese

¹³³ James L. Cochrane, *Are U.S. Regulatory Requirements For Foreign Firms Appropriate?* 17 Fordham International Law Journal, 62 (January 1994).

companies seeking a listing on U.S. stock exchanges do not have a problem with U.S. GAAP.¹³⁴ The European companies, for example from Germany and Switzerland, where sophisticated and well developed accounting systems have existed for a long time, are not willing, however, to voluntarily conform to U.S. GAAP.

2. The SEC has taken a position to accommodate foreign private issuers on a case-by-case basis, and relax the standards in certain situations, especially for those from European countries where accounting does not substantially differ from the U.S. GAAP.
3. Mutual recognition of national accounting and disclosure requirements is already in process. U.S.-Canada multi-jurisdictional disclosure system is one of the examples of it.¹³⁵ This process on a larger scale, promise to be very complicated and time-consuming.

The most effective route for resolving the accounting issue would be recognition by the SEC of the principles produced by the International Accounting Standards Committee ("IASC"). IASC principles have already been adopted by many major non-U.S. issuers. Accounting based on these standards allows the U.S. investors to make completely informed judgments about issuer's soundness and state. Acceptance of these principles by the SEC might result in a real breakthrough in the development of the U.S. capital market, making it even more competitive on international scale and allowing hundreds of European companies to enter it. A remark of Herbert Biener, Ministerialrat at the German Justice Ministry and the senior civil servant for accounting may be interesting in this respect:

In 1991 in Germany, 578 foreign enterprises were listed on stock exchanges. Although they publish only their original financial statements without reconciliation to German accounting standards, damages to investors have not been reported. A deficiency of comparability of financial statements is therefore no reason for denying mutual recognition. There is no doubt that improved comparability is helpful but, in a market

¹³⁴ James L. Cochrane, *Are U.S. Regulatory Requirements For Foreign Firms Appropriate?* 17 Fordham International Law Journal, 63 (January 1994).

¹³⁵ Multijurisdictional Disclosure and Modifications to the Current Registration and Reporting System for Canadian Issuers, Securities Act Release No.6902, Exchange Act Release No. 29,354, 56 Fed. Reg. 30,036-01 (July 1, 1991).

economy, this issue can be solved by competition. If investors prefer enterprises to give comparable information, competitors will consider whether in this case additional information should be used to influence the market price of their securities.¹³⁶

The future of American Depositary Receipts demands a search for very flexible and competition-oriented, rather than only investor-protective, regulation. The U.S. banking and securities industry is now facing a risk of losing some of its international stature, due to very static internal regulations. By adopting regulations that parallel the requirements of the international market and by making the U.S. market more accessible for the foreign issuers, U.S. regulators may enable American investors to seek and realize opportunities previously unavailable. It may allow the participating banks to expand their services. Finally, the increase of capital flow over U.S. boundaries will enhance U.S. economic growth.

On the other hand non-U.S. companies should not be afraid of the United States's stringent regulatory requirements. Many companies have managed to go through the U.S. registration process and many continue to do it. For the companies representing emerging markets, including the Russian Federation, breaking through the registration difficulties in the U.S. means not only accessing a capital for a reasonable price, but it is also the best way to acclimate to financial markets' culture and operational standards. It is also a good chance to enhance a company's visibility and openness for the other parties - like investors, creditors and business partners.

¹³⁶ H. Beiner, *What Is the Future of Mutual Recognition of Financial Statements and Is Comparability Really Necessary*, 3 *The European Accounting Review* 335, 341 (1994).

BIBLIOGRAPHY

1. *The ADR: An Instrument of International Finance and a Tool of Arbitrage*, 8 Vill.L.Rev.22 (1962). John T. Connor, Jr., *Russian ADRs in U.S. Capital Markets*, BNY Home Page (August 1996) <<http://www.bankofny.com/adr/aovrview.htm#what>>.
2. Regis Moxley, 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).
3. Douglas B. Spoors, *Exploring American Depositary Receipts: The International Augmentation of U.S. Securities Market*, 6 Transnational Lawyer, at 181 (1993).
4. Joseph Valli, *American Depositary Receipts: An Overview*, Fordham International Law Journal, 2 (January 1994).
5. Peter Handerson, *Local Demand Sparks Rise of Russian Pre-ADR Shares*, Reuters (January 30, 1997) <<http://www.nd.edu/~astrouni/zhiwriter/97/97013003.htm>>
6. Erin Arvedlund, *Rostelecom To Get Its Disputed ADR*, Moscow, Reuters (1997) <<http://www.nd.edu/~astrouni/zhiwriter/97/97013004.htm>>.
7. Beck, *International Trading: Trading Links Between Toronto Stock Exchange and Midwest Stock Exchange, Current Developments in International Securities, Commodities and Financial Futures Markets*, 111-119, Singapore Conferences on International Business Law, Faculty of Law, National University of Singapore, (1987).
8. Frode Jensen, III, *The Attraction of the U.S. Securities Markets to Foreign Issuers and the Alternative Methods of Assessing the U.S. Markets: From a Legal Perspective*, 17 Fordham International Law Journal, 25 (January 1994).

9. Mark A. Saunders, *American Depositary Receipts: an Introduction to U.S. Capital Markets for Foreign Companies*, 17 Fordham International Law Journal, 48, 69 (1993).
10. HAL S. SCOTT, PHILIP A. WELLONS, INTERNATIONAL FINANCE, 292, (The Foundation Press, Inc. 4th ed. 1997).
11. *Depositary Receipts Handbook*, Bankers Trust, Corporate Trust & Agency Group (August 1997) <<http://www.bankerstrust.co/ms/drecept/handbook.htm>>
12. James L. Cochrane, *Are U.S. Regulatory Requirements For Foreign Firms Appropriate?* 17 Fordham International Law Journal, 58 (January 1994).
13. Beiner, *What Is the Future of Mutual Recognition of Financial Statements and Is Comparability Really Necessary*, 3 The European Accounting Review 335, 341 (1994).

MAY 05 1999

FOR LIBRARY
USE ONLY