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The Regulation of American Depositary Receipts: Americanization of the International Capital Markets

Jonathan W. Royston*

I. Introduction

American Depositary Receipts (ADRs) are negotiable receipts issued by a United States bank or trust company (the Depositary) to evidence ownership of securities of a foreign company deposited with the Depositary's office or agent in the foreign country. ADRs are typically registered in the name of the United States holder (the Holder) and represent so-called "Depositary Shares" to be traded in the United States. Each Depositary Share may represent one or more of the foreign securities deposited abroad.

The ADR is the most widely used form of trading foreign securities in the United States, and its use has grown significantly since its inception in 1927. Yet, despite the dramatic increase in securities

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1 See Moxley, The ADR: An Instrument of International Finance and a Tool of Arbitrage, 8 VILL. L. REV. 19, 22 (1962). ADR instruments are known by various names. American Depositary Certificates, for example, are issued against the deposit of foreign bonds or notes. ADRs have also been known popularly as New York Shares and American Share Certificates. ADR, as used in this article refers to one or more of these types of instruments. Id. at 22 n.6. See generally L. Loss, FUNDAMENTALS OF SECURITIES REGULATION 246 (1983).

2 Depositary Share is defined as "a security, evidenced by an [ADR], that represents a foreign security or a multiple of or fraction thereof deposited with a depositary." 17 C.F.R. § 230.405 (1984). ADR is not synonymous with Depositary Share, because ADR is the designation of the certificate representing the depositary share, just as a stock certificate is merely written evidence of ownership of the stock it represents. See BLACK'S LAW DICTIONARY 206 (5th ed. 1983).

3 In addition to ADRs, foreign equity securities also may be traded in the United States as ordinary shares issued in the foreign country or as shares issued only for distribution and sale in the United States (American shares). L. Loss, supra note 1, at 246 n.3. Another commentator notes that another way an American investor can acquire foreign securities is through American investment funds that hold foreign ordinary shares. Note, Foreign Securities: Integration and Disclosure under the Securities and Exchange Acts, 58 NOTRE DAME L. REV. 911, 912 (1983).

4 L. Loss, supra note 1, at 246 n.3; Investor's Ticket Abroad: Depositary Receipts are Growing in Popularity, BARRONS, Apr. 30, 1984, at 24-26 (containing complete list of over 500 foreign companies that have securities traded in the United States in the form of ADRs) [hereinafter cited as BARRONS]. In 1961 there were approximately 150 foreign companies whose securities were traded in the United States by means of ADRs. In 1978 there were
investment among countries, the long-range United States policy of subjecting foreign issuers to the disclosure requirements and accounting standards imposed upon domestic issuers is not comforting to those who advocate greater freedom in the international flow of capital. This article discusses the current regulatory framework and its underlying policy; proposes theoretical ADR certificate provisions; and reviews related issues of disclosure, currency exchange rates, inflation, and accounting.

II. Regulation of ADRs

A. The Voluntarism Principle

ADRs are securities subject to regulation by the Securities and Exchange Commission (the Commission) and registration under the securities laws. In its desire to foster the free international flow of capital, however, the Commission has adopted certain exemptions and other provisions of leniency for foreign issuers. As the Commission has explained on more than one occasion, its view of the regulation of foreign issuers is based upon a distinction 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."5

The Commission adopted differing regulations and practices for ADRs despite the legislative history of the Securities Act of 1933 (Securities Act),6 which reflects an intent to treat "foreign private issuers"7 the same as domestic issuers.8 The Commission adopted its principle of "voluntarism," because subjecting foreign issuers to the Commission's requirements and regulations may discourage or im-

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7 17 C.F.R. § 230.405 (1984). Foreign private issuers are defined as companies other than those that: (A) are owned by a majority in interest of U.S. residents; and (B)(i) are operated principally from the United States, (ii) have a majority of their Board of Directors residing in the United States, or (iii) have more than fifty percent of their assets in the United States.

8 Hearings on S. 875 Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess. 89-90 (1933); Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 1st Sess. 12-13 (1933).
pede registration and sale of foreign securities in the United States. Also, if requirements are too strict, investors will invest through foreign securities markets where disclosure requirements and other investor-protective measures may be patently inadequate.  

The "voluntarism" dichotomy applies equally to the sale of ADRs in the United States as it does to the integrated disclosure system for registered offerings by foreign private issuers. For instance, the foreign issuer may not be involved voluntarily in the trading of its shares in the form of ADRs where a foreign dealer or private shareholder has deposited the foreign issuer's securities with the Depositary. Occasionally, the Depositary may initiate the arrangement by soliciting the deposit of the foreign securities against issuance of ADRs. In these circumstances, it can hardly be said that the foreign issuer has voluntarily entered the United States securities markets. Consequently, the Commission's regulation of foreign issuers who, through no effort of their own, have ADRs traded in the United States, is much more lenient than the regulation of foreign issuers whose securities are traded directly in United States securities markets. In fact, the foreign issuer is not deemed to be the issuer or registrant with respect to the ADRs representing its securities, because the Depositary actually issues the ADRs and the foreign issuer need not be a party to the depositary agreement.

