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The Threat of Un-sponsored ADR Programs

Foreign companies are being targeted by US depository banks as a result of new rules that have relaxed the requirements on unsponsored American Depositary Receipt programs. Foreign companies need to be ready to guard against having new securities trading in the United States without their consent as depository banks seek to register unsponsored ADRs on their shares.

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Recently adopted amendments to Rule 12g3-2(b), which exempts foreign private issuers from the registration requirements of Section 12(g) of the Securities Exchange Act of 1934 (Exchange Act), have limited the ability of foreign companies to control the establishment of unsponsored American Depositary Receipt (ADR) programs in their securities and have resulted in the explosive growth of these unsponsored programs. Significant concerns arise for foreign companies when unsponsored ADR programs are created in their securities.

Overview of ADR Programs

An ADR is a certificate that evidences American Depositary Shares (ADSs and, together with ADRs,

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ADRs), which represent one or more (or a fraction) of an underlying security (typically ordinary shares of non-US companies). The ADRs are issued by a US commercial bank, known as the depository, through a depository facility (also referred to as an ADR program). ADR programs permit investors to invest in securities of non-US companies through an instrument denominated in US dollars and with a three-day settlement; dividends also are paid in US dollars. If the securities underlying the ADRs are listed on a US national securities exchange or are the subject of a US public offering, the ADRs and the underlying securities must be registered with the Securities and Exchange Commission (SEC) under the Exchange Act. Registration under the Exchange Act subjects the issuer to annual and interim reporting and disclosure obligations, including requirements to reconcile financial statements to IFRS or US GAAP, as well as the provisions of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act).

Levels of ADR Programs

There are three levels of ADR programs.

Level I

In a Level I program, the ADRs are traded in the US over-the-counter market. While a Level I program does not involve an official stock exchange listing in the United States, it permits US residents and other investors to trade the securities of a foreign company in dollars in the US settlement system. Level I programs do not trigger Exchange Act reporting and disclosure

obligations, including requirements under the Sarbanes-Oxley Act, provided the issuer qualifies for a Rule 12g3-2(b) exemption as described below. In addition, the ADR depository must file a Form F-6 registration statement with the SEC. A Form F-6 registration statement contains limited information and includes no substantive information about the issuer or the underlying securities.

A Level I ADR program may be sponsored or unsponsored. A sponsored ADR program is created when the issuer of the deposited securities enters into a deposit agreement with a depository that agrees to issue ADRs against the deposit of the issuer's shares in the issuer's home market. Under a sponsored ADR program, the issuer is able to exercise control regarding the terms and operation of the ADR program. Sponsored ADRs are issued by a single depository and cannot be duplicated by another depository.

An unsponsored ADR program, on the other hand, is set up by a depository without the participation or consent of the issuer. While the depository may request a letter of non-objection from the issuer before establishing an unsponsored ADR program, there is no obligation or condition that the issuer's consent for the ADR program be obtained. Effectively, there is no limit on the number of unsponsored ADR programs that can be established. The most effective way for an issuer to prevent the establishment of an unsponsored ADR program is for the issuer to set up a sponsored ADR program.

The SEC staff has taken the position that an unsponsored program may not coexist with a sponsored program for the same securities because of the market disorder and confusion that could result.¹ Therefore, once an issuer establishes a sponsored ADR program, unsponsored ADR programs for the same underlying securities may not be established. If an issuer seeks to set up a sponsored program after one or more unsponsored programs have been created, the preexisting unsponsored programs must first be terminated and the underlying securities and accounts of ADR holders under such programs must be transferred to the new sponsored program. There may be fees associated with collapsing such

unsponsored programs, which the issuer may be required to pay.

Level II

A Level II ADR program always is sponsored as it involves listing the ADRs and the underlying securities on a US stock exchange. A Level II ADR program is used by issuers that are not raising capital at the time of its establishment. Level II ADR issuers are required to file a Form 20-F registration statement and must comply with reporting and disclosure obligations under the Exchange Act, including, among others, requirements under the Sarbanes-Oxley Act, and a requirement to reconcile financial statements to IFRS or US GAAP.

