AMERICAN DEPOSITORY RECEIPTS [ADR]

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INTRODUCTION

- Before the introduction of ADRs in 1927, investors in the US faced numerous hurdles when attempting to invest in stocks of foreign companies. American investors could purchase the shares on international exchanges only, and that meant dealing with currency exchange rates and regulatory differences in foreign jurisdictions.
- They needed to familiarize themselves with different rules and risks related to investing in companies without a US presence. However, with ADRs, investors can diversify their portfolio by investing in foreign companies without having to open a foreign brokerage account.

What Is an American Depositary Receipt (ADR)?

- The term American depositary receipt (ADR) refers to a negotiable certificate issued by a U.S. depositary bank representing a specified number of shares—usually one share—of a foreign company's stock. The ADR trades on U.S. stock markets as any domestic shares would. ADRs offer U.S. investors a way to purchase stock in overseas companies that would not otherwise be available. Foreign firms also benefit, as ADRs enable them to attract American investors and capital without the hassle and expense of listing on U.S. stock exchanges.
- ADRs are listed on the NYSE, NASDAQ, AMEX and can be sold over-the-counter

- American depositary receipts are denominated in U.S. dollars. ADR holders do not have to transact the trade in the foreign currency or worry about exchanging currency on the forex market. These securities are priced and traded in dollars and cleared through U.S. settlement systems.
- In order to begin offering ADRs, a U.S. bank must purchase shares on a foreign exchange. The bank holds the stock as inventory and issues an ADR for domestic trading. ADRs list on either the New York Stock Exchange (NYSE) or the Nasdaq, but they are also sold over-the-counter (OTC). U.S. banks require that foreign companies provide them with detailed financial information. This requirement makes it easier for American investors to assess a company's financial health.

How does American Depositary Receipt (ADR) work?

- A company, listed on its domestic stock exchange, sells its shares to U.S. banks. The bank trades them on the U.S. exchange.
- The U.S. bank analyzes the company's financial health and issues American Depository Receipts based on their demand.
- Bank issues ADRs against the shares held by it. The American Depositary Receipts are available for trade on the major stock exchanges of America.
- Once the U.S. stock exchange lists the ADR certificates for trading, investors can buy them through brokers or dealers.
- Securities Exchange Commission (SEC) is the American regulatory body. It ensures compliance with U.S. and foreign trading policies during ADR trading.

ADR risk factors and expenses

Because ADRs are issued by non-US companies, they entail special risks inherent to all foreign investments. These include:

- **Exchange rate risk**—the risk that the currency in the issuing company’s country will drop relative to the US dollar
- **Political risk**—the risk that politics or regime changes in the issuing company’s country will undermine exchange rates or destabilize the company and its earnings
- **Inflation risk**—the risk that inflation in the issuing company’s country will erode the value of that currency