The recently adopted registration form for ADRs, Form F-6, states that the registrant is "[t]he legal entity created by the agreement for the issuance of ADRs." What the form does not state directly is that the foreign securities issuer may also be an ADR issuer. The general instructions to Form F-6 state that the Depositary shall not be deemed to be "an issuer, a person signing the registration statement, or a person controlling such issuer" even if the Depositary signs the registration statement on behalf of the fictitious legal entity. In this manner, the Commission makes the ADR arrangement eminently attractive to the Depositary banks and trust companies by not subjecting those entities or their directors to Securities Act liability.

B. Prior Regulation

Prior to the March 1983 adoption of Form F-6, the Depositary or sponsoring foreign issuer had a choice between two registration forms for the issuance of ADRs: Form C-3, which was seldom used,

9 Rel. No. 33-6360, supra note 5, at 84,651.
10 L. Loss, supra note 1, at 247.
13 Form F-6, supra note 11, ¶ 7005, at 6194, Instruction 1.
and Form S-12, which was closer in substance to current Form F-6. Form C-3, originally adopted in 1937, consisted of two parts. Part I was signed by the Depositary or other issuer of the ADRs, and Part II was signed by the foreign issuer and contained information about the foreign issuer. Part II was only required to be filed if the issuer or other person acting as underwriter was seeking to effect a distribution of the securities underlying the ADRs. Form C-3 was used so rarely that in one instance, the Commission was not certain how a registrant should comply with the requirements.

In 1955 the Commission offered the simpler Form S-12 as an alternative to Form C-3. To use Form S-12, two conditions had to be met. First, the Holder had to be permitted to withdraw the deposited securities covered by the ADRs at any time subject to certain charges, permitted delays, and government regulation of withdrawal. Second, the deposited securities should not require registration under the Securities Act if sold directly in the United States. In other words, Form S-12 could not be used if the ADRs were being used as a means of effecting an issuer distribution of the underlying deposited securities. Form S-12 only required disclosure in four areas, all of which could be disclosed in the ADR certificate.

If Form S-12 was not available, the foreign issuer had to use Form C-3 to register the ADRs and the deposited securities. Form S-12, in contrast, would only register the Depositary Shares embodied in the ADR and not the deposited securities. New Form F-6 incorporated the bulk of the substance of Form S-12 and expanded the integrated disclosure system to include registration of ADRs.

C. Current Regulatory Framework

Form F-6 is available for the registration of ADRs if the Form S-12 conditions and one of the following conditions are satisfied: (1) the foreign issuer is filing reports pursuant to the requirements of sections 13(a) or 15(d) of the Securities Exchange Act of 1934 (Ex-

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14 For a detailed discussion of the history and development of ADR regulation, see Moxley, supra note 1, at 28-32.
15 See id. at 28.
16 Form S-12, SEC Securities Act Release No. 3593, [1952-1956 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,372 (Nov. 17, 1955) (formerly codified as 17 C.F.R. § 239.19) (rescinded 1983). See also L. Loss, supra note 1, at 247; Moxley, supra note 1, at 29-31. Form S-12 developed out of a desire to continue to treat banks leniently in their issuance of ADRs, as had been the administrative practice prior to 1955 when ADRs were treated as exempt securities issued by a bank under section 5(a)(2) of the Securities Act. Moxley, supra note 1, at 29.
17 Rel. No. 33-6459, supra note 12.
18 The second condition for Form S-12 availability was incorporated in the Form F-6 requirements with a slight modification. Form F-6 requires that the deposited securities either be exempt from Securities Act registration or concurrently registered thereunder. Id. at 85,834; Form F-6, supra note 11, ¶ 7002, at 6191.
change Act); 19 (2) the deposited securities are exempt under rule 12g3-2(b); 20 (3) the deposited securities are registered concurrently with the filing of Form F-6. 21 Additionally, Form F-6 may be used only if the issuer or underwriter is not seeking to effect a distribution of the deposited securities through the ADR arrangement, in which event the exemption in section 4(3) of the Securities Act would be available for secondary trading of the deposited securities in the United States. 22 To distribute the deposited securities, the foreign issuer must file the applicable registration form. 23

Rule 12g3-2(b) exempts securities of foreign private issuers from the registration requirement of section 12(g) of the Exchange Act if the issuer furnishes information that it: (i) has disclosed publicly in the issuer’s country; (ii) has filed with an exchange that has made the information public in the issuer’s country; or (iii) has disseminated to its shareholders. 24 Rule 12g3-2(c) exempts the Depos-
tary Shares registered on Form F-6 without the necessity of filing information, but does not so exempt the underlying deposited securities. Rule 12g3-2(b) is unavailable for: (1) securities, including Depositary Shares, quoted before October 5, 1983 on an "automated inter-dealer quotation system," such as the NASDAQ system of the National Association of Securities Dealers, Inc. (NASD); (2) securities of a foreign issuer that has been a reporting company within the last eighteen months; and (3) securities of a class of securities issued in an exchange offer to acquire a reporting company.

If the foreign issuer is not a reporting company or is not exempt under rule 12g3-2, it must register the underlying securities on Form 20-F concurrently with the registration of the Depositary Shares. Form 20-F, however, is so detailed that foreign issuers prefer the simpler procedures under rule 12g3-2(b), if they are available.

If a Depositary has previously filed a Form F-6 in connection with a deposit agreement that is virtually identical to the Form F-6, registration under Form F-6 may be made effective immediately upon its filing, or at any time thereafter, by appropriately marking the cover page of the form and including a certification under rule 466 of Regulation C. This automatic effectiveness is convenient for banks and trust companies that frequently issue ADRs under identical forms of deposit agreements. Such control over the effective date also reduces the risk of exchange rate fluctuation if the proposed offering price is based on dollars rather than on the foreign currency.

