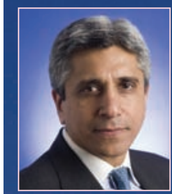
A fistful of dollars



AKBAR POONAWALA EXPLAINS THE RECENT RULE CHANGES IN THE US THAT MAY RESULT IN GREATER SHARE OWNERSHIP OF UK CORPORATES BY US INVESTORS.

Executive summary

- The US financial regulator has amended its rules for non-US equity issuers, making the creation of American Depositary Receipt programmes considerably easier. It's an opportunity that UK companies might want to seize.

Thanks to changes made by US regulator the Securities and Exchange Commission (SEC) to the Securities Exchange Act of 1934 which came into effect late last year, non-US security-issuing corporates no longer need to apply for exemption from SEC filing and reporting requirements. In effect, if they fulfil a few basic conditions – such as posting their domestic financial reports on a website in English, and conducting at least 55% of the trading volume of their equities on a primary exchange in their home market – they are automatically exempted and so can establish unsponsored and sponsored level I American Depositary Receipt (ADR) programmes for their shares.

IMPLICATIONS AND POTENTIAL BENEFITS The amendments to the SEC rules have potentially important implications for all publicly listed corporates based outside the US, although they should not be greeted with alarm.

There are two type of ADR programme: sponsored and unsponsored. A sponsored programme involves a single depositary bank. With unsponsored programmes, there may be up to four depositary banks operating programmes simultaneously for a particular issuer.

Unsponsored ADR programmes imply no cost or regulatory burden for the corporate in question. Indeed, such schemes can generate wide-ranging benefits. They can widen a corporate's investor base to include US investors that are unable or unwilling to invest overseas. Many US institutions – such as life assurance and pension funds – are not permitted to invest in foreign securities, and ADRs offer them a legitimate way to purchase the securities of non-US corporates. Unsponsored programmes can also be used to judge whether sufficient demand exists in the US to justify establishing a higher level ADR programme.

Anticipating significant demand for the shares of certain issuers in ADR form, depositary banks have set up unsponsored programmes for more than 800 companies worldwide. The vast majority of these companies only recently became eligible for such programmes as a consequence of the SEC rule changes.

Notwithstanding the benefits, some corporates were reportedly surprised to discover that depositary banks had established unsponsored programmes in their securities without their prior knowledge. The amended SEC rules allow depositary banks to initiate such an ADR programme without first obtaining consent or even notifying a company.

MANY US INSTITUTIONS – SUCH AS LIFE ASSURANCE AND PENSION FUNDS – ARE NOT PERMITTED TO INVEST IN FOREIGN SECURITIES, AND ADRS OFFER THEM A LEGITIMATE WAY TO PURCHASE THE SECURITIES OF NON-US CORPORATES.

UNFAMILIAR MARKET PRACTICES, FOREIGN CURRENCY CONVERSIONS AND OVERSEAS CUSTODY DISCOURAGE US INVESTORS FROM DIVERSIFYING INTERNATIONALLY, BUT ADRS MITIGATE MANY OF THESE OBSTACLES AND GENERATE A RANGE OF ADVANTAGES, SUCH AS GIVING PRICE QUOTATIONS AND DIVIDENDS IN US DOLLARS.

Deutsche Bank is one of the major depositary banks in the ADR market and has set up many of these programmes since the change in the regulatory regime. But before undertaking such action, it is the bank's policy to consult the corporate beforehand. If there are objections, the bank will not proceed. This period of consultation with the corporate is also an opportunity for the bank to explain the benefits of an ADR programme and to discuss the possibility of establishing a higher-level sponsored programme.

In terms of judging demand in the US for the ADRs of overseas corporates, the preferred route is to canvass opinion from buy-side organisations such as pension funds and other institutional investors. These institutions can give a strong idea of where demand for foreign-issued securities lies.

ADR HIERARCHY The first ADR scheme was set up in 1927 for British retailer Selfridges. ADRs represent a straightforward mechanism for individuals and institutions in the US to invest in the equities of foreign corporates without having to make any cross-border transactions. Depending on the nature of the scheme, ADRs can be traded over the counter (OTC) and/or on US-based exchanges. Much like ordinary equity, the highest level of ADR can be used by corporates to raise capital in the US.

From the perspective of potential US investors, there are numerous advantages to investing in foreign corporates through ADRs. Unfamiliar market practices, foreign currency conversions and overseas custody discourage US investors from diversifying internationally, but ADRs mitigate many of these obstacles and generate a range of advantages, such as giving price quotations and dividends in US dollars.

The hierarchy of ADR schemes requires different amounts of input and commitment from the issuing corporate. The unsponsored ADR is the most basic type: the securities are traded solely OTC and there is no regulatory or reporting requirements (aside from the basic conditions described above) for the corporate in question. Unsponsored ADRs can also be issued by more than one depositary bank, and are enjoying a resurgence since the SEC rule change.

Level I schemes are next in the ADR hierarchy. These involve a single designated depositary bank and are one of the most convenient ways for a corporate to actively gain exposure to US investors for their securities. Level I ADRs are OTC instruments with relatively minimal reporting requirements (the issuer merely posts on its website in English certain material information that it is already required to make available to shareholders in its home market).

A more substantial commitment is required for undertaking a level II ADR programme. Filing a registration with the SEC is mandatory and issuers must comply with either US GAAP or international financial reporting standards (IFRS). However, the key advantage of level II ADRs is that securities issued under the programme can be listed on US exchanges such as the New York Stock Exchange and Nasdaq.

The highest level of ADR – which requires the most commitment from issuers – is the level III programme. This type of ADR entails the issuance of new securities in the US for the purpose of raising capital and is subject to the most stringent SEC reporting requirements of all ADRs. Indeed, the level of regulatory commitment is very similar to that required from domestic corporates in the US that wish to make a public share offering.

As well as the standard escalating levels of ADRs, there are several mechanisms for overseas corporates to privately place depositary receipts with large qualified institutional buyers (QIBs). However, these are less common than the standard level I, II and III programmes.

Many corporates which have seen unsponsored programmes set up in their shares may, in due course, migrate to higher-level schemes if they judge there is sufficient demand from US investors to justify the added reporting burden.

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