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Un-sponsored ADR Programs: Challenges and Concerns

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Today's Discussion

- Background on ADR programs
- Impact of changes to Rule 12g3-2(b) exemption
- What are the legal implications of ADR programs?
- How do ADRs impact corporate actions?
- Counting shareholders / FPI determination

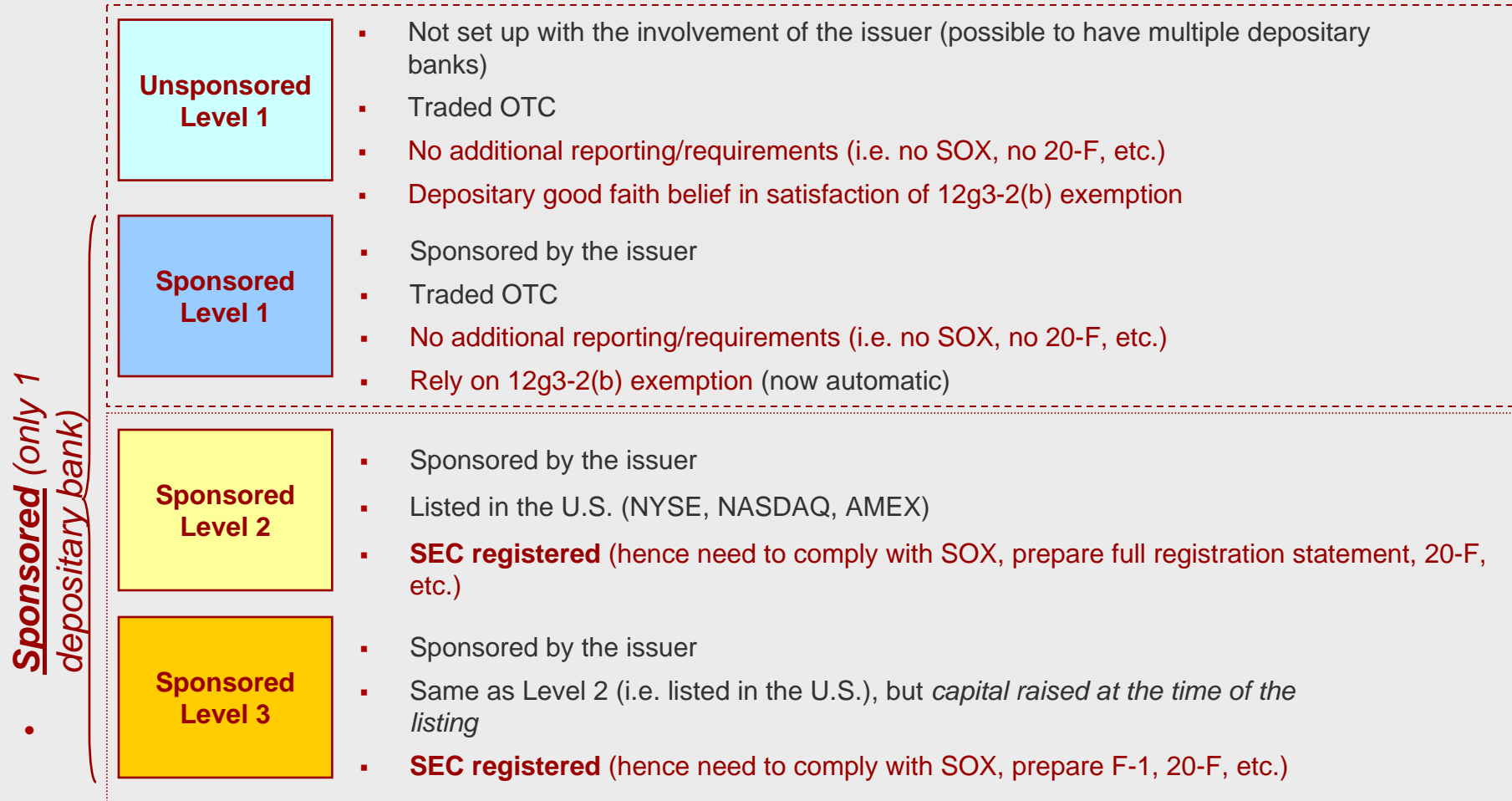
What is an ADR Program?

- American Depositary Receipt (ADR) programs are facilities that allow trading in the American market of shares listed outside the United States
- An ADR is a security issued by a depositary that represents a certain number of a foreign private issuer's underlying equity securities held by the depositary or its custodian
- ADRs are denominated in U.S. dollars and the depositary, as the holder of the underlying equity securities, converts any cash distributions attributable to such securities into U.S. dollars and passes them on to the ADR holders
- ADR holders sometimes have the right to vote the underlying shares through the depositary (generally only in *sponsored programs*)

Sponsored and Un-sponsored Programs

- **Sponsored programs:** the issuer is party to the deposit agreement and only one such ADR program can exist at a time
- **Un-sponsored programs:** the issuer is not party to the deposit agreement and multiple programs can exist simultaneously

There are 4 Types of ADR Programs



Why ADRs?