Form F-6 is similar in substance to its predecessor, Form S-12.

two-thirds are Canadian. This is significant because Canadians will not be able to avail themselves of rule 12g3-2(b) after 1985 if their securities or ADRs are listed on an automated inter-dealer quotation system, such as NASDAQ. 17 C.F.R. § 240.12g3-2 (d) (3)(iii) (1984). The phasing out of the availability of this exemption to certain Canadian issuers is part of the Commission's philosophy that North American, and other foreign issuers at a later date, will eventually be able to comply fully with U.S. securities disclosure laws without unreasonable effort or expense. See SEC Securities Act Release No. 6493, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,435, at 86,295 (Oct. 6, 1983) [hereinafter cited as Rel. No. 33-6493].

See supra note 20 and accompanying text.

See 17 C.F.R. § 240.12g3-2 (d) (1984).


17 C.F.R. § 230.466(a) (1984). Item 3(f) of Form F-6 also requires that the registration statement include a certification by registrant under rule 466 that registrant previously filed a registration statement on Form F-6 with a deposit agreement containing (virtually) identical terms. In addition, Item 3(f) requires that the previous Form F-6 be identified.

Unlike Form S-12, however, Form F-6 is integrated with the Exchange Act's annual disclosure statements and certain interim reporting requirements. The two items of information required in a prospectus in Part I of Form F-6 may be incorporated into the text of the ADR certificate. These two items are a description of the securities to be registered, as required by Item 202(f) of Regulation S-K, and disclosure regarding the availability of information either pursuant to the standard reporting requirements or the rule 12g3-2(b) exemption.

The description of the Depositary Shares required by Item 202(f) of Regulation S-K encompasses various details regarding the terms of the deposit. Most of the terms can be found on the typical ADR certificate itself. The information required includes the following:

(i) the amount of deposited securities represented by one unit of [ADRs]; (ii) the procedure for voting, if any, the deposited securities; (iii) the collection and distribution of dividends; (iv) the transmission of notices, reports and proxy soliciting material; (v) the sale or exercise of rights; (vi) the deposit or sale of securities resulting from dividends, splits or plans of reorganization; (vii) amendment, extension or termination of the deposit; (viii) rights of holders of receipts to inspect the transfer books of the depositary and the list of holders of receipts; (ix) restrictions upon the right to deposit or withdraw the underlying securities; (x) limitation upon the liability of the depositary.

According to Item 202(f), the registrant must also describe all fees that may be imposed on the Holder, itemizing the type of service, the corresponding amount, and the recipient of the fee. Form F-6, however, alters this fee disclosure by providing that the amounts charged may be omitted if a general description of the service is provided and the Depositary undertakes to give notice of any fee increases (or reductions) and, upon request, to provide a revised fee schedule. For practical purposes, the initial fees probably should be included in the ADR certificate or the prospectus.

Instruction 2 to Item 202 requires additional information relating to foreign law, foreign taxes, and reciprocal tax treaties, but the Commission does not appear to enforce this requirement strictly. Presumably, this information goes beyond a pure description of the securities for purposes of lenient disclosure in Form F-6, especially because, as Item 202 recognizes, this disclosure may appear in another portion of a more comprehensive registration statement.

30 See Form F-6, supra note 11, ¶ 7002, at 6192 (General Instruction III.B).
32 Id. § 229.202(f)(2).
33 Id.
34 See, e.g., Victoria Exploration N.L. (Australian), Form F-6, SEC File No. 2-92733 (filed Aug. 15, 1984) (available in the Commission's Public Reference Room).
In addition to the above disclosures, Part II of Form F-6 requires the filing of the following exhibits: (1) the deposit agreement; (2) other agreements relating to the custody of the deposited shares or the issuance of the Depositary Shares; (3) an opinion of counsel on the legality of the Depositary Shares; and (4) the name of each dealer who (i) has deposited shares against the issuance of ADRs within the preceding six months, (ii) proposes to deposit shares against the issuance of ADRs, or (iii) assisted in the proposed issuance of ADRs.35

Finally, Item 4 of Part II of Form F-6 requires certain undertakings by the Depositary. The Depositary must provide semiannual reports listing the number of Depositary Shares outstanding, the number of Holders of ADRs, and the names of any dealers in the ADRs. The Depositary also must make available information it has received about the foreign issuer and information that has been made generally available to holders of the deposited shares. If the Depositary has reserved the right to increase fees, it must notify the ADR holders thirty days in advance of any change in fee schedule.36

If information requested in the description of the securities is not applicable, the registrant ordinarily may omit a discussion of that item. For example, if there is no established procedure for voting the underlying securities, the registrant need not explain the absence of voting rights. Rule 404 of Regulation C provides that in Part I of any registration statement "unless otherwise specified, no reference need be made to inapplicable items, and negative answers to any item . . . may be omitted."37 In any event, the potentially misleading effect of such an omission is avoided by the requirement under rule 481(a) of a cross-reference sheet, which would typically indicate the inapplicability of a numbered portion of an item.38

