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The ADR: An Instrument of International Finance and a Tool of Arbitrage

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THE ADR: AN INSTRUMENT OF INTERNATIONAL FINANCE AND A TOOL OF ARBITRAGE

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I.

SPECIALIZATION IN OUR SECURITY MARKETS.

ONE HUNDRED AND SEVENTY years have been added to the pages of financial history since twenty-four New York security brokers created a rather loose formal organization in 1792 by signing an agreement to the effect that they would not buy or sell "any kind of stock at a less rate than one-quarter percent commission. . . . " Until 1817, these brokers met "in the open air" to transact their daily business. Over these years, there has evolved a considerable degree of specialization in the New York financial market: two principal stock exchanges having 2,280 members dealing in 2,487 issues;[1] the emergence of a third stock exchange, a produce exchange, a cotton exchange, a cocoa exchange, and a coffee and sugar exchange; investment bankers, analysts, chartists, customers men, brokers who are exchange members, and brokers who are members of no exchange but who "make" the over-the-counter market in particular types of securities such as government bonds, real estate bonds, foreign securities, bank and insurance company securities, as well as securities of corporations enjoying a rather limited geographic market.

The purpose of this article is to deal with that highly specialized field whereby residents of one country buy, hold or sell the securities of another country—the international arbitrage of securities. International trading in securities has a direct relationship to international commerce, plays a part in the shifting of bank credits between countries, affects the international balance of payments, and helps to stabilize daily rates of foreign exchange. We shall review some of the problems that initially arose in the New York market in the international arbitrage of securities, and the manner in which these and

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1. The New York Stock Exchange reports that as of July 31, 1962 there were 7,533,263,840 shares listed on that Exchange with a total market value of $318,839,254,058. The American Stock Exchange reports that as of December 31, 1961, there were 1,799,444,094 shares listed and unlisted on that Exchange with a total market value of $33,010,870,230.

subsequent hardships were overcome by the mechanism of dealing in foreign securities in the form of American Depositary Receipts.

II.

THE AMERICAN VENTURE INTO FOREIGN SECURITIES.

In the late 1920's the domestic market in equity securities was such that certain farsighted brokers and investors broadened their viewpoints and examined special situations in foreign (primarily United Kingdom)[2] equity securities tinged with an American flavor—such as the stocks of British-American Tobacco Company, Limited, Ford Motor Company Limited,[3] and The Singer Manufacturing Company Limited. Soon a considerable amount of American investment developed in these and other foreign stocks, and this interest and such investments brought into focus those specialized security traders known as "arbitragers."[4] Such specialists had operated for many years in Europe, but not in the United States financial community.

The situation then was that trading in actual foreign certificates was subject to risks, delays, inconvenience, and expense not inherent in trading in domestic securities. Aside from the obvious barriers of time, language, and differing customs, other problems which arose in dealing directly with the physical foreign securities made it highly desirable to devise a system to overcome these hardships. Many brokers and investors hesitated and even refrained from dealing in foreign securities at that time because of the differences between American and foreign forms and customs, and the varying financial and corporate practices. Regular transatlantic air passenger and air mail service had not yet begun. Transit delays because of the distance between the United States and European security markets were an important deterrent to the growth of interest in foreign stocks, since time is usually an important factor in the completion of a security

2. As this article spans many years, both prior and subsequent to exchange control regulations, the term "United Kingdom" is used in a general geographic sense and not as a substitute for the term "Scheduled Territories" (nor the obsolete term "Sterling Area") as it is strictly defined in the (English) Exchange Control Act, 1947.

3. The Ford Motor Company, Dearborn, acquired the Ordinary Capital of Ford Motor Company Limited pursuant to the Offer dated December 10, 1960.

4. The New York Stock Exchange had adopted the following definition for international arbitrage in securities:

> The term "International Arbitrage In Securities" means the business of buying or selling securities in one market with the intent of reversing such transactions in a market in a country different from that in which the original transaction has taken place, in order to profit from price differences between such markets, and which business is not casual but contains the element of continuity.

transaction. On purchases, delays were naturally inevitable, but on sales there were also delays in obtaining the proceeds of securities sold in their native markets, with the added hazards of fluctuating exchange rates, loss of return on invested capital, and heavy transportation costs. Once an American purchased a foreign security, the physical transfer of the actual certificate and the collection of dividends in foreign funds merely added to existing difficulties. Upon the death of an American who had foreign securities registered in his name, ancillary administration proceedings in the courts of the foreign country would in most cases be required, as well as payment of applicable death or estate duties, before the securities could be transferred out of the name of the decedent or accrued dividends collected. The practice of foreign corporations of issuing bearer shares presented another difficulty in that American shareholders had no direct contact with the corporations and were required to watch financial publications (in many instances printed in a foreign language) for notices covering corporate activities, meetings, dividend declarations, mergers, and capital reorganizations. Often they were faced with the burden of shipping their holdings back to the country of origin or, in some cases, to an agency appointed in the United States, before they could collect dividends. Americans had long been accustomed to and preferred registered shares which permit the receipt of notices of corporate action, meetings, and dividend checks, at the address of the registered holder.

In an attempt to overcome the difficulties recited, as well as many others, various solutions were studied such as the creation of negotiable receipts to be used in the American market in lieu of the stock certificates of foreign corporations. Some of these devices took the form of separate deposit agreements entered into by various parties such as a Depositary bank, the foreign corporation, and an underwriter who was interested or instrumental in marketing the shares of a particular foreign company in this country. These deposit agreements were basically similar, but with variations depending on the circumstances surrounding each issue, or the particular purpose to be served. A number of these early deposit agreements were between a broker and a Depositary bank—the foreign corporation not being a party. It was necessary for the principals (the broker and the Depositary) to reach mutual accord in solving new problems not specifically covered in the text of these primitive deposit agreements. It was inevitable, though not then appreciated, that with the erosion of time the particular broker, for a variety of reasons, would cease to be in business. In such cases the Depositary bank would then find itself in the uncomfortable position that called for unilateral policy as well as operational decisions not

visualized at the time the agreement was executed. Thus, even then it was apparent that one of the weaknesses of these preliminary attempts was the absence of continuity, even in those cases where the purposes to be served would lend themselves to standardization. The need was urgent for an acceptable American certificate which would be uniform with regard to the functions to be performed and the fees to be charged, and which at the same time, would contain elements which could be properly performed only by an American bank or trust company. It must be remembered that initial American investment interest in foreign securities was directed to United Kingdom equities and, as United Kingdom companies are not permitted to maintain a registrar (corresponding to our stock transfer agency) outside of the United Kingdom and the Commonwealth, it was important to create "substitution certificates" that could be issued, traded, and transferred in the United States, in order to meet this new venture abroad. In many, many instances the foreign corporation at that time was not interested in creating an American market in its securities and therefore it was obvious that the solution to these problems would lie only in our own national ingenuity and ability for specialization.