- Why do companies have ADR programs?
 - Increase and diversify shareholder base in US
 - Improve overall stock liquidity
 - Raise visibility in the US marketplace (with customers, suppliers, and peers)
 - Facilitate US employee stock plans
 - Raise capital in the US or use as acquisition currency (if listed ADR – i.e. Level 2 or 3 ADR)

- Why do investors buy ADRs?
 - Restrictions: certain funds can only hold dollar denominated instruments
 - Convenience: ease of holding and trading, as ADRs are like holding a US stock (no need to sell and clear offshore)
 - Larger trading window (from European opening to US close)

12g3-2(b) Exemption

- The SEC requires foreign private issuers having more than 300 shareholders resident in the US to either register that class of equity security with the SEC or satisfy the exemption from registration afforded by Rule 12g3-2(b)
- Amendments to 12g3-2(b) that took effect in October 2008 eliminated the previous requirements that issuers make written application to the SEC and periodically submit to the SEC hardcopies of their financial statements and other material communications to claim the 12g3-2(b) exemption
- Under the amended 12g3-2(b) exemption, foreign private issuers can **automatically qualify** for the exemption by satisfying the following conditions...

Requirements for 12g3-2(b) exemption

- The exemption from registration is automatically granted to foreign private issuers that:
 - Electronically publish “promptly” all “material information” (as discussed below) in English on their internet website that is (i) available to the public in their home country, (ii) filed within the exchanges on which they are listed or (iii) distributed to their shareholders;
 - Maintain a listing of shares on one or more foreign exchanges, which constitute the issuer’s primary trading market (meaning at least 55% of the average trading volume occurred on one or two securities exchanges outside the US and at least one of the non US exchange trading is higher than the trading in the US); and
 - Do not have SEC periodic reporting obligations (which generally means the company is not listed on a national securities exchange or has not publicly offered securities in the U.S.)

“Material” information and “prompt” publication

- The SEC has indicated that the following types of information should be considered “material” (and would therefore need to be disclosed promptly in English on an issuer’s website to qualify for the Rule 12g3-2(b) exemption):
 - results of operations or financial condition;
 - changes in business;
 - acquisitions or dispositions of assets;
 - the issuance, redemption or acquisition of securities;
 - changes in management or control;
 - the granting of options or the payment of other remuneration to directors and officers; and
 - transactions with directors, officers or principal security holders
- What is considered “prompt” depends on (i) the type of document and (ii) the amount of time required to prepare the English translation (same day publication of material press releases, but more time for financial statements and annual reports)

Changes to Rule 12g3-2(b): why so many unsponsored programs?

- An issuer must qualify for the 12g3-2(b) exemption or be registered with the SEC before an unsponsored ADR program can be established for its shares
- Now that the 12g3-2(b) exemption is effectively automatic for many foreign private issuers, depositary banks can assume, after limited inquiry, that an issuer qualifies for the exemption
- Depositaries are then free to create an unsponsored ADR program in respect of any such foreign private issuer's shares
- The result: nearly 1900 new unsponsored programs since October 10, 2008, the effective date of the 12g3-2(b) amendment (including: 118 U.K., 107 France, 138 Scandinavia, 70 Germany, 49 Spain, 44 Italy)

Sponsored/un-sponsored Level I ADRs – liability issues

- Form F-6 (ADR registration statement)
 - Securities Act liability issues
- Rule 12g3-2(b)
 - Exchange Act liability issues
- Jurisdictional nexus
 - *Pinker v Roche Holdings Ltd.*
 - Other activities
- Impact on D&O insurance?

Reporting Requirements of a Level-I ADR Program?

- There is no additional reporting requirement other than promptly providing material information (including financials and local disclosure) in English on the issuer's website (as provided by applicable local corporate law and stock exchange rules)
- No need for reconciliation to U.S. GAAP or IFRS
- No need for Sarbanes-Oxley compliance
- Accordingly, the US compliance impact and related costs from this perspective are limited

How do ADRs affect corporate actions?

- Is the depositary or the beneficial holder recognized as the shareholder under the corporate law of the issuer?
 - Impacts on voting rights or obtaining a quorum at shareholder meetings
 - Ability of depositary to vote underlying shares in different ways on behalf of beneficial owners on corporate actions such as mergers and schemes?
- Ability to extend rights offerings to holders of ADRs vs. cash-outs under the terms of the deposit agreement?
- Offering ADRs to target shareholders holding through ADRs in connection with business combination transactions
- Tender offer mechanics for target company ADRs
- Treatment of ADR holders in demergers/spin-offs