One significant innovation in Form F-6, as compared to Form S-12 and prior procedure, is the ease with which a Depositary may now alter the fee schedule. While Form S-12 required the fee schedule to be printed on the ADR certificate, Form F-6 permits a general description of the fees to be charged, without disclosure of specific amounts, if the Depositary gives advance notice of any fee changes. Also, under Form F-6 the Depositary must supply the new fee schedule if the Holder so requests.39 This new procedure enables ADR arrangements to keep pace with inflation without the parties incur-

35 Form F-6, supra note 11, ¶ 7004.
36 Id. at 6193-94.
38 Id. § 230.481(a). Potential investors are also protected from being misled by § 230.174, which exempts Form F-6 registrations from the prospectus delivery requirements.
39 Form F-6, supra note 11, ¶ 7004 Item 4(c).
ring substantial costs in replacing the ADR certificates.\footnote{40}

Form F-6 is filed by the "legal entity created by the agreement for the issuance of the [ADRs],"\footnote{41} and the Depositary is permitted to sign on the entity's behalf. Form F-6 expressly provides that the Depositary is not deemed to be "an issuer, a person signing the registration statement or a person controlling such issuer."\footnote{42} As far as the Commission is concerned, the Depositary does not expose itself to Securities Act liability by signing Form F-6.\footnote{43} In discussing Form S-12, Professor Loss noted that this creation of a shell entity as the issuer means that no one has actual issuer liability under section 11 of the Securities Act.\footnote{44}

If the foreign issuer "sponsors" the ADR arrangement, it also must sign Form F-6. The term "sponsor," as used in Form F-6, means that the foreign issuer is the principal depositor or that there is a deposit agreement between the foreign issuer and the Depositary. The foreign issuer that sponsors the ADR is not given dispensation from Securities Act liability, which is consistent with the previous treatment of issuers under Forms C-3 and S-12.

Form S-12 was not available if the issuer's purpose in initiating the ADR arrangement was to effect a distribution of the securities.\footnote{45} Form S-12, however, could be used if the foreign issuer acted as sponsor or manager of the ADR arrangement under the deposit or other agreement.\footnote{46} If the definition of sponsor included an "issuer" or "underwriter" in the sense of a manager of an investment contract program, Form S-12 was not available. The distinction between a sponsor or manager of the ADR arrangement and an issuer with respect to a distribution of the deposited securities principally depends on the purpose of the ADRs' issuance and the degree of control over the ADR certificates vested in the foreign issuer.\footnote{47}

\footnote{40}{For further disclosures pertinent to Subsection 202(f), see infra text accompanying notes 49-50.}
\footnote{41}{Form F-6, supra note 11, ¶ 7005 Instruction 1.}
\footnote{42}{Id.}
\footnote{43}{Id.}
\footnote{44}{L. Loss, supra note 1, at 248.}
\footnote{45}{One condition for the use of prior Form S-12, as well as Form F-6, is that "the deposited securities, if sold in the United States or its territories, would not be subject to the registration provisions of the Securities Act." Rule as to Use of Form S-12, 17 C.F.R. § 239.19 (1982) (rescinded 1983). For a discussion of this requirement, see supra notes 17 & 22 and accompanying text.}
\footnote{46}{See supra text accompanying notes 14 & 25.}
\footnote{47}{Where no person or persons perform the acts and assume the duties of sponsor or manager pursuant to the provisions of the trust or other agreement or instruments under which receipts are to be issued, the entity created by the agreement for the issuance of [ADRs]... shall be deemed to be the issuer of the ADRs for all purposes of this Form and the [Securities] Act. Rule as to Use of Form S-12, 17 C.F.R. § 239.19 (1982) (rescinded 1983).}

L. Loss, supra note 1, at 245-47.
III. Terms of a Typical ADR Arrangement

Historically, it was common for a United States investment banking house to initiate the ADR arrangement to facilitate the sale of a block of shares of a foreign corporation that it held. The investment bank and the United States bank that served as the Depositary would enter into an agreement. The investment bank, as depositor, typically would retain a degree of control over the ADR arrangement, even to the extent of being able to terminate the arrangement after notifying the Depositary and the Holders. The Depositary merely acted as custodian of the deposited securities, a capacity similar to a bank acting as a depositary for a corporation, or a creditors' committee in reorganization that might issue certificates of deposit or voting-trust certificates. Under this arrangement, the investment bank assumed the role of "issuer," as would any depositor with substantial managerial control. The issuer of the deposited securities would not have any role in the issuance of the ADRs unless the investment bank sought its cooperation or consent. For example, the investment bank may seek the cooperation of the issuer in listing the securities on an exchange or seek an exemption from the reporting requirements of the Securities Act.

In recent years, a foreign issuer whose stock is traded on a foreign exchange might seek to have ADRs representing its securities traded in the United States, either to raise capital or for the convenience of its United States shareholders. In such a case, the foreign issuer, as depositor, would execute a deposit agreement with the Depositary, which would govern the relationship between the issuer, the Depositary, and the Holders of the ADRs. If the foreign issuer retained substantial managerial control over the deposit, it would clearly be the issuer of the ADRs.

