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Understanding Global Depositary Receipt (GDR) and American Depositary Receipt (ADR)

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ABSTRACT

An autonomous third party, such a bank, that serves as both a fiduciary and a safekeeping facility is known as a depositary. For example, stock-related services for a depositary receipt scheme can be supplied by a depositary bank. A tradable financial security is a worldwide depositary receipt. It is a certificate that trades on two or more international stock markets, representing shares in a foreign corporation. GDRs are generally traded on American stock markets, Eurozone stock exchanges, and Asian stock exchanges. The local currency of the exchanges where GDRs are traded is used to determine the price of GDRs and their dividends. It is a simple method for investors in the United States and other countries to purchase overseas equities. A corporation that uses global depositary receipts can list its shares outside of its home nation in many countries. A Chinese business may, for instance, design a GDR scheme that would allow it to issue shares into the London and American markets via a depositary bank middleman. Every issue must abide by all applicable laws in both the place of origin and any outside markets. Conversely, an American depositary receipt, which solely listings on U.S. stock markets, symbolises shares of a worldwide corporation. A U.S. bank will buy shares on a foreign market in order to provide ADRs. The underlying shares will be held by the depositary bank, which will also issue an ADR for domestic trade. Only American exchanges list American depositary receipts, which are shares of a foreign business. A GDR is listed on several foreign stock markets and represents shares in a foreign corporation.

Keywords: *GDR - Global Depositary Receipt, ADR - American Depositary Receipt.*

I. INTRODUCTION

A depositary bank will issue a global depositary receipt (GDR), which is a negotiable financial instrument. It trades on the national stock markets of the nations of its investors and represents shares in a foreign firm. With the help of GDRs, a business (the issuer) can connect with

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investors on international capital markets. Issuers frequently employ global distribution rights (GDRs) in conjunction with private placements or public stock offerings to attract money from foreign investors. Global depositary receipts and American depositary receipts (ADRs) are closely related, with the exception that ADRs only list shares of international companies traded on U.S. exchanges. One kind of bank certificate that represents shares of stock in a foreign corporation is called a global depositary receipt. The GDR's underlying shares are still held in reserve by a custodial organisation or depositary bank. Global investors situated abroad can purchase shares of an international firm using GDRs, even though the shares trade as domestic shares in the nation where the company is based. Companies can raise money from investors in other nations by using GDRs. The GDRs will be valued in the currencies of those investors' native nations. GDRs trade in a variety of marketplaces and provide investors the chance to profit from arbitrage as they are negotiable certificates. In general, when European investors want to trade shares of firms based outside of Europe locally, they refer to GDRs as European Depositary Receipts, or EDRs. Generally speaking, GDR transactions are less expensive than various other methods that investors utilise to trade foreign stocks. GDRs allow an issuer to raise capital simultaneously in multiple markets through a global offering.[4] For instance, a U.S. based business can use a GDR to get its shares listed on the Hong Kong and London Stock Exchanges. The American corporation signs a depositary receipt contract with each of the overseas depositary banks. These banks then package and distribute shares to the stock exchanges that represent them. The regulatory compliance guidelines for both nations are adhered to by these operations.

II. Characteristics of GDR

Exchange-traded securities known as GDRs are not directly guaranteed by any underlying assets (as shares of a company are backed by their assets). Instead, GDRs, which are really traded overseas, indicate ownership of shares in a foreign corporation.

Moreover, distinct traits that set one GDR apart from another may exist. These might consist of:

- Conversion ratio: The number of shares of the parent business that each GDR represents is known as the conversion ratio. This ratio may differ amongst GDRs and may be modified over time to account for shifts in the underlying shares.

[4] Manoj Kumar, Depositary Receipts: Concept, Evolution and Recent Trends, SSRN, https://www.academia.edu/download/46916868/Depositary_Receipts__Concept__Evolution_20160630-22938-18mcdkb.pdf, (last accessed on DEC. 14,2023,06:40 PM)

- Denomination: There are other currencies in which GDRs can be valued, including pounds sterling, euros, and US dollars. Since the price of a GDR's shares abroad are set in local currency, the currency utilised for the investment may have an effect on both the price of the GDR and the hazards involved, such as currency risk.
- Sponsorship: Depository banks are the issuers of GDRs, and each GDR may have a different sponsor bank. The reputations, financial standing, and other attributes of various banks may vary, which may have an effect on the risks and possible rewards of a GDR.
- Fees: The costs associated with issuing, selling, and retaining GDRs might also differ. These charges may have an effect on the total cost and possible profits of a GDR investment.