Level III

Level III ADR programs always are sponsored and are used by issuers to list the ADRs and underlying securities on a US stock exchange and to conduct a public offering in the United States at the same time. Because these programs involve a registered offering of securities in the United States, Level III ADR issuers generally file a registration statement on Form F-1 under the Securities Act of 1933 (Securities Act). The depository also is required to file a registration statement on Form F-6. A Level III ADR program subjects issuers to the same Exchange Act reporting and disclosure obligations as Level II ADR issuers, including the requirements under the Sarbanes-Oxley Act.

Legal Framework of Rule 12g3-2(b)

As mentioned above, whether an ADR program is sponsored or unsponsored, the ADR depository must file a registration statement with the SEC on Form F-6 before the ADRs can be traded. A depository only may file a Form F-6 and issue ADRs if the issuer is a reporting company under the Exchange Act or exempt from Exchange Act registration under Rule 12g3-2(a) or Rule 12g3-2(b).

Under Section 12(g) of the Exchange Act, an issuer must register within 120 days of the last day of its fiscal year, and be subject to the onerous reporting requirements of the Exchange Act, if the issuer

has 500 or more recordholders of its equity securities, and its total assets exceed \$10 million. However, an issuer will be exempt from registration under the Exchange Act: (1) under Rule 12g3-2(a) if fewer than 300 holders of its equity securities are resident in the United States as of each fiscal year end, or (2) by claiming the Rule 12g3-2(b) exemption.

In addition to allowing issuers to be eligible for Level I ADR programs, the Rule 12g3-2(b) exemption provides a number of benefits. For example, the exemption:

- Avoids the risk that the foreign private issuer inadvertently may be subject to the reporting requirements of the Exchange Act if it is discovered that the issuer has more than 500 holders of its equity securities;
- Ensures automatic compliance with the informational requirements of Rule 144A under the Securities Act, which requires the issuer to provide a buyer of such issuer's securities pursuant to Rule 144A, upon request, with a brief statement of the nature of the issuer's business and of its products and services as well as certain financial information. Under Rule 144A(d)(4), issuers must make general information available to investors upon their request, including "the issuer's most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as the issuer has been in operation." These financial statements, which generally would be prepared in accordance with statutory (home-country) accounting principles, are required to be audited to the extent audited financial statements are "reasonably available;"
- Enables the issuer to qualify for an exemption from the securities laws of a number of US states; and
- Avoids any impediment to trading that may arise in the secondary market because of a potential failure of transmission of information required under Rule 144A(d)(4).

In general, to claim the exemption under 12g3-2(b), an issuer must not have any class of securities listed on a national securities exchange in

the United States or otherwise be a reporting company under the Exchange Act, and the issuer must maintain a foreign listing. Additionally, the issuer must have published its material disclosure documents since the beginning of its most recent fiscal year, in English, on its Web site or through an electronic information delivery system generally available to the public in its "primary trading market." Prior to the recent amendments to Rule 12g3-2(b) effective October 10, 2008, an issuer was required to apply by written application to the SEC for a Rule 12g3-2(b) exemption and periodically provide information to the SEC on an ongoing basis in order to maintain the exemption. Therefore, an issuer could prevent a depository from launching an unsponsored ADR program by not applying for the exemption.

Recent Amendments to Rule 12g3-2(b) and ADR Programs

Effective October 10, 2008, the SEC amended Rule 12g3-2(b) and Form F-6. The Rule 12g3-2(b) amendments eliminated the written application process formerly required for the 12g3-2(b) exemption, and provided for the automatic availability of the exemption as long as the required information is made available on the issuer's Web site.² Similarly, the amendments to Form F-6 now only require the depository to state that, if the issuer of the securities is not an Exchange Act reporting company, the securities are exempt from registration by 12g3-2(b). Additionally, a depository now may file a Form F-6 for an unsponsored ADR program if the depository, after reasonable diligence, holds a "reasonable, good faith belief" that the issuer complies with the requirements. Finally, it should be noted that the SEC has declined to require that the depository obtain the consent of the issuer of the underlying securities before registering ADRs on Form F-6.