An ADR arrangement also may be formed when a United States bank or trust company announces that it is willing to act as Depositary to issue receipts of a designated company, which, presumably it considers to promise active trading in the ADRs. Usually, the designated company's stock is actively traded on a foreign exchange. A deposit agreement would not be necessary because the ADR certificate can embody all the terms and provisions of the deposit agreement if such an agreement is required by the depositor. In response to an overture from the prospective Depositary, a large holder of the foreign shares may attempt to negotiate a deposit agreement to his liking, perhaps giving himself control over the entire ADR arrangement. In some circumstances, it is conceivable that both the share-
holder-depositor and the Depositary may assume the role of "issuer" of the ADRs.\(^5^0\)

The provisions of an ADR certificate can vary depending upon the ADR arrangement and the degree of managerial control retained by the Depositary. A typical ADR certificate has the appearance of an ordinary stock certificate and may constitute the entire agreement between the Depositary and the Holder. Subject to possible variations, an ADR certificate may contain the following provisions:\(^5^1\)

1. Language certifying that the underlying shares had been deposited with the Depositary or its agent at a specified location, that each ADR represents one underlying share, and that Holder is the owner of a certain number of ADRs created by the certificate.

2. A provision that incorporates by reference the terms and provisions of a deposit agreement between the depositor and the Depositary and merely summarizes those provisions. This provision should state that the ADR certificate is qualified by the detailed provisions of the deposit agreement. Alternatively, the ADR certificate may contain all of the terms to which the Holder is a party.

3. A provision giving the Holder the right, subject to certain restrictions set out in the certificate, to have a certificate representing the underlying deposited shares delivered to him upon surrender of the ADR certificate and payment of any fees and charges. The Holder would assume the risk and cost of forwarding such a certificate.

4. An exculpatory clause disclaiming liability for negligence or misconduct of any agent or employee of the Depositary who was selected with reasonable care. The Holder could also waive any liability of the Depositary, under present or future laws, arising out of the ADR arrangement.

5. A provision stating that, subject to the Depositary's right to close the transfer books, the ADR certificate may be transferable on such transfer books when properly endorsed and delivered for transfer and that the Depositary may rely on this record ownership for purposes of distributions, communications, notices, or other rights of the Holder.

6. A provision giving the Holder the right to inspect the ADR transfer book and the right to receive any reports or communications made generally available to the owners of the deposited shares.

7. A provision that, subject to any currency exchange controls of foreign governments, the Holder has the right to receive, in United States currency, any cash dividends on a payment date established by the Depositary after deducting applicable fees and expenses. With noncash distributions and stock dividends, the Depositary may also reserve the right to sell the property and distribute the cash, if proportionate distribution is not practicable, or if the distribution is otherwise not feasible. The time and manner of determining the applicable exchange rate should be specified.

\(5^0\) L. Loss, supra note 1, at 244-47; Moxley, supra note 1, at 31. See generally Brooks, Currency Translations in the Registration Statements of Foreign Issuers, 35 Bus. Law. 435, 440-43 & n.54 (1980).

\(5^1\) These suggested provisions were gleaned from various actual registration statements on file with the Securities Exchange Commission.
(8) A provision reserving to the Depositary the right, upon any fundamental corporate change, to substitute new ADR certificates for the outstanding ADR certificates or to treat the outstanding ADR certificates as new deposited shares received in an exchange or conversion. The Depositary should reserve the right to release the deposited shares to comply with the requirements of any forced conversion or exchange and reserve the discretion to make any voluntary conversion or exchange.

(9) A provision stating that, upon redemption of the deposited shares, the Depositary has similar rights to surrender to the foreign issuer the deposited shares and to pay cash to the Holders for the ADRs representing those deposited shares. If only a portion of the deposited shares is redeemed, the certificate should establish some means to determine which ADR certificates to redeem, such as ratably, first sold, last sold, or simply at random. Because the ADR certificate does not identify a specific underlying foreign stock certificate, the order of a partial redemption of the ADRs could not be tied to "corresponding" deposited securities that have been redeemed.

(10) A provision requiring the Depositary to supply any proxy or similar materials to the Holder and to vote the underlying deposited shares, to the extent practicable, in accordance with the request of the Holder. The certificate may also set forth specifically the mechanics for voting or include such mechanics in the Deposit Agreement. For example, the certificate may state that the Depositary may fix its own record date.

(11) A provision granting the Depositary the right to select a successor to any custodian of the deposited shares and to amend, without the agreement of the Holders, the Deposit Agreement and the ADR certificate, provided the Depositary gives notice to the Holders of any amendment that would prejudice a substantial right of the Holder or change any fees. Form F-6 requires at least thirty days notice of any changes in fees.

(12) A provision granting the Depositary the right to terminate the Deposit Agreement, if any, or the agreement evidenced by the ADR certificate. Some notice of termination should be provided, and the Depositary or the foreign issuer, if a party to the Deposit Agreement, may permit the right to terminate to be exercised only if (i) a specified minimum number of Depositary Shares is outstanding, (ii) a majority of the Holders calls for termination, or (iii) the custodian, agent, or Depositary resigns and no successor can be found. Such a provision also would identify the Holder's rights after termination.

(13) A provision that requires the Holder to execute certificates or documents required to comply with any applicable law or governmental regulation relating to the issuance, transfer, payment, or distribution of the Depositary Shares. This provision also should state that all action required of the Depositary is contingent upon obtaining any necessary governmental approval or satisfying governmental requirements.

(14) Subject to certain additional requirements of Form F-6, a provision regarding the specific maximum fees corresponding to each service performed or a description of the fees charged and an undertaking to provide the fee schedule upon request. Items for
THE REGULATION OF ADRs

which charges or expenses may be included are: (i) issuance of ADRs; (ii) release of deposited securities upon surrender of ADRs; (iii) transfer of ADRs; (iv) splits or combinations of ADR certificates; (v) cash dividend payment; (vi) expenses of conversion of foreign currency into dollars; and (vii) taxes and other governmental charges.