(A) Special Considerations

A GDR given out by a depositary bank is equivalent to a certain quantity of underlying shares, which can range from a single share to many shares in a certain foreign business. A GDR's specific share composition is determined by how appealing an investment it will be to regional investors. In the United States, for example, a depositary bank would wish to issue GDRs with the number of shares or fractions thereof and corresponding U.S. dollar value that would be most acceptable to investors in the United States. The foreign company's shares are initially purchased by the depositary bank (or, receives them from an investor who already owns them). After then, it gathers a specific quantity of them. A GDR is used to symbolise this bundle. The depositary bank then issues the GDR on a regional stock market. The depositary bank continues to hold the underlying shares on deposit (or custodian bank in the international country). The exchange where GDRs are traded regulates the GDR trading procedure. Global depositary receipts, for instance, are listed and traded in US dollars in the US. They use US currency to pay dividends as well. They must abide by the rules and procedures of the exchange where their transactions are conducted as well as the trading and settlement procedures. In reality, issuers from the Middle East and Africa, Asia Pacific, Latin America, and Europe have increased their usage of GDR programmes due to their flexibility and efficiency in helping them meet their capital-raising goals. The globalization of financial markets has accentuated cross-border capital flows and has led to competition between leading stock exchanges “to attract listings and trading volume and to stoke capital-raising activity by overseas companies in their

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markets”.[5]

(B) Trading GDRs

Global businesses issue GDRs in an effort to draw in money from overseas investors. GDRs provide exposure to a global market and trade on the local markets of the investors. The underlying shares of the GDRs are held by a custodian or depositary bank during trades, providing a degree of security and enabling participation for all parties. The buying and selling of GDRs is overseen by brokers acting as buyers' agents. The brokers often work in the international market and are citizens of their native nation. A broker in the investor's nation, a broker in the foreign company's market, a depositary bank acting as the buyer's representative, and a custodian bank are all involved in the multi-stage real asset acquisition process. GDRs may also be sold by brokers on behalf of investors. Investors have two options: they may either convert them into common stock for the firm or sell them exactly as they are on the appropriate markets. They can also be cancelled and sent back to the firm that issued them. When trading GDRs, traders frequently make comparisons between, say, the GDR's price in US dollars and the price of the shares trading on the local exchange of the foreign business in US dollars. Usually, they will purchase the less costly security and sell the other. The underlying shares and the GDRs eventually achieve parity as a result of this arbitrage trading activity. Owing to the trading practise known as arbitrage, the price of a GDR closely resembles the stock of the foreign firm listed on the home exchange.

(C) Advantages of GDRs

- GDRs enables foreign businesses to connect with a wider range of possible investors.
- They could improve the liquidity of shares.
- Businesses are able to carry out a successful and economical private offering.
- An otherwise unknown foreign company's prestige or validity may be enhanced by having its shares listed on significant international markets.
- GDRs give investors the chance to diversify their investments globally.
- Compared to creating overseas brokerage accounts and buying equities in foreign marketplaces, GDRs are more affordable and easier.
- There are no fees associated with cross-border custody or safekeeping for investors.

[5] Shrutika Chugh, Neil Fargher, Sue Wright, Cross-listing as a Global Depository Receipt: The influence of emerging markets, regulation, and accounting regime, 10 JCAE 262, 263 (2014), https://doi.org/10.1016/j.jcae.2014.10.004.

- GDRs are traded, cleared, and settled in accordance with the domestic protocols and practises of the investor.
- All dividends and capital gains on GDRs are realised by US holders in US dollars.

(D) Disadvantages of GDRs

- GDRs might come with hefty administrative costs.
- Dividend payments are made after deducting international taxes and currency conversion costs.
- Naturally, the depositary bank deducts the amount required to pay for overhead and international taxes.
- To prevent paying double taxes on realised capital gains, American investors may need to request a credit from the Internal Revenue Service (IRS) or a refund from the taxing body of the foreign nation.
- GDRs may have little liquidity, which would make selling them challenging.
- They may also be subject to political and currency risk in addition to liquidity risk.