Many depositories have taken the position that the combination of the amendments to Rule 12g3-2(b) and the revisions to Form F-6 have made it easier to establish unsponsored ADR programs and these depositories have therefore increased their activities in setting up unsponsored Level I ADR programs without the issuer's consent or knowledge.

Before the amendments, an issuer could prevent an ADR depository from establishing unsponsored ADRs by not formally applying for or meeting the requirements of the Rule 12g3-2(b) exemption. Accordingly, the automatic availability of the exemption for issuers and the reasonable belief standard for depositories have facilitated the proliferation of unsponsored ADR programs.

Considering that ADR depositories can generate substantial fees from investors for issuing and canceling ADRs, ADR depositories have been active in unilaterally establishing unsponsored ADRs to meet purported demand for previously unlisted issuers' securities. According to statements made by several market observers and regulators, over 1,000 unsponsored ADR programs have been established by depositories in the weeks following the adoption of the recent amendments to Rule 12g3-2(b). European companies have been the principal targets to date for the establishment of these unsponsored ADR programs.

Legal and Practical Implications to an Issuer of an Unsponsored ADR Program

Several legal and practical consequences may stem from the establishment of an unsponsored ADR program for an issuer's securities. For example, the establishment of an ADR program may increase interest in the issuer's securities in the US market and result in an issuer having more than 300 holders of a class of its equity securities in the United States. This scenario would trigger the requirement that the issuer register the class of securities with the SEC under Section 12(g) of the Exchange Act unless it has qualified for and maintained a Rule 12g3-2(b) exemption.

In order to determine the appropriate course of action, an issuer should determine whether one or more ADR programs have been established on its behalf by checking the SEC Web site for a Form F-6 filed under the issuer's name. Additionally, an issuer should calculate (or hire an outside expert to calculate) the number of outstanding shareholders, considering that the SEC requires one to "look through" the holders of record to determine the identity of the actual beneficial holders.³

In addition, the issuer's lack of control over one or more unsponsored ADR programs may lead to market perception problems arising from an investor drawing negative conclusions in respect of the issuer's securities, particularly if the investor is unaware that an ADR program is unsponsored. In an unsponsored program, the issuer has very little control over the US trading price of the ADRs because the issuer does not participate in negotiating the share to ADR ratio. Accordingly, multiple depositories could create confusion among investors by offering ADRs at different prices and ratios.

However, even if the depository in question were to withdraw the unsponsored program, this does not foreclose other depository banks from creating new unsponsored programs unless the issuer takes additional affirmative steps. Even if an issuer is successful in withdrawing its securities from an unsponsored program, investors may be displeased by the suspension or termination of ADRs trading in the US market, and downward selling pressure may result. An issuer that has successfully cancelled an unsponsored ADR program should be careful when limiting English disclosure on its Web site, or stating on the Web site that the information provided is not sufficient to satisfy Rule 12g3-2(b), as such issuer may be perceived as effectively opting for less disclosure to its existing shareholders.

Additionally, the issuer has no control over the fees charged to the ADR holders by the depository. Finally, considering that multiple unsponsored programs may exist for the securities of a single issuer, depositories may provide different services to their holders. For example, multiple depositories may offer dividend payments to holders at different exchange rates, which may create confusion among holders. Therefore, one or more unsponsored depository programs may cause a negative perception of the issuer in the US market.