In 1927, Guaranty Trust Company of New York,[5] in co-operation with several prominent arbitrage brokers both in New York and abroad, and in collaboration with various stock exchanges, devised a system for the creation of American Depositary Receipts whereby the only parties were the Depositary and the holders of the Receipts, the foreign corporations not being a party to these arrangements. These Receipts quickly received popular acceptance.

III.

THE ADR.

American Depositary Receipts,[6] or "ADR's" as they are now commonly known and referred to in this country and abroad, are instruments designed to overcome the earlier difficulties and to facilitate the purchase, holding, or sale of foreign securities by Americans. Contrary to the possible inference to be drawn from their title, ADR's in all cases represent, and are negotiable receipts for, foreign securities. In the ADR, the Depositary certifies that a stated number of foreign shares (or securities received in exchange therefor) have been de-

5. A predecessor of Morgan Guaranty Trust Company of New York.

6. Various certificates issued are sometimes called "American Depositary Receipts," "American Shares Certificates," "American Shares," and "New York Shares"; while these differ somewhat with respect to certain legal points, it is believed that the differences are not relevant to this article. Accordingly, hereafter, they will all be referred to as American Depositary Receipts or ADR's.

posited with its offices or custodians abroad and will be held on deposit as long as the ADR's remain outstanding. While the holder of an ADR may at any time demand and receive delivery of the underlying foreign shares, it is not necessary for him ever to come into physical possession of the actual foreign shares; hence, such foreign share certificates are rarely transported to the United States. Except in unusual situations, ADR's are issued only against the deposit of such foreign share certificates as are dealt in upon a recognized foreign securities exchange.

The holder of an ADR can sell his shares in the American market and complete his transaction by delivery of the ADR endorsed in blank, a procedure which is the same as that for a stock certificate of an American corporation. Moreover, the holder can, if the market conditions or his discretion so dictate, sell the underlying foreign shares in a foreign market, surrender his ADR to the American Depositary, and have his actual foreign shares promptly released to his designee abroad for delivery against such a foreign sale. All of this can be done with the greatest facility because ADR's, initially issued in the United States upon cabled advice from the foreign custodian of the deposit therewith of the equivalent foreign shares, provide that upon cancellation of the ADR's by the Depository, the underlying foreign shares can be released and delivered abroad upon cabled advice from the Depositary.

The ADR's are issued in registered form only (even though the underlying foreign shares may be in bearer, registered, or nominative form) and are transferable at the office of the Depositary with the same facility as domestic stock certificates. They are in a form readily understandable in this country because they have some of the characteristics of an American stock certificate. This is one of the important features of ADR's. The lack of these facilities was one of the reasons why there were so few transactions in foreign shares prior to 1927, and it was one cause of the general antipathy prevailing at that time, on the part of brokers and arbitragers, toward creating American markets in foreign shares. Any dividends declared on the deposited foreign shares are collected by the American Depositary's foreign custodian and, in turn, paid by the Depositary, by check, to the registered holders of ADR's, after transmission of the foreign dividend funds[7] by cable to New York, and the conversion of the dividend into dollars. Under tax conventions entered into by the United States with certain

7. Such as English sterling, Australian sterling, French francs, Belgian francs, Mexican pesos, German marks, Dutch guilders, Italian lire, South African rand, Japanese yen, etc.

foreign countries for the purpose of avoiding the effect of double taxation,[8] holders of ADR's may claim in their Federal tax returns certain credits for the applicable foreign tax withheld from dividends on the stock represented by their ADR's. The Depositary prepares the necessary certifications pursuant to such conventions in the form approved and accepted by the Internal Revenue Bureau, and these certifications are available to the holders of the Receipts. The American Depositary endeavors, through its offices and custodians abroad, to keep itself informed as to action taken by the issuing corporation, such as the declaration of dividends, the issuance of subscription rights, plans for recapitalization, and offers of exchange of securities as well as publication of notices of meetings.

It is the practice of the Depositary—to the extent possible and advisable—to promptly pass on such information to the holders of the ADR's. In cases where the issuer of the underlying stock has complied with the requirements of the Securities Act of 1933 and other applicable laws in this country, rights to subscribe are passed on to the holders so that they may be exercised by them or, in the alternative, are sold if possible for the benefit of such holders. Thus the Depositary performs functions which the average American holder of actual foreign shares may find either difficult or impossible to perform for himself, or possible only after considerable delay. In many respects, the holder of an ADR is in a more favorable position than his fellow American shareholder who holds actual foreign share certificates of the same foreign corporation.