This implies that the value of GDR may change in response to real-world occurrences in the other country, such as a recession, a financial crisis, or political unrest.

III. American Depository Receipts (ADRs)

American banks offer securities known as American Depositary Receipts, or ADRs. ADRs are convertible into tradable securities and represent ownership stakes in foreign companies' stock. These financial products are traded on well-known US stock exchanges including the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotations (NASDAQ), have US dollar designations, and are governed by US securities laws. ADR stands for American Depositary Receipts in their entirety. With American Depositary Receipts (ADRs), investors in the United States can gain exposure to non-US companies without having to deal with international stock markets. They stand for some of the most well-known brands in the world of business, such as Unilever, Nokia, and Royal Dutch Petroleum. ADRs are used by these and several other foreign-headquartered corporations to trade their shares on US exchanges. ADRs enable an investor to acquire foreign securities without the usual political, economic, and institutional risks and challenges associated with direct purchase of foreign securities. Such issues as obtaining stock certificates and collecting dividends in foreign currencies can be quite daunting by U.S. standards.[6] For US citizens who want to participate in international businesses but are worried about adhering to foreign exchange laws, American Depositary Receipts (ADRs) are useful tools. Consider that you would want to invest in a distant company, but you are unsure about how to obtain the company's shares or how to perform the required financial due diligence. ADRs come in handy here. With a partnership with a foreign corporation, a massive American financial institution makes the assurance, "We'll take care of all the complex things." To generate American Depositary Receipts (ADRs), which can subsequently be traded on the New York Stock Exchange, shares of that foreign company are bought. If the firm is lucrative, your financial institution will pay you a percentage of the profits. It's a simpler method of investing in overseas companies, albeit there can be costs involved. Investors can trade in ADRs just like domestic securities, since these receipts are listed on the national stock exchanges or the over-the-counter market. Upon request, ADRs are easily converted into the underlying shares, and investors who own foreign securities can also exchange them for ADRs. Usually, the depository bank charges a fee for its services.[7]

The formal process of how ADR works is as follows:

1. Issuer Selection

A foreign business that wants to use ADRs to access American capital markets chooses a bank or other financial institution in the country to serve as its depository bank. An essential function of the depository bank is the issuance and administration of ADRs.

2. ADR Creation

The depository bank buys a certain quantity of shares of the foreign company's stock in the foreign market. These shares are held by the custodian of the foreign depository bank. After that, the depository bank issues ADRs in the US, each of which represents a certain number of shares of the equity of the foreign firm.

3. Level of ADRs

ADRs fall into several categories based on how closely the foreign firm and the depository bank collaborate:

Generally, businesses that do not plan to raise cash on the U.S. market employ Level 1 ADRs. They provide investors in the United States basic access and have few reporting obligations.

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[6] Dal O. Didia, Emerging Markets, American Depository Receipts and International Diversification, 3 JIBE 43, 44 (2015), http://dx.doi.org/10.15640/jibe.v3n2a3.

[7] Officer, Dennis T. and Hoffmeister, Ronald J. (1987) "ADRs: A Substitute for the Real Thing?" The Journal of Portfolio Management 13(2): 61-65.

In the US, Level 2 ADRs must submit more thorough disclosures and reports to the Securities and Exchange Commission (SEC). Issuers of Level 2 ADRs commonly use them to raise capital in the US market.

Companies actively seeking capital in the U.S. market often employ Level 3 ADRs, which have even stringent reporting requirements.

4. Trading on U.S. Exchanges

After they are issued, ADRs are listed and traded on US stock exchanges including the NASDAQ and the New York Stock Exchange (NYSE). American investors may buy and sell ADRs just as they would any other stock that is listed in the country.

5. Dividends and Benefits

Dividends paid by the foreign firm to the depository bank are converted into US dollars and distributed to holders of ADRs by the bank. ADR holders may potentially benefit from further business activities, provided that the depository bank permits them, such as stock splits and rights offer.

6. Voting Rights

American Depositary Receipts (ADRs) usually grant holders of ADRs particular rights, such the ability to vote in shareholder meetings of the foreign firm and participate in important decision-making processes. Voting rights are subject to the conditions specified in the ADR programme and the ADR level.