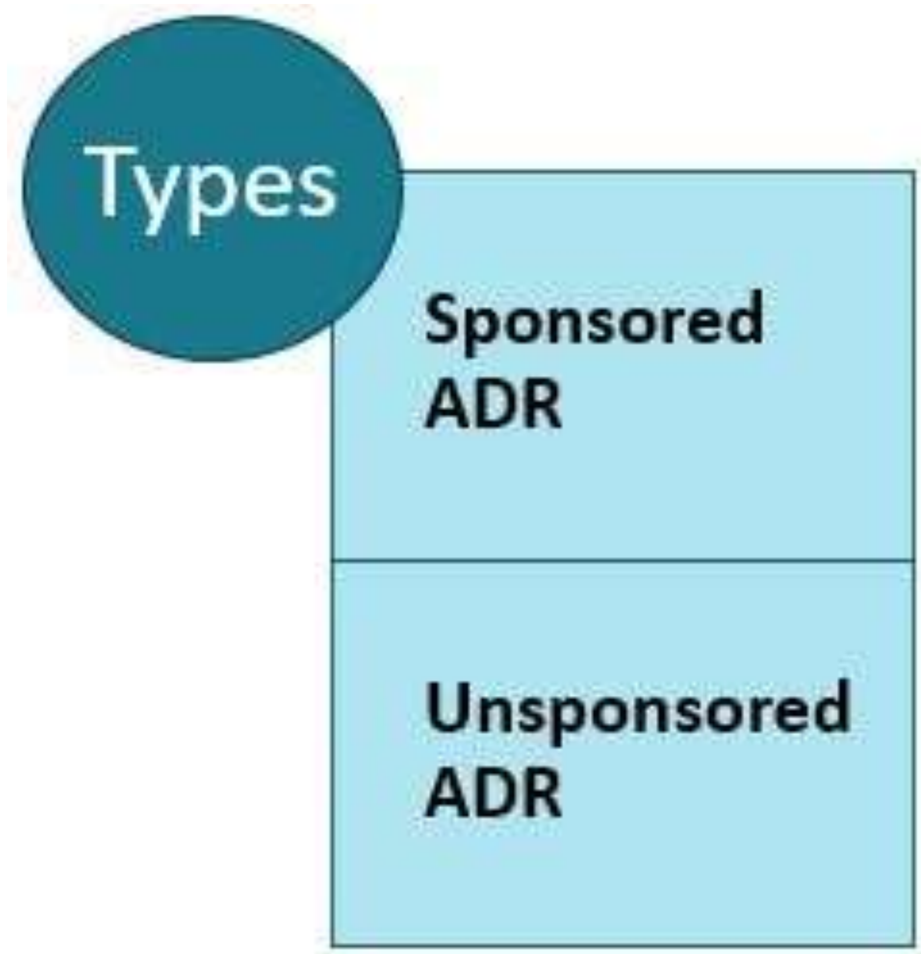
Pros

- Easy to track and trade
- Available through U.S. brokers
- Denominated in dollars
- Offer portfolio diversification

Cons

- Could face double taxation
- Limited selection of companies
- Unsponsored ADRs may not be SEC-compliant
- Investor's may incur currency conversion fees

Types of American Depositary Receipts



The ADRs that are sold in US financial markets can be categorized into sponsored and unsponsored.

1. Sponsored ADR

- For a sponsored ADR, the foreign company issuing shares to the public enters into an agreement with a US depositary bank to sell its shares in US markets. The US bank is responsible for recordkeeping, sale, and distribution of shares to the public, distribution of dividends, etc. Sponsored ADRs can be listed on the US stock exchanges.

2. Non-Sponsored ADR

- A non-sponsored ADR is created by brokers/dealers without the cooperation of the foreign company issuing the shares. Non-sponsored ADRs are traded in US over-the-counter markets without requiring registration with the Securities and Exchange Commission (SEC).

Levels of American Depositary Receipts

- ADRs are grouped into three levels depending on the extent of the foreign company's access to the US trading market.
- **1. Sponsored Level I:** Level I is the lowest level at which sponsored ADRs can be issued. It is the most common level for foreign companies that do not qualify for other levels or that do not want their securities listed on US exchanges. Level I ADRs are subject to the least reporting requirements with the Securities and Exchange Commission, and they are only traded over the counter. The companies are not required to issue quarterly or annual reports like other publicly traded companies. However, Level I issuers must have their stock listed on one or more exchanges in the country of origin. Level I can be upgraded to Level II when the company is ready to sell through US exchanges.

2. Sponsored Level II ADRs: Level II ADRs have more requirements from the SEC than Level I, and the company gets an opportunity to establish a higher trading presence on the US stock markets. The company must file a registration statement with the SEC. Also, the company must file Form-20-F in accordance with the GAAP or IFRS standards. Form 20-F is the equivalent of Form-10-K, which is submitted by US publicly traded companies. If the issuer fails to comply with these requirements, it may be delisted or downgraded to Level I.

3. Sponsored Level III ADRs: Level III is the highest and most prestigious level that a foreign company can sponsor. A foreign company at this level can float a public offering of ADRs to raise capital from American investors through US exchanges. Level III ADRs also attract stricter regulations from the SEC. The company must file Form F-1 (prospectus) and Form 20-F (annual reports) in accordance with GAAP or IFRS standards. Any materials distributed to shareholders in the issuer's home country must be submitted to the SEC as Form 6-K. Examples of foreign companies that have managed to enter this ADR level include Vodafone, Petrobras, and China Information Technology.

Global Depository Receipts

Global Depositary Receipt (GDR)

GDRs are negotiable certificates issued by depositary banks that represent ownership of a specified number of a company's shares.

They are listed on Non-US stock exchanges like the London Stock Exchange or the Luxembourg Stock Exchange. The GDR market is an institutional one and hence offers less liquidity but allows trading across a more significant number of countries.

For example, if Infosys wants to list its share in Australia, they will deposit a substantial number of shares with an Australian Bank. The bank can then issue receipts (GDRs) against these shares to investors. Each receipt represents a particular number of shares.

GDR IN THE INDIAN MARKET

SEBI came out with a detailed framework for issuance of depository receipts (DR) in October 2019. The introduced changes allow increased access to foreign funds through ADRs and GDRs.