Corporate governance problems also may arise from the creation of unsponsored ADR programs. Depositories of unsponsored ADR programs typically do not provide voting rights to ADR holders for the underlying shares, distribute shareholder communications, or establish procedures for

shareholder services such as rights offerings, stock splits, and corporate reorganizations, which may jeopardize investor relations. As the number of shareholders increases with the creation of a large unsponsored ADR program, an issuer's ability to obtain a quorum or pass shareholder resolutions may be impaired.

Options Available to an Issuer that Discovers an Unsponsored ADR Program

An issuer that finds its securities trading in an unsponsored ADR program should voice its strong objection to the depositary. While a depositary is not required to terminate an unsponsored program upon the issuer's request, a number of unsponsored ADR programs have been withdrawn shortly after their establishment, upon the issuer's request. Objecting to the program may be particularly effective if the issuer believes that it is ineligible to qualify for the 12g3-2(b) exemption because the issuer's stated non-compliance would make it unlikely that the depositary could reasonably believe the issuer is compliant. In this regard, care also should be exercised to determine that the existing unsponsored ADR program has not increased interest in the issuer's securities in the US market and resulted in the issuer having more than 300 holders of a class of its equity securities in the United States, as this scenario would trigger the requirement that the issuer register the class of securities with the SEC under Section 12(g) of the Exchange Act unless it has qualified for and maintained a Rule 12g3-2(b) exemption. Issuers also may be required to pay termination fees in connection with the closing of an established unsponsored program, particularly when there are several unsponsored programs in place.

An issuer can foreclose the establishment of an unsponsored ADR program by setting up its own sponsored Level I ADR program. As noted, the SEC has stated that a sponsored program cannot coexist with an unsponsored program. Therefore, if an unsponsored program does not already exist, an issuer may establish a sponsored program. The benefits of a sponsored program over an unsponsored program are numerous. The issuer can negotiate the appropriate share to ADR ratio with the depositary

and exercise more control over the voting, dividend payment and other provisions of the deposit agreement under a sponsored program, thereby avoiding many of the market perception and corporate governance problems discussed above. Further, the issuer can communicate directly with ADR holders, which should foster more positive investor relations.

Conclusion

An issuer faces a host of potential problems when a depositary establishes an unsponsored ADR program on behalf of an issuer without the issuer's consent or knowledge. Non-US companies without unsponsored ADR programs should consider foreclosing the establishment of unsponsored ADR programs in their securities by establishing a sponsored Level I ADR program. Alternatively, non-US companies in non-English speaking jurisdictions that wish to avoid the establishment of an unsponsored ADR program should consider limiting English disclosure on their Web site, including adding a note to the effect that the information provided is not sufficient to satisfy Rule 12g3-2(b) provided there is relatively little or no US market interest in their securities. Non-US companies with unsponsored ADR programs also should address the following issues:

- Whether the issuer qualifies for the 12g3-2(a) exemption and is exempt from registration under the Exchange Act;
- Whether the issuer is able to remain fully compliant with revised Rule 12g3-2(b) and remain exempt from registration under the Exchange Act, including the potential for technical non-compliance for failure to present fully-translated English language annual reports and other required documents;
- Whether the issuer risks US market perception and corporate governance problems due to the existence of an unsponsored ADR program;
- Whether terminating an existing unsponsored ADR program can be done without having a negative effect on investor relations and on demand for the issuer's securities; and
- Whether establishing a sponsored Level I ADR program would promote the issuer's interests.

NOTES

1. SEC Release No. 33-6894 (May 23, 1991).
2. SEC Release No. 34-58465 (September 5, 2008).
3. “Holders of Record” under Rule 12g3-2(a) is determined by Rule 12g5-1, which generally defines holders of record as “each person who is identified as the owner on records of security holders maintained

by or on behalf of the issuer...” However, for purposes of 12g3-2(a), securities held of record by a broker, dealer, bank or nominee for the accounts of US residents are counted as held by the number of separate accounts for which the shares are held. The issuer may rely in good faith on information as to the number of such separate accounts supplied by the brokers, dealers, or banks or a nominee for any of them.

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