(15) A force majeure clause that excuses reasonable delays in forwarding shareholder materials or dividends and the performance of other obligations delayed due to their transnational character.

IV. Special Considerations in Using ADRs

If the foreign issuer is required to register the deposited securities underlying the ADRs, the foreign issuer must submit periodic and other reports under section 15(d) of the Exchange Act, despite the section 15(d) exemption for the Depositary Shares contained in rule 15d-3. Even if the deposited securities are not registered, the foreign issuer may have a reporting obligation under section 12(g) of the Exchange Act if it has not complied with the requirements of the rule 12g3-2(b) exemption. Lastly, a foreign issuer may have a reporting obligation if it registers the Depositary Shares on a national securities exchange under section 12(b) of the Exchange Act. In any of these reporting circumstances, special forms, rules, and other considerations apply to the disclosure by the foreign issuer. Foreign issuers that are reporting companies must file annual reports on Form 20-F, but need not file interim reports. They also must file current reports relating to significant corporate developments on Form 6-K.

A. Form 20-F

Form 20-F has a dual personality—in addition to serving as the annual report form, it is also the registration form for foreign issuers under section 12(g) of the Exchange Act. The Commission adopted Form 20-F in December 1979 and later, as part of its expansion of the integrated disclosure system, revised it to include foreign private issuers.

The fundamental difference in the disclosure required by Form 20-F and that required on Form 10-K, by the annual report for domestic issuers, is that Form 20-F disclosure is less extensive in certain areas. For example, the description of the issuer's business is at

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52 17 C.F.R. § 240.15d-3 (1984); see §§ 240.13a-16, .15d-16.
53 See Exchange Act, §§ 12(g), 13(a), 15 U.S.C. §§ 78l(g), 78m(a) (1982).
54 Form 6-K is only required to be filed to furnish new information that the foreign issuer: (i) is required to disclose in the country; (ii) has filed with a foreign stock exchange, which has made the information public; or (iii) has distributed to holders of the deposited securities. See Form 6-K, 4 Fed. Sec. L. Rep. (CCH) ¶ 30,971 (April 28, 1967). See generally 10A H. BLOOMENTHAL, INTERNATIONAL CAPITAL MARKETS AND SECURITIES REGULATION § 5.02[5][a], at 5-20 (1982).
least as lenient as the disclosure on Form S-18. Similarly, industry segmental reporting generally only requires information regarding sales. Several other items, such as certain interim financial information, projections of estimated future net revenues for oil and gas production companies, and cash remuneration of individual officers, are not required by Form 20-F. Accounting principles applied in the financial statements need not conform to United States generally accepted accounting principles (GAAP) if such departures, and their effect, are disclosed and quantified.

The most significant substantive revisions of Form 20-F that were adopted in 1982 are: (1) the requirement that Form 20-F include selected financial information and management discussion and analysis of financial condition and results of operations; and (2) mandatory, as opposed to only practicable, quantification and reconciliation of financial statements to United States GAAP when using another comprehensive body of accounting principles. Other innovations also were adopted for the financial statements, such as two alternative disclosure items, one of which essentially requires the same information as required of domestic issuers. The more lenient disclosure item is primarily available to foreign issuers making offerings to their existing security holders.

Certain disclosure requirements are peculiar to Form 20-F and foreign issuers for obvious reasons. The nature and extent of the principal trading market for the securities, form of ownership, comparative currency exchange ratios and trends, and governmental economic, fiscal, monetary or other policies that materially affect operations or investment by United States citizens are all subjects of disclosure peculiar to foreign issuers.

B. Inflation and Exchange Rate Fluctuations

Although inflation and exchange rate fluctuations are not problems peculiar to ADRs, they do arise in the ADR context, especially in the drafting of the Deposit Agreement and the ADR certificate. Whether the foreign issuer is required to file Form 20-F or a full-blown Securities Act registration statement for the deposited securities, the Commission’s disclosure requirements pertinent to the

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55 See Rel. No. 33-6360, supra note 5, at 84,647-49. 10A H. BLOOMENTHAL, supra note 54, § 5.02[5][b]. For a discussion of the accounting provisions, see infra text accompanying notes 64-71. For a general discussion of the integrated disclosure system for foreign private issuers, see 3C H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 15.11[3]-[5] (1984).

56 See Rel. No. 33-6360, supra note 5, at 84,647-49. A World Class Issuer is a foreign private issuer with an equity float of $500 million, 30% of which is held by U.S. residents.

57 See Form 20-F, supra note 27, passim. The Commission has exercised its authority under 17 C.F.R. § 230.408 (1984) to require foreign issuers to submit additional material information, such as risk of expropriation, foreign tax laws, and other economic, legal, and even political factors. L. Loss, supra note 1, at 75.
presentation of financial data in a foreign currency may present the practitioner with interpretation problems.