Indian companies can now list their GDR at the International Financial Services Centre in Gujarat. With the new rules in place, the companies now have an additional source for raising funds. As per the amended rules, DRs can be issued by way of public offering, private placement, or in a manner that is accepted in the concerned jurisdiction. Companies planning to issue GDR need to seek prior approval of the Ministry of Finance and Foreign Investment Promotion Board (FIPB).

Examples of companies that have issued GDRs in India include Aditya Birla Capital listed in the Luxembourg Stock Exchange, GAIL Indian is listed in the London Stock Exchange, UPL is listed on Singapore Exchange.

Features of Global Depository Receipts

Exchange-Traded – Global Depository Receipts are exchange-traded instruments. The intermediary buys a bulk quantity of a foreign company and creates the GDRs, which are then traded on the local stock exchange. Since GDRs are for multiple countries, they can trade on various stock exchanges at the same time.

Conversion Ratio – The Conversion Ratio, which means the number of shares of a company that one GDR holds can be anything ranging from a fraction to a very high number. It depends on the type of investors that the intermediary is planning to target. Usually, one GDR certificate holds 10 shares. But the range is flexible.

Unsecured – Global Depository Receipts are unsecured securities. They are not backed by any asset, other than the value of the shares held in that certificate.

Price Based on Underlying – The price of a GDR is based on the price of the shares that it holds. The price also depends on the supply and demand of a particular GDR, which can be managed. The intermediary might price it a touch higher than just the value of the securities in terms of transaction costs, etc., to make a profit for being the intermediary.

Advantages of Global Depository Receipts

Liquidity – Global Depository Receipts are liquid instruments that are traded on stock exchanges. The liquidity can be managed by managing the supply-demand of the instruments.

Access to Foreign Capital – GDRs have emerged as one of the essential mechanisms to raise capital from foreign markets in today's world. The securitization process is being carried out by big names such as JP Morgan, Deutsche, Citibank, etc. It is giving companies all over the world access to foreign capital through a relatively simpler mechanism. It is also helping companies increase their worldwide visibility by issuing GDRs in multiple countries.

Easily Transferrable – Global Depository Receipts can be easily transferred from one person to another. It makes trading them easy, even for non-resident investors. The transfer of GDR does not involve extensive documentation like some other securities.

Potential Forex Gains – Since GDRs are international capital market instruments, they are exposed to foreign exchange rate volatility. The dividends paid for every share in a GDR is denominated in the domestic currency of the company whose shares are being held in the GDR. A favorable exchange rate movement can potentially provide gain beyond just the capital gains and the dividends received for the shares in a GDR.

Disadvantages of Global Depository Receipts

- The following are the disadvantages of global depository receipts(GDR)
- **High Regulation –** Since Global Depository receipts are issued in multiple countries, they become subject to regulation from various financial regulators. It is crucial to adhere to all the regulations, and even a small mistake can lead to a company being heavily reprimanded. Companies might have to bear huge consequences for even a tiny mistake.
- **Forex Risk** – As we stated earlier, Global Depository Receipts are exposed to the foreign exchange rate volatility. Since the dividends received and the original price of the shares are denominated in the foreign currency, an **appreciation of foreign currency** can reduce the return generated and even cause losses to the investors.
- **Suitable for HNIs** – Global Depository Receipts are usually issued with the multiple numbers of shares in each certificate to lower the transaction costs. Small investors might not be able to shell out that kind of money and might be unable to take advantage of the GDR. In this case, it becomes a more suitable product for HNIs.
- **No Voting Rights** – Under the mechanism of the Global Depositary Receipts, the shares of a company are sold in bulk to an intermediary in another country who further securitizes them into GDRs. Therefore, the voting rights in the company are retained by the intermediary who has directly bought the shares, and not by investors who buy the GDR.

Difference Between ADR and GDR

- ADR is an abbreviation for American Depository Receipt whereas GDR is an acronym for Global Depository Receipt.
- ADR is a depository receipt issued by a US depository bank, against a certain number of shares of non-US company stock, trading in the US stock exchange. GDR is a negotiable instrument issued by the international depository bank, representing foreign company's stock that is offered for sale in the international market.
- With the help of ADR, foreign companies can trade in US stock market, through various bank branches. On the other hand, GDR helps foreign companies to trade in any country's stock market other than the US stock market, through ODB's branches.
- ADR is issued in America while GDR is issued in Europe.
- ADR is listed in American Stock Exchange i.e. New York Stock Exchange (NYSE) or National Association of Securities Dealers Automated Quotations (NASDAQ). Conversely, GDR is listed in non-US stock exchanges like London Stock Exchange or Luxembourg Stock Exchange.
- ADR can be negotiated in America only while GDR can be negotiated in all around the world.

Thank You