The holder of an ADR is at all times in a position to reap the benefit of any variation in market quotations for his shares which might develop between the foreign and American markets. As a matter of fact, this feature tends to equalize the quotations in all markets, both foreign and domestic, since any marked variations in price between the different markets is soon acted upon by the arbitrager. Basically, the variations in market quotations between New York (when dealing in ADR's) and the native markets (when dealing in actual foreign shares) are due to costs. For example, when Americans are net buyers on balance (when the demand for ADR's is not met by American selling) the arbitrager steps in and buys such securities abroad and supplies our market with the securities in the form of ADR's. The arbitrager then must take into consideration the price of the securities on

8. The initial convention for the avoidance of double taxation was between the United States and Sweden and became effective January 1, 1940. Since that time, similar conventions have been executed between the United States and: Australia; Austria; Belgium; Canada; Denmark; Finland; France; Germany; Greece; Honduras; Ireland; Italy; Japan; The Netherlands; Netherlands Antilles; New Zealand; Norway; Pakistan; South Africa; Switzerland, and the United Kingdom.

the foreign stock exchange plus the foreign tax or stamp duty, commission of the foreign broker, and cable charges, as well as the fee of the Depositary for the issuance of the ADR's, and simultaneously calculate such costs against the price he will be able to obtain for the ADR's. However, in addition to these calculations, the arbitrager must take into consideration the foreign exchange control regulations and restrictions, if any. In so far as these regulations and restrictions apply to United Kingdom[9] sterling securities, such securities sell in our markets at discounts; this fluctuating discount is governed by the difference between the rate of exchange for free sterling and the rate of exchange for blocked sterling. Thus arbitragers trade in blocked sterling and, when they have occasion to buy in London sterling securities for an American account, they use blocked sterling (rather than free sterling) so that the factors involved are not only the cost of the securities in London, but also the price the arbitrager must pay to acquire sufficient blocked sterling to cover the London trade. This situation arose as a result of exchange control restrictions which, when initiated by the British, permitted Americans to continue to sell in London United Kingdom sterling securities. However, such sterling proceeds of sale were "blocked" on the books of a bank or broker in the United Kingdom and could normally only be used to purchase a United Kingdom sterling security, or sold to another resident of the same monetary area. Such sterling proceeds of sale have since been commonly referred to as "Blocked Sterling," "Security Sterling," or "Switch Sterling," though these terms do possess technical distinctions.

The use of blocked sterling, when dealing in the United Kingdom sterling securities, has never created a prohibitive hardship that would actually forbid or prevent American buying or selling such United Kingdom sterling securities. At the time the restrictions were imposed, residents of the United States could continue to receive dividends or interest from such securities in free sterling. There have been many occasions when an English company made a cash sterling payment as a return of capital (this should not be confused with a dividend payment or an interest payment) and, in such cases, it was the practice of these United Kingdom corporations to mail to the registered holders of their securities who resided in the United States, a sterling warrant or check. This warrant or check had stamped across its face a statement to the effect that the warrant or check was payable only to a "Blocked Sterling Account." In these cases, the warrants or checks could not be paid in the usual manner; instead, they would be endorsed

9. The basic United Kingdom controls and restrictions became effective in the early months of 1940 following the outbreak of World War II.

by their American payees and presented in London for collection. Inasmuch as such funds were for blocked sterling account, the blocked sterling funds when collected could then be sold in New York at the blocked sterling rate. Generally the blocked sterling rate was at a discount, below the free sterling rate. Inasmuch as blocked sterling may be transferred from one English bank or broker to another English bank or broker, it can be appreciated that blocked sterling is quoted and traded daily in New York, particularly among the international arbitrage brokers, and large amounts of blocked sterling change hands on this basis daily.[10] In order to lessen confusion regarding the manner in which residents of the United States deal in London in United Kingdom sterling securities by using blocked sterling, the author has selected two specific examples: Example "A" will deal with the manner in which an American resident holding United Kingdom securities would sell them in London and ultimately obtain the proceeds in this country in the form of United States dollars; Example "B" will deal with the situation where a resident of the United States purchases United Kingdom sterling securities in London by the use of blocked sterling.

Example "A"

Assuming that a resident of the United States held a United Kingdom sterling security he wished to sell, he could ship the sterling security in good market order to his broker in London with specific instructions to sell the security "at the market" on the London Stock Exchange which, of course, would be duly executed. It is at this point (*i.e.*, the sale in London of a United Kingdom sterling security for American account) that the proceeds of such sale would be credited on the books of a bank or broker in London for American account and would be designated "Blocked Sterling." The American could use this blocked sterling either to purchase another United Kingdom sterling security or, if he did not wish to do so, he could arrange to sell the blocked sterling in New York, probably to an international arbitrage broker. This sale, as we have indicated above, would normally be at a discount and the American seller would wind up with dollars here in New York. The arbitrage broker who purchased the blocked sterling proceeds of sale could then use these blocked sterling funds to purchase another United Kingdom sterling security in London, should he so desire.

Example "B"

Assuming that a resident of the United States desired to purchase a United Kingdom sterling security in London at the

10. It has been estimated that, currently, about £200,000 blocked sterling is traded per day in our markets.

market, he would normally complete the trade through his London correspondent and then purchase, through an arbitrage broker in New York, that amount of blocked sterling necessary to cover the cost of the securities. The arbitrage broker in New York would merely instruct his London correspondent to hold a specific amount of blocked sterling at the disposal of the individual American buyer. Obviously, the securities purchased by means of blocked sterling would then be held at the disposal of the American buyer.

It should, of course, be clearly understood that normally an American individual dealing in United Kingdom sterling securities does so at the dollar prices prevailing in New York and the techniques of unwinding the trades in London either on the "buy side" or the "sell side" probably are completed by the arbitrage broker for his own account, rather than for account of the individual. In addition, it must be remembered that there is only one lawful currency of England, *viz.*, "Sterling," and the designation "Blocked Sterling" does not indicate a separate currency, but rather, it is an indication to banks, brokers, and individuals, both in London and New York, that such funds generally arose as a result of a sale in London of United Kingdom sterling securities for American account.

The rate for blocked sterling is governed by the economic law of supply and demand for United Kingdom sterling securities by nonresidents thereof. Thus, it will be observed from Appendix A that as American demand for United Kingdom sterling securities has increased, the result has been a comparatively modest discount prevailing at this time between free sterling and blocked sterling. There have been times when such discounts have disappeared and, during such infrequent periods, the arbitrager has purchased United Kingdom sterling securities with free sterling, not blocked sterling. It is also extremely interesting to observe from Appendix A that when England devalued free sterling on September 19, 1949 from a parity of $4.03 per £ to $2.80 per £, there was no exceptional fluctuation at that particular time in the rate for blocked sterling. For the same basic exchange control reasons, though with variations, American dollar securities traded in London by residents of the United Kingdom are traded at premiums above prices prevailing in New York[11] and, similarly, Swedish securities, owned by nonresidents of Sweden, are traded outside of Sweden at premiums over prices for the same securities within Sweden.[12] Thus, historically, when regulations and restric-

11. The premium in London for American dollar securities has fluctuated from a high of about 35% to the present premium of 2⅝%.