Prior to the adoption of integrated disclosure, foreign issuers provided financial statements in the foreign currency and in "convenience translations," which consisted of the same financial statements restated in dollars at one exchange rate for all periods. Absent subsequent material changes, the exchange rate for the convenience translations was generally that for the period of the most recent balance sheet included in the disclosure document.58

In 1981 the Commission adopted regulations that: (1) require a five-year history of exchange rates, including the exchange rates for the most recent financial statements; (2) require financial statements to be stated in the currency of the foreign issuer's country of organization; (3) permit a convenience translation only since the most recent fiscal year; and (4) require, in the case of issuers whose financial statements are stated in a currency of certain hyper-inflationary economies, a quantification of the effects of changing prices on financial condition and results of operations.59

The Commission's resolution of the currency translation and inflation problems is practical and functional. The advent of floating exchange rates and the occasionally spiraling increases in these rates relative to the dollar, rendered the former method of using only one translation ratio "potentially misleading."60 A foregone advantage of convenience translations is their illustration of the magnitude of the financial statement items. Under the present requirements, the investor or securities analyst needs to use the exchange rate history to translate items in which he is interested.

The Commission chose a relatively high level of inflation—one hundred percent cumulative inflation in three years—as the threshold for requiring a quantification of the effects of inflation. This high threshold may be detrimental to investors because inflation levels below the threshold may have an effect on the financial statements,

58 Guide 24 of Guides for Preparation and Filing of Registration Statements, 33 Fed. Reg. 18617 (1968) (formerly codified as 17 C.F.R. § 231.6384). Noting the distortion in performance data that results from the use of convenience translations, one commentator suggested five alternatives to the currency translation requirements existing in 1980. The rules actually adopted appear to be a combination of his fourth and fifth suggested alternatives, although his analysis was not as detailed, and did not contain a historical exchange rate disclosure requirement. Brooks, supra note 50, at 450-52.

59 SEC Securities Act Release No. 33-6362, [1981-1982 Transfer Binder] Fed. Sec. L. REP. (CCH) ¶ 83,056 (Nov. 20, 1981) [hereinafter cited as Rel. No. 33-6362]. A hyper-inflationary economy for purposes of the Commission's rules is one that has experienced 100% "cumulative inflationary effect" in the last three years. The price index to be used is not specified.

There are various alternative procedures that may be followed to determine the format of the information required. For example, the inflation adjustment disclosures may be combined with the text of the financial data. See 17 C.F.R. § 229.301 Instruction 3 (1984).

60 Rel. No. 33-6362, supra note 59, at 84,662.
yet such effects need not always be described, as they must in the case of domestic issuers. The standard for judging an economy to be hyper-inflationary is not clear for two reasons. First, the Commission failed to choose an index or criteria for computing inflation. It is critical to adopt a standard for measuring inflation because, for example, the general consumer price index will rise more rapidly than the wholesale price index. Second, the cumulative effect of inflation is an ambiguous concept, which is not used in economic theory or practice. The "cumulative" effect may refer to time or stages of production, or merely to an aggregate of the annual inflation rate of each of the three years, rather than to the difference between the index at the beginning of year one and the end of year three.

Although some related clarifying disclosures are required, the Commission's rules do not require a discussion of the interaction between inflation and exchange rates, which could help an investor interpret the disclosures. Historically, the exchange rate is directly correlated to the inflation rate, and exchange rate fluctuations have always followed inflationary trends. Investors may benefit from knowing these trends or correlations in applying the exchange rate history and any supplemental inflation information to the financial statements.

C. Accounting Principles: Quantification Versus Reconciliation

In adopting the integrated disclosure system for foreign issuers, the Commission made it clear that if a foreign issuer presents its financial statements in a registration statement, such as Form 20-F, in accordance with "a comprehensive body of accounting principles other than those generally accepted in the United States," any material variations from United States GAAP occasioned by the use of those principles must be quantified on the face of the balance sheet.
The manner of disclosing GAAP variations is explained in the two alternative financial statement items in Form 20-F. The issuer must identify the body of accounting principles used in either the accountant's report or a reasonably prominent headnote preceding the financial statements. According to Form 20-F, material variations in the income statement must be reconciled in a tabular format substantially similar to the sample included in the text of Form 20-F. The issuer must show any quantified difference in each income statement item and how it affects net income. The quantified item variations causing a decrease in net income are segregated from those causing an increase. The balance sheet variations, on the other hand, may be presented "in parentheses, in columns, as a reconciliation of the equity section, as a restated balance sheet or in any similar format that clearly presents the difference in the amounts." If the variations quantified are "significant," the instructions to Form 20-F suggest including the quantifications on the face of the financial statements.

Compliance with United States GAAP has been a substantial obstacle to foreign issuers. Even before the adoption of more lenient standards for financial statements of foreign issuers, the Commission occasionally accepted financial statements that departed from United States GAAP. The 1982 developments relating to financial disclosure of foreign issuers take a small step backward in the progress toward the internationalization of United States securities markets. Mandatory quantification clearly is more beneficial to investors than discretionary quantification. Yet, it is unclear whether the benefit to the unsophisticated investor outweighs the detriment caused by the resultant unavailability of some foreign securities in United States markets.


Id. Item 17(c)(2)(ii).


desired security, he may find that very little financial disclosure is 
required.\textsuperscript{72} At the very least, the reconciliation and quantification 
provisions are now sufficiently specific for those foreign issuers that 
can afford to comply with them.\textsuperscript{73}

**D. Withdrawal of Deposited Securities**

The typical ADR deposit agreement provides that the United 
States Holder of the ADR certificate has a right to withdraw the un-
derlying deposited securities. This provision raises two questions to 
which section 4(1) of the Securities Act\textsuperscript{74} and rule 144\textsuperscript{75} do not pro-
vide clear answers. First, if the underlying deposited securities are 
not required to be registered, does withdrawal of the securities result 
in a de facto distribution of the deposited securities in the United 
States without registration? Second, and more importantly, can the 
United States Holder resell the deposited securities in the United 
States after they have been withdrawn?