7. ADR Fees and Costs

ADRs come with a host of costs and charges, including currency conversion, custody, and issue fees. These expenses are usually borne by the holders of ADRs and may affect their total returns.

8. ADR Cancellation

ADR cancellation is a situation in which investors may elect to exchange their ADRs for the underlying foreign shares. Typically, this is done when investors want to hold shares directly on a foreign market.

(A) Types of ADRs

There are two types of ADRs:

- Sponsored ADRs

A depositary receipt (ADR) issued by a bank on behalf of a foreign corporation whose stock serves as the underlying asset is known as a sponsored American depositary receipt (ADR).

When an ADR is sponsored, a legal connection is formed between the ADR and the foreign entity that pays the issue fee for the security. While unsponsored ADRs are limited to trading on the over-the-counter market, sponsored ADRs have the ability to be listed on reputable exchanges (OTC).

- Unsponsored ADRs:

An unsponsored ADR programme is started by a depositary bank without the contractual consent of the business. The demand from brokers and investors drives the creation of an unsponsored ADR scheme. ADRs are traded on the over-the-counter (OTC) market in the United States.

(B) Advantages of ADRs

- Access to Wider Investor Base: By using ADRs, foreign firms may reach a broader global investor base—especially in the United States—without having to deal with the hassles of listing on many different foreign exchanges. The U.S. stock exchange, which typically has higher trading volumes and liquidity than international markets, is where ADRs are listed and traded. This may draw in more investors and make the company's stock more liquid.
- Diversification: By investing in businesses from different nations and sectors, investors may diversify their portfolios and reduce risk by using ADRs.
- Enhanced Investor Interest: By making foreign firms more visible and recognisable on the international stage, ADR listings may spark greater investor interest and favourable branding.
- Extra Shares Issues: Foreign firms can raise money on the U.S. market by issuing additional shares to investors through Sponsored ADRs, especially Level 2 and Level 3.
- Prevents the Troubles and Risks of Currency Conversion: It is easy for American investors to buy and sell shares in ADRs without having to deal with foreign exchange regulations or currency conversions because ADRs trade like ordinary equities on American marketplaces. Additionally, dividend payments to ADR investors are made easier by having foreign business dividends translated into US dollars and disbursed by the depository bank. By exposing investors to the stocks of overseas firms without requiring them to trade in foreign currencies directly, ADRs reduce the risk associated with currency exchange rates.

(C) Disadvantages of ADRs

- Extended Waiting Time Returns: ADRs may require a significant period of time to generate returns, just like any other investment. However, the investment's designation as an American Depositary Receipt does not determine how long it takes to generate returns (ADR). The factors that affect stock prices are numerous and include the underlying company's financial performance, the state of the market, and general economic concerns. Certain American Depositary Receipts (ADRs) could appreciate more quickly than others, but many might take longer to provide returns.
- Variations in the Foreign Exchange Market: It is reasonable to be concerned about the fluctuations in foreign exchange prices. Though the primary function of American Depositary Receipts (ADRs) is to indicate ownership in a foreign firm, ADRs are denominated in the U.S. dollar. As a result, fluctuations in the exchange rate between the US dollar and the currency of the company's home country may impact how much an investment is worth. The existence of these modifications may possibly elevate the risk and uncertainty associated with your investment.
- Lesser Investment Options: While it is true that not all international businesses issue American Depositary Receipts (ADRs), there are a limited number of ADRs that are available for purchase. American Depositary Receipts (ADRs) of a number of globally renowned corporations are listed on US stock exchanges, providing investors with access to a diverse range of industries and markets. However, it should be remembered that not all foreign businesses are reachable through American Depositary Receipts (ADRs).

IV. CONCLUSION

Any investment, including American Depositary Receipts (ADRs), should be carefully considered after a thorough evaluation of one's risk tolerance and investing goals. It makes sense to diversify one's investment portfolio by integrating a range of investment possibilities if one is worried about the aforementioned drawbacks. This will lower the related risks. A financial adviser session may offer expert insights catered to your individual requirements and objectives. ADRs provide a multitude of advantages to overseas enterprises and American investors alike, such as heightened market accessibility and prospects for capital funding, streamlined trading, and exposure to international investments.

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