12. Nonresident owned Swedish securities have been traded outside of Sweden at a premium ranging from a high of about 35% to the present premium of about 9%.

tions exist on remittances of capital funds (*i.e.*, such as proceeds of sale of securities for account of nonresidents) the result is either discounts or premiums for such securities in so far as trading in securities by nonresidents of that particular country is concerned.[13]

IV.

EFFECTS OF THE UNITED STATES SECURITIES LAWS.

American interest in foreign securities, since the inception of the present ADR mechanism, evidenced a continuous expansion from the time of its origin in the late 1920's until 1933, when the United States Securities Act of 1933 became effective. In retrospect it would appear that the Securities Act of 1933 did not envisage the extent to which American interest would develop in foreign securities. While it is true that Registration Form C-3 under the Securities Act of 1933 has been on the books since 1937, it has been used, practically speaking, not at all (only in a few isolated cases in connection with ADR's). In one instance, a registration statement was filed on behalf of a New York bank " . . . on Form C-3 on the understanding that the only part we would have to answer would be the part No. 1, but we got a deficiency letter in which we were requested not only to explain the terms of the ADR's, but also to explain what the British Foreign Exchange control regulations were at the time, what the British tax situation was at the time, to go into certain questions about the underlying securities, to set forth the terms on which these ADR's would be sold, and taking into account the fact this was an open-end arrangement that might last for a long time, and the British Foreign Exchange control regulations might change from time to time, and the tax laws might change, requiring presumably changes in the prospectus to bring the information up to date, our clients came to the conclusion very regretfully that they couldn't do it."[14] Thus for all intents and purposes while Americans continued (subsequent to 1933) to purchase foreign securities not subject to registration under the 1933 Act, ADR's were seldom available for those foreign corporations where such ADR's were not in existence prior to the 1933 Act.

13. While our example, for purpose of brevity, has been limited to United Kingdom sterling securities, the practicalities and implications of foreign exchange control regulations and restrictions of the United Kingdom and other countries are set out in greater detail in John Fountain's *'Switch currencies' and Other 'Monetary Mysteries'* (The Financial Analysts Journal, January — February 1961.)

14. Excerpt from the "Official Report of Proceedings Before The Securities & Exchange Commission In The Matter of The Conference on American Depositary Receipts" on June 20, 1955.

It should be remembered in this connection that the Securities Exchange Commission (SEC) concluded early in the administration of the Act that where ADR machinery had been set up prior to the effective date of the Act, and where prior to that date the offer to issue ADR's against the deposit of securities outstanding on that date had been made, no registration of such ADR's was necessary even though the ADR's were issued after the effective date of the Act. This conclusion was reached on the basis of section 3(a)(1) of the Act, which exempts from registration securities publicly offered prior to the effective date of the Act. However, the SEC took the position that this exemption would not apply to new offerings of ADR's after the effective date of the Act, or to any issue of ADR's against the deposit of securities which could not be sold without registration. In such cases the SEC required the ADR's themselves to be registered, and also required registration of the deposited securities if the latter required registration under the terms of the Act.

As time went on, the SEC staff somewhat liberalized their earlier attitude by taking the position in a number of specific instances that a bank might offer and issue an ADR after the effective date of the Act without registration, provided the deposited security could be sold without registration. This practice was justified on the theory that the ADR itself was entitled to exemption from registration under section 3(a)(2) of the Act as a security issued by a bank. This staff interpretation of the "bank" exemption was never made the subject of an official rule or regulation by the SEC, and was not questioned or exhaustively considered by the Commission itself until the Conference of June 20, 1955. As a result of this Conference and subsequent discussions with the SEC staff, the Commission expressed unwillingness to expand the earlier interpretations of section 3(a)(2) which had exempted ADR's from registration, and decided instead to adopt a greatly simplified registration form which could be used by banks and thereby make possible the continued issuance of ADR's without undue additional difficulty or expense.

Registration Form S-12 was accordingly adopted by the Commission, effective November 17, 1955. The Commission's Rule regarding its use is as follows:

A. *Rule as to use of Form S-12*

Form S-12 shall be used by an issuer as defined below for registration under the Securities Act of 1933 of American Depositary Receipts issued against securities of foreign issuers deposited or to be deposited with an American depositary (whether physically held by or for the account of such depositary in America or

abroad) provided: (i) that the holder of the receipts may withdraw the deposited securities at any time, subject only (a) to temporary delays caused by closing of transfer books or the deposit of shares in connection with voting at shareholders' meetings, or the payment of dividends, (b) to the payment of fees, taxes and similar charges and (c) to compliance with any laws or governmental regulations relating to the withdrawal of deposited securities; and (ii) 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 of 1933.

Where no person or persons perform the acts and assume the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which the receipts are to be issued, the entity created by the agreement for the issuance of the American Depositary Receipts (or any corporation or trust organized to act only as a conduit in connection with the deposit of the underlying securities pursuant to such an agreement) shall be deemed to be the issuer of the American Depositary Receipts for all purposes of this form and the Act.

Notwithstanding the fact that the depositary may sign the registration statement in the name of such issuer, the depositary itself shall not be deemed an issuer, a person signing the registration statement, or a person controlling such issuer.

It is evident from this Rule, and from the requirements of the Form itself, that the SEC has gone to great lengths to make registration of ADR's possible under the prescribed circumstances without making the Depositary bank or its directors subject to Securities Act liabilities. The Form defines the "issuer" of the ADR's, which is also the registrant required to execute the Form, as "the entity created by the agreement for the issuance of the ADR's being registered." The Depositary may sign the registration statement on behalf of such legal entity and, notwithstanding the fact that it may so sign, it is not itself to be deemed an issuer of the ADR's, a person signing the registration statement, or a person controlling the registering issuer.