The difficulties surrounding the first question may be illustrated 
as follows. First, assume the investment banking firm initiated the 
ADR arrangement. Assume further that the issuance of the ADRs in 
the United States does not trigger the requirement of registration of 
the deposited securities, because the issuer is not seeking to effect a 
distribution. When the United States Holder withdraws the depos-
ited security and takes delivery of the certificate in the United States, 
the deposited security arguably is being delivered within the mean-
ing of section 5 of the Securities Act.\textsuperscript{76} Because the deposited secur-
ity has not been registered under the Securities Act, the sale is 
unlawful unless section 4 of the Securities Act exempts the transac-
tion from section 5. It is not clear whether section 4 exempts such a 
sale. Section 4(1) exempts a transaction by any person other than an 
issuer, underwriter, or dealer.\textsuperscript{77} The Depositary, however, is not an 
issuer of the deposited securities and, presumably, is not an under-
writer, even though technically it may fall within the definition of un-
derwriter in section 2(11) of the Securities Act.\textsuperscript{78}

An analogous situation was presented in *Securities and Exchange*
Commission v. Chinese Consolidated Benevolent Association, Inc.,\textsuperscript{79} in which a benevolent association received money from its members to buy Chinese government bonds by depositing the money with the Bank of China's agent in the United States. The Second Circuit Court of Appeals held that the association was an underwriter despite the absence of an agreement with the issuer and the absence of commissions or other compensation. The court reasoned that the "solicitation was equally for the benefit of the Chinese government and broadly speaking was for the issuer in connection with the distribution of the bonds."\textsuperscript{80}

A fundamental distinction between Chinese Consolidated and the nonissuer ADR arrangement is that the distribution in Chinese Consolidated benefited the issuer. Nevertheless, because the Depositary could be considered an underwriter, it would be safest to seek a no-action letter from the Commission. The Commission may look at a number of factors in determining whether the delivery pursuant to the withdrawal orders of the ADR Holders causes the Depositary to become an underwriter of a distribution of the deposited securities. The most influential factor in such a decision is the volume of distribution\textsuperscript{81} over which the Depositary has no control except by limiting the ability to withdraw the deposited securities. Form F-6, however, requires that the securities be able to be withdrawn freely with limited exceptions, which do not include the prevention of a distribution of the deposited securities into United States securities markets. Given the requirements of Form F-6, and because the Commission does not appear to be concerned about a massive exercise of withdrawal rights, the Commission should take a no-action position.

The second question raised by the withdrawal provision of the typical ADR agreement—Can the United States Holder sell the deposited securities after withdrawal?—also has no clear answer. If the individual investor is serving as a "[link] in a chain of transactions through which securities move from an issuer to the public,\textsuperscript{82}" he may be an underwriter. The only safe harbor is to comply with current public information, volume, manner of sale, and holding period requirements of rule 144 to avoid being deemed a person engaged in the distribution of a deposited security.

A no-action position under section 4 of the Securities Act may also be sought for the definition of underwriter, but rule 144 contains criteria similar to that applicable in granting such a no-action request. Rule 144 usually will not apply to foreign securities, be-

\textsuperscript{79} 120 F.2d 738 (2d Cir. 1941), cert. denied, 314 U.S. 618 (1942).
\textsuperscript{80} Id. at 740.
cause its requirement that current public information be available is not satisfied by supplying information in compliance with rule 12g3-2(b), unless the same information outlined in rule 15c2-11(a)(4) has been supplied pursuant to rule 12g3-2(b). Although there is no apparent practical reason for an individual investor to buy ADRs for the purpose of selling the underlying security after withdrawal, the regulatory framework does not address this possibility.

V. Conclusion

Many other issues remain to be resolved in connection with the use of ADRs, such as potential liabilities under the terms of the deposit agreement or ADR certificate, choice of law in resolving disputes as to such liabilities, permissibility of forwarding proxy materials to ADR holders to elect to receive stock dividends,\(^8\) effect of a merger or consolidation on the ADRs, and Commission jurisdiction over an issuer that has not participated in the ADR arrangement.\(^8\)\(^4\) Unfortunately, most of these issues will never be resolved because the ADR is seldom the subject of administrative hearings or litigation.\(^8\)\(^5\)

The ADR is a valuable tool for achieving the goal of genuinely free international securities markets. However, the rationale underlying the more lenient standards for foreign issuers apparently is giving way to the Commission's avowed long-term plan of equal treatment for foreign and domestic issuers. Unless the United States is willing to compromise its domestic disclosure requirements to meet those of foreign countries, this goal of equal treatment may be unrealistic and self-defeating. Foreign companies may soon find their American investors in foreign markets, beyond the Commission's reach.

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\(^8\)\(^3\) Morgan Guaranty Trust Co., SEC No-Action Letter [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,075 (Oct. 17, 1974) (Commission determined that depositary bank could transmit and solicit proxies to U.S. ADR Holders regarding stock or cash dividend distribution without registration under the Securities Act, but could not make election between stock or cash available to such Holders without registration).