Counting shareholders / Timing

- Determining number or percentage of beneficial holders resident in the US is a critical concept for foreign companies under US securities laws
- “Look through” analysis to determine beneficial owners
 - To determine residence of beneficial holders holding through brokers, dealers, banks or other nominees
 - Only need to look through record ownership of nominees located in the US, place of organization of the issuer and, if other than one of the foregoing, the jurisdiction of the issuer’s “primary trading market”
- Timing of analysis?
 - Analysis for 300-holder threshold should occur as of each fiscal year end (if exemption hasn’t already been claimed); but since it is effectively automatic, calculation concerns have less significance than in the past—unless an issuer specifically seeks to exclude reliance on Rule 12g3-2(b)

FPI determination (only FPIs can have an ADR program)

- However, in order to benefit from the 12g3-2(b) exemption, a company must constitute a “foreign private issuer”, meaning that it is a company organized outside of the US in respect of which
 - 50% or less of the company’s outstanding voting securities are held by US residents *or*
 - Even if Shareholding Test is breached, none of the following apply:
 - A majority of the company’s executive officers or directors are US citizens or residents
 - More than 50% of the company’s assets are located in the US; or
 - The company’s business is principally administered in the US

Timing of FPI Determination

- SEC requires the FPI determination to be made as of the end of a company's second fiscal quarter
- However, since the availability of the 12g3-2(b) exemption and, consequently, the need for the 12g3-2(b) exemption is determined as of the year end and a company must be an FPI to claim the exemption, a company should monitor whether it is at risk of losing its FPI status and, if so, to confirm the percentage of US holders also as of its fiscal year end

Annex: What are ADR Programs and how do they work?

What are ADRs?

- ADRs are securities that represent the common stock of issuers listed on a non-U.S. exchange. ADRs are issued by a depository bank that holds the underlying shares represented by the ADRs with a custodian in the local market.
- ADRs are denominated in U.S. dollars and settle and clear like U.S. stocks.

Advantages of ADRs for the Issuer

- Improve the visibility of the issuer in the U.S.
- With a Level I ADR, no duty to provide periodic reports or paper filings to the SEC.
- Increase and diversify investor base.
- The depository can acquire the shares represented by the ADRs directly from the issuer, without affecting liquidity in the local market.
- ADRs can facilitate stock option plans and DRIPs for U.S. employees.

Advantages of ADRs for U.S. Investors

- U.S. investors can buy, hold and sell an ADR like any other U.S. stock.
- ADRs are settled and cleared in the U.S. and the payment of dividends (in U.S. dollars) and the exercise of voting rights, if applicable, are managed by the depository.
- ADRs provide access to investors that: (i) can only invest in U.S. stocks (or in a limited number of non-U.S. stocks); (ii) do not want to incur the expense of using a non-U.S. broker or depository.

Types of Programs

Sponsored

- Program is established at the request of the issuer, and the terms thereof are negotiated between the issuer and the depository.
- There can only be one sponsored program, and the existence of a sponsored program prevents unsponsored programs from being established.

Unsponsored

- Programs established by one or more depositories without the involvement (or sometimes even the consent) of the issuer.
- Multiple unsponsored programs may exist.

Disadvantages of Unsponsored Programs

- Issuer's loss of control over relationship with investors.
 - unilaterally sets the ratio of shares represented by each ADR and the program fees;
 - has no obligation to provide company communications to investors or exercise the investors' voting rights.
- The existence of multiple unsponsored programs with potentially variable fees and terms could cause confusion or discontent among investors.

The depository

Advantages of Sponsored Programs

- Issuer can negotiate the program terms: ratio of shares per ADR, fees, rights to shareholder information and voting.
- Issuer and depository can modify the terms of the program.
- Issuer maintains control over its investor relations.
- Often little or no cost to the issuer, as program fees pay for start up and program maintenance.

Types of ADRs

Level I

- Easy to establish.
- Issuer is not required to reconcile financials to US GAAP or IFRS, nor comply with Sarbanes Oxley.
- No additional reporting obligations; issuer must only comply with its local laws and listing requirements and publish its locally required disclosures and financials on its website in English.
- Traded OTC (Over the Counter).

Level II

- Registered with SEC, requiring reconciliation to U.S. GAAP (unless financials are prepared in English language IFRS) and compliance with Sarbanes Oxley.
- Non-capital raising, but listed on NYSE, NASDAQ or AMEX.

Level III

- Same as a Level II.
- In addition, Level III can be used for capital raising.

How Are Sponsored Level I Programs Established?

- Issuer must be exempt from SEC registration, but following amendments to Rule 12g3-2(b), most companies are automatically exempt. It is not necessary to formally apply to the SEC for the exemption.
- Issuer and depository will enter into a letter agreement and a deposit agreement that govern the program, including fees, issuance and transfer of the ADRs and the rights of holders.
- Form F-6 registration statement must be filed with the SEC and signed by the depository and the issuer's CEO, CFO, controller and a majority of the issuer's board of directors.
- Timeline: 2-5 weeks.

MCLE Code: NY Bar Attendees

Record this code now:

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New York Bar Participants will need to record this code on the MCLE Activity Form to receive New York MCLE credit for viewing this program.

Please email Latham & Watkins at rsvp@lw.com to obtain the Activity Form.

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