In promulgating this new Form with these unusual provisions, the SEC indicated its intention to exercise its rulemaking powers under the Securities Act of 1933 in such a manner as to minimize, from a practical as well as a theoretical standpoint, any possible liability (under the Securities Act of 1933) of a banking institution or of its directors, either by reason of its executing the ADR's themselves as Depositary and performing the functions set forth therein, or by reason of its signing and filing the registration statement on Form S-12 on behalf of the entity which is the "issuer." Any other liability which a bank or its directors might incur as a result of transactions in ADR's, as Deposi-

tary or otherwise, would appear to result from the nature of the transactions themselves and not to differ materially from the possible liabilities arising from such transactions which existed prior to the imposition of registration requirements under the Securities Act of 1933. With the adoption of Registration Form S-12, American interest in foreign securities evidenced increased activity and this was reflected in the creation of fresh ADR's.

Most ADR's issued after registration under Form S-12 are not listed on any national securities exchange but are traded-in on the over-the-counter market. The ADR's are so adaptable that they may be utilized by those who desire to have them listed on stock exchanges, particularly after adequate distribution has been obtained; this listing may be accomplished through co-operation between the Depositary and the issuer of the underlying securities, provided the applicable requirements of the particular stock exchange and the Securities and Exchange Commission are met. As international controls continue to be relaxed, this is of increasing importance. By rules of the Commission, foreign corporations have been granted, under the Securities Exchange Act of 1934, especially lenient treatment, in the form of specific exemption from certain requirements to which registered American corporations and their officers, directors, and large stockholders are subject, *e.g.,* section 13 (Annual and Periodic Reports), section 14(a) (Proxy Solicitation), and section 16 (Stock Transactions by Directors, Officers and Large Stockholders).

A number of foreign corporations desired to create ADR's for the convenience of their existing American holders; in such cases, this has resulted in the execution of a separate deposit agreement between the Depositary bank and the foreign corporation and, in these deposit agreements, the foreign corporations have assumed certain obligations as well as certain charges of the Depositary. The extent of the companies' commitments are set out in these modern deposit agreements. In the instances subsequent to 1933, registration of the ADR's as well as the underlying securities was pursuant to the Securities Act of 1933.[15]

During the long history of American investment in foreign securities, it is most interesting to note that in the field of jurisprudence, the ADR has been singularly free of court rulings, judicial opinion, or legal conflict, both prior and subsequent to the Securities Act of 1933 and the Securities Exchange Act of 1934. As indicated heretofore, the

15. Some of the foreign corporations using this deposit agreement facility are The Bowater Paper Corporation Limited (England), Caribbean Cement Company Limited (Jamaica), Montecatini (Italy), Unilever N. V. (Holland), and Sony Corporation (Japan). Prior to the Securities Act of 1933, Rhodesian Selection Trust Limited and Electric & Musical Industries Limited were parties to specific deposit agreements.

adoption of Registration Form S-12 in 1955 under the Securities Act of 1933 was no doubt the most important development in this area since the creation of ADR's, well over thirty years ago. Since 1955, the only legislative proposals in this area by the SEC are Rules 402A and 440, covered by SEC Release No. 4511 on July 16, 1962 (reproduced in Appendix B). The SEC invited interested parties to file comments on the proposed Rules until September 17, 1962 (extended from August 17, 1962) and thereafter, the Commission probably will adopt Rules in final form and fix an effective date. It should be clearly understood, of course, that ADR's (registered under Form S-12) were not created to stimulate American interest in or to foster American buying of foreign securities (these are the functions that fall within the province of brokers and underwriters under our securities laws); rather, as set out herein, the system is one of simplification and standardization for American-held foreign securities.

V.

VARIATIONS AND VOLUME.

Since the origination of ADR's more than three decades ago, a number of innovations have been introduced in connection with their use. One of these is the appointment of Custodians to hold the underlying shares in countries other than the principal financial center abroad. For example, certain South African securities historically have enjoyed an active market in Johannesburg as well as in London and New York. The Depositary has now entered into arrangements whereby South African securities may be deposited with the South African Custodian of the Depositary or with the London office of the Depositary, thus facilitating for the first time, through the use of ADR's, three-way arbitrage involving Johannesburg, London, and New York. A broker may now purchase South African securities in Johannesburg to be deposited with the South African Custodian against the issuance of ADR's in New York or, if market conditions warrant, he may purchase the same South African securities in London and deposit them with the London office of the Depositary, similarly against the issuance of ADR's in New York. In turn, the ADR's may be surrendered to the Depositary in New York for cancellation against the delivery of the underlying shares either in London or Johannesburg, as ordered by the broker. It is anticipated that three-way arbitrage may extend to Japanese securities, *viz.*, Tokyo, New York, and London, and also to Australian securities with respect to Sydney, New York, and London. Another more recent innovation resulting from the

interest of some Americans in foreign debt securities is that, while ADR's were initially created for foreign equity securities, they have been adapted (with slight modification of text) and are now available for debt securities as well as for foreign convertible debentures.

No doubt one of the most intriguing questions of American buying of foreign securities is that of volume. This question is particularly important because of the fact that there is no single authoritative source as to either direct or indirect American investment abroad. Unofficial attempts have been made in the past to determine the number of foreign shares held in actual form or represented by outstanding ADR's. Obviously such figures even if obtainable would fluctuate from day to day as a result of constant arbitrage. Probable estimates as to volume could be obtained by canvassing a cross-section of the knowledgeable professionals interested in this area.[16]

VI.

SOPHISTICATION AND DIVERSIFICATION.

ADR's are unique instruments in that the Depositary does not necessarily act for or as an agent of the foreign corporation (in the absence of specific deposit agreements mentioned heretofore) whose stock is deposited against the issuance of ADR's. The Depositary may have no direct connection with the corporation except to appear on its records as a registered stockholder. As a matter of fact, each ADR outstanding is an individual contract or agreement between the Depositary and the particular holder of that ADR. The ADR usually recites all of the terms and conditions under which it is issued and the deposited shares are held. The Depositary has no interest whatsoever in the marketing of any ADR's or the deposited securities, but acts solely as

16. George Bookman in *An Accent on Foreign Stocks* (Fortune Magazine — July, 1962) stated that:

> American interest in some foreign stocks has become so intense that for a few of them, including Philips Lamp and Royal Dutch Petroleum, there is now more trading in New York than in the companies' homelands. Americans recently held about 37 per cent of Royal Dutch. The accumulation of foreign stocks by Americans has been especially great since 1954. From that year to the end of 1961, the market value of American-held foreign stocks (excluding Canadian stocks) rose from $327 million to $2.2 billion. However, the actual net purchases of foreign stock accounted for only about half this gain; the other half, some $925 million, came from price appreciation — a fact which suggests that the purchasers have done pretty well. From 1954 through 1961 the net purchases of all foreign stocks have averaged $205 million a year. This is fifteen times the average of the previous eight years. Most American buying of foreign stocks has been by institutional investors. But more recently the general public began to take up the idea. There are some security analysts, at least, who suspect that the increasing tendency of U.S. investors to "go foreign" will be the most important development in investing since the great shift into equities after World War II. . . . More than 300 foreign issues are actively traded over the counter in New York alone, with volume ordinarily running between two and three million dollars a day.

a Depositary offering its services to facilitate the holding of and trading in foreign shares by Americans. While the Depositary naturally investigates the character and standing of the company whose shares are to be deposited against the issuance of ADR's, nothing in the mechanics of the system or the ADR itself can be construed as a recommendation by the Depositary of either the company or its shares to the investor. In the absence of a corporate principal, the Depositary must look to the holders of the ADR's to bear its charges for performing the services provided for in the ADR. Basically these charges cover the issuance, cancellation, transferring, splitting, and grouping of the ADR's, as well as the distribution of cash or stock dividends to the holders. The applicable fees of the Depositary are collectible only when such activity occurs, and the expense of operating these systems is borne by the Depositary.

The system of ADR's not only provides an advantage and convenience to investors in the United States, but also may help to broaden the market for the shares of the company concerned. This feature has been recognized by some companies as a possible means of introduction to capital markets which they may desire to tap in future financing. Since their inception ADR's have proved successful, workable, and fully adapted to American practice, as well as to American investors' psychology and customs, and they have been accepted by our financial community as a welcome addition to our capital structure. The system of ADR's was built on such a flexible basis that practical problems arising as a result of numerous, diverse, and complex exchange control regulations and restrictions were overcome, even many that were unforeseeable at the time the system was created—this, despite wars, threats of wars, and periods of inflation and deflation. Our financial community over the years has looked, and continues to look, to the experienced Depositary as a library of information, not only as a guide in the general philosophy of the business but also for specifics. In creating ADR's for foreign corporations domiciled in various foreign countries, the Depositary has accumulated a wealth of experience with regard to foreign transfer requirements,[17] the basis of assessment of foreign transfer tax (or stamp duty), ad valorem duty as distinguished from nominal duty, taxable status of dividends, foreign estate requirements and death duties, requirements of foreign banks to hold securities in safekeeping (with applicable fee schedules), as well as foreign exchange controls and restrictions.

17. The requirements for transfer of registered shares, nominative shares (registered with coupons attached), or inscribed shares (transferable only on the books by means of specific power of attorney) vary, not only from country to country, but company requirements, within the same foreign country, also may differ.

It is important to note that these foreign corporations with respect to which ADR's are made available[18] enjoy a wide industrial diversification. Represented are: aircraft, automation, business equipment, chemicals, communications (television, radio, tape recorders), drugs, electrical equipment, electronics, exotic fuels, glass, mining (gold, silver, diamond, copper, lead, etc.), oil, papers, retail stores, rubber, steel, textiles, and tobacco. As continued American interest develops in foreign securities, it is the consensus of the knowledgeable financial community that this existing broad base will expand to other geographical areas, as well as to other industrial undertakings. There are very cogent reasons for this; probably the most significant are the now accepted philosophy of an expanding world economy, the world-wide interest in the Common Market, and the importance of private American capital in foreign enterprise. In the early years of this business, constant, even daily arbitrage was important, but there was a tendency for the American investor at that time to get tied into a particular foreign investment situation for a number of years. This no longer holds true. The contemporary American investor in foreign securities is, without doubt, more sophisticated, and now deals in foreign securities in the form of ADR's with the same facility as when dealing in domestic securities. It is revealing to note that this has reached a point where foreign investment movements now run along domestic lines in so far as a demand for shares of a particular industry is concerned. By this is meant that if the domestic industrial interest is in electronics, automations, drugs, chemicals, or golds, rather than in oils, papers, textiles, etc., the same trend may be observed in foreign securities. Probably there does exist another similarity: when an American purchases foreign securities, it would seem that he is equally concerned with appreciation—growth situations rather than yields.

VII.

INTERNATIONAL TECHNIQUES IN FOREIGN DEALINGS IN UNITED STATES DOLLAR SECURITIES.

For substantially the same economic reasons as previously mentioned, foreigners have since our early days invested in our economy through the purchase of American dollar securities. While the prob-

18. Model, Roland & Co. (a member firm of the New York Stock Exchange) in their "ADR Guide" Revision VI dated July 20, 1962, lists 185 foreign corporations domiciled in 17 foreign countries with respect to which ADR's are available. Of these, 8 are listed on the New York Stock Exchange, 20 are traded in on the American Stock Exchange, and the remaining 157 are traded in on the over-the-counter market.

lems of American dealing in foreign securities have been solved through the medium of ADR's, it is interesting to observe that the methods of dealing in American dollar securities in the principal foreign financial centers have been resolved unilaterally by each particular country in their own fashion as follows:

In Belgium	by the use of Depositary Receipts in bearer form with coupons attached;
In England	by the use of "Marking Names";
In France	by the use of "Sicovam";
In Holland	the utilization of "Dutch Administration Certificates";
In Switzerland	the registration of American dollar securities in the names of Swiss banks; and
In Germany	based on very limited experience, actual American certificates have been accepted for listing. (Quite recently there has been a re-emergence of German interest in American dollar securities.)

In view of these variations in dealing abroad in American dollar securities, there was inaugurated, in 1955, a global solution—a system whereby foreign investors may own and hold substitution certificates for certain American dollar securities in a form to which they are accustomed, *i.e.,* bearer certificates with coupons attached. Through their offices abroad, the Depositary issues BDR's (Bearer Depositary Receipts—a reverse of the ADR system) representing the deposit in their New York office of actual shares of the American companies registered in the name of the nominee of the Depositary.[19]

19. The BDR system is set out in greater detail in "The ADR-BDR Brochure" (1962); certain other highly specialized international techniques of dealing in "substitution certificates" are the subject of a separate "Memorandum as To The Methods In Dealing and Requirements For Quoting and/or Listing American Dollar Equity Securities on The Principal Foreign Stock Exchanges" (1962), both of which have been prepared by and are available at Morgan Guaranty Trust Company of New York.

APPENDIX A

FLUCTUATING RATES FOR BLOCKED STERLING PREVAILING IN NEW YORK DURING THE PAST FIFTEEN YEARS AS OF THE FIRST BUSINESS DAY OF EACH CALENDAR MONTH

Year	*Month*	*Rate for Blocked Sterling*	*Rate for Government Obligations*	*Rate for Commercial and Industrial Securities*
1948	June (A)	$2.05		
	July	2.00		
	August	1.60		
	September	1.70		
	October (B)	1.50		
	October 18th		$1.55	$1.50
	November		1.50	1.50
	December		1.60	1.60
1949	January		1.65	1.65
	February		1.80	1.80
	March		1.85	1.85
	April		1.90	1.95
	May		1.87	1.90
	June		1.90	1.92
	July		1.70	1.75
	August		1.75	1.82
	September (C)		1.75	1.90
	October		1.80	2.00
	November		1.60	2.00
	December		1.45	1.75
1950	January		1.63	1.73
	February		1.70	1.90
	March		1.64	1.76
	April		1.48	1.65
	May		1.55	1.90
	June		1.67	1.80
	July		1.63	1.67
	August		1.50	1.55
	September (D)	$1.75		
	October	2.00		
	November	2.07		
	December	2.02		
1951	January	2.00		
	February	2.03		
	March	2.07		
	April	2.06		
	May	2.04		
	June	2.04		
	July	2.28		
	August	2.35		
	September	2.32		
	October	2.26		
	November	2.25		
	December	2.23		
1952	January	2.35		
	February	2.32		
	March	2.30		
	April	2.40		
	May	2.43		
	June	2.46		
	July	2.47		
	August	2.50		
	September	2.55		
	October	2.56		
	November	2.60		
	December	2.60		

Year	Month	Rate for Blocked Sterling
1953	January	2.62
	February	2.62
	March	2.64
	April	2.68
	May	2.67
	June	2.64
	July	2.65
	August	2.68
	September	2.70
	October	2.69
	November	2.68½
	December	2.70
1954	January	2.73
	February	2.73½
	March	2.73½
	April	2.77
	May	2.79
	June	2.78¾
	July	2.77
	August	2.76½
	September	2.76
	October	2.73
	November	2.72½
	December	2.71
1955	January	2.73½
	February	2.71
	March	2.75
	April	2.76
	May	2.75¾
	June	2.77
	July	2.77½
	August	2.76½
	September	2.78¼
	October	2.75¼
	November	2.75
	December	2.74½
1956	January	2.74
	February	2.73½
	March	2.73¾
	April	2.77½
	May	2.77⅛
	June	2.75⅝
	July	2.70⅜
	August	2.66⅜
	September	2.63
	October	2.59⅜
	November	2.57⅜
	December	2.56¼
1957	January	2.60
	February	2.62½
	March	2.61½
	April	2.59
	May	2.58
	June	2.56
	July	2.62
	August	2.71
	September	2.69
	October	2.71
	November	2.74½
	December	2.74

Year	Month	Rate for Blocked Sterling
1958	January	2.74⅛
	February	2.74⅛
	March	2.78⅝
	April	2.78
	May	2.79¼
	June	2.78¾
	July	2.77⅞
	August	2.77½
	September	2.77¼
	October	2.77⅛
	November	2.78¼
	December	2.79
1959	January	2.80
	February	2.80⅜
	March	2.79⅞
	April	2.80⅞
	May	2.81⅛
	June	2.80¼
	July	2.80⅜
	August	2.80⅜
	September	2.80
	October	2.79⅛
	November	2.79⅛
	December	2.79⅝
1960	January	2.79¼
	February	2.79⅝
	March	2.78¼
	April	2.78⅜
	May	2.76⅞
	June	2.77⅜
	July	2.78⅜
	August	2.80⅛
	September	2.80⅞
	October	2.80⅞
	November	2.81⅜
	December	2.80¾
1961	January	2.79⅛
	February	2.78⅜
	March	2.78⅞
	April	2.75¼
	May	2.78½
	June	2.78⅜
	July	2.76⅛
	August	2.76⅝
	September	2.79½
	October	2.80⅛
	November	2.81
	December	2.80¾
1962	January	2.80⅝
	February	2.81
	March	2.81⅜
	April	2.81¼
	May	2.81⅛
	June	2.79½
	July	2.79½
	August	2.79¾

(A) Free Sterling quoted at a parity $4.03 per £1.
(B) Classification between proceeds of sale of United Kingdom Government obligations and proceeds of sale of commercial and industrial securities commenced October 18, 1948.

(C) On September 19, 1949, Free Sterling was devalued from a parity $4.03 per £1 to $2.80 per £1.

(D) Classification between proceeds of sale of United Kingdom Government obligations and proceeds of sale of commercial and industrial securities which commenced October 18, 1948, ended on September 2, 1950 and thereafter, sterling proceeds of sale of United Kingdom sterling securities were merely referred to as blocked sterling.

APPENDIX B

Release No. 4511 of the Securities and Exchange Commission

"NOTICE OF PROPOSED RULES 402A AND 440

Notice is hereby given that the Securities and Exchange Commission has under consideration two proposed new rules under the Securities Act of 1933 relating to the registration of securities by foreign issuers other than foreign governments.

RULE 402A

Section 6(a) of the Securities Act requires that where a registrant is a foreign or territorial person, the registration statement shall be signed by its duly authorized representative in the United States. This signature is in addition to the signatures required where the registrant is a domestic issuer. Under Section 11 of the Act, an authorized representative may be liable to persons purchasing the securities offered pursuant to the registration statement. In order for this provision to operate effectively for the protection of investors, it is essential that the authorized representative be a person having a reasonable degree of responsibility. In the past, efforts have been made to meet the requirement that the registration statement be signed by an authorized representative in the United States by organizing a dummy corporation solely for that purpose. Other devices may similarly be used to evade the intent and purpose of the requirement.

The proposed new Rule 402A would require that where the registrant is a foreign person other than a foreign government, the authorized representative in the United States shall meet certain qualifications designed to insure that there may be in this country a person against whom investors may have recourse in appropriate cases. The text of the proposed rule follows:

Rule 402A. Authorized Representatives of Foreign Issuers.

(a) If the registrant is a foreign person other than a foreign government, its duly authorized representative in the United States who signs the registration statement pursuant to Section 6(a) of the Act shall meet the following qualifications and shall state immediately preceding his signature to the registration statement that he meets such requirements:

(1) Such representative shall be a broker or dealer registered with the Commission pursuant to Section 15(b) of the Securities Exchange Act of 1934 and, if the securities to be registered are to be offered through underwriters, such representative shall be named in the registration statement as the underwriter, or one of the underwriters, of such securities.

(2) If such representative is a natural person, he shall be an adult person who is a citizen and resident of the United States, has been such a citizen and resident for at least the last five years and has his principal business operations or employment in the United States.

(3) If such representative is a corporation or an unincorporated trust, association or joint stock company, it shall be incorporated or organized under the laws of a State or Territory of the United States or the District of Columbia, shall have its principal business operations in the United States and shall have been engaged in business in the United States for at least the last five years.

(4) If such representative is a partnership, it shall be formed under the laws of a State or Territory of the United States or the District of Columbia, shall have its principal business operations in the United States, shall have been engaged in business in the United States for at least the last five years and at least a majority of its general partners shall be citizens and residents of the United States.

(5) No person shall be qualified to serve as an authorized representative if such person or any director, officer, general partner or parent of such person (i) has been convicted of any felony or other offense punishable by death or imprisonment for a term exceeding one year, (ii) is subject to any order, judgment or decree of any court of competent jurisdiction temporarily or permanently enjoining or restraining him from engaging in or continuing any conduct or practice involving any aspect of the securities business, (iii) is subject to any order of the Commission which restricts him from engaging in any conduct or practice involving any aspect of the securities business, (iv) is suspended or has been expelled from membership in a national security dealers association or a national securities exchange for conduct inconsistent with just and equitable principles of trade, or (v) has been declared a bankrupt, or made an assignment for the benefit of creditors, within the last five years.

(b) Any person named in a registration statement which has become effective as the duly authorized representative of a foreign issuer, other than a foreign government or political subdivision thereof, shall be deemed to continue to act in such capacity until an amendment to the registration statement naming another qualified duly authorized representative has become effective; provided, that the naming of another authorized representative shall not operate to relieve the person previously named from any liability incurred prior to the effective date of the amendment naming his successor.

(c) If at any time there is no duly authorized representative upon whom any notice required by Section 8 of the Act may be served, such notice shall be sent to or served on the issuer at its last address of record filed with the Commission.

RULE 440

The proposed new 440 would require that where the registrant, any of its directors or officers, any selling security holder or any underwriter is a nonresident (other than a foreign government or a political subdivision thereof) it shall furnish to the Commission a consent and power of attorney authorizing the Commission to accept service of process in connection with civil actions arising out of the offering or sale of the registered securities. The purpose of this rule is to make it easier for purchasers of the registered securities to obtain service of process upon foreign issuers and their insiders in connection with civil actions instituted in the courts in this country. The text of the proposed rule follows:

Rule 440. Consent by Certain Foreign Persons to Service of Process.

(a) If the registrant, any of its directors or officers, any person for whose account any of the securities to be registered are to be offered, or any underwriter of such securities, is not a resident of the United States, each such nonresident person (other than a foreign government or a political subdivision thereof) shall at the time the registration statement is filed, furnish to the Commission in a form prescribed by or acceptable to it, a written irrevocable consent and power of attorney which. . . .

(1) designates the Securities and Exchange Commission as an agent upon whom may be served any process, pleading or other papers in any civil suit or action brought against such issuer in any court in any place subject to the jurisdiction of the United States where the cause of action (i) accrues on or after the effective date of this rule, and (ii) arises out of any offering made or purported to be made pursuant to such registration statement or any purchase or sale of any security in connection therewith; and

(2) stipulates and agrees with respect to any such civil suit or action that (i) the laws of the United States shall control; (ii) any appropriate court of the United States or any political subdivision thereof shall have jurisdiction over such civil suit or action; (iii) any such civil suit or action may be commenced by the service of process upon the Commission and the forwarding of a copy thereof as provided in paragraph (b) of this rule; and (iv) that the service as aforesaid of any such process, pleadings or other papers upon the Commission shall be taken and held in all courts to be as valid and binding as if due personal service thereof had been made.

(b) Service of any process, pleadings or other papers on the Commission under this rule shall be made by delivering the requisite number of copies thereof to the Secretary of the Commission or to such other person as the Commission may

authorize to act in its behalf. Whenever any process, pleadings or other papers as aforesaid are served upon the Commission, it shall promptly forward a copy thereof by registered mail to the issuer and to its duly authorized representative at their addresses set forth in the registration statement. The Commission shall be furnished a sufficient number of copies for such purpose, and one copy for its files.

(NOTE: Forms 3-A, 4-A, 5-A and 6-A prescribed for use in connection with Rule 262 of Regulation A may be used with appropriate changes for the consents and powers of attorney required by Rule 440 until such time as the Commission shall prescribe other forms therefor.)"