

HOW would you like to invest in Chinese heavyweights such as Internet search engine Baidu and China Petrochem in local time, and using your own CDP account?

The launch of Singapore Exchange's GlobalQuote platform last week has opened up a slew of opportunities to invest in as many as 19 Chinese companies, through American Depository Receipts (ADRs). The launch has been hailed as a milestone, with SGX and Nasdaq OMX poised to add yet more ADRs of Asian-based companies.

But what are ADRs, and what risks should you be aware of? Is it possible to arbitrage, or profit from price discrepancies between an ADR here and its primary listing of shares or ADRs in Hong Kong or the US?

ADRs began in 1927 in the US, an innovation then to make it easy for investors to buy and hold a foreign share. Those benefits are retained today and they are numerous, particularly for small investors as they offer access to markets that may normally be more difficult to access.

On GlobalQuote, investors are able to buy and sell ADRs, much as they would any other stock listed on SGX, with no need to open a separate overseas account or pay foreign custody fees. One of the major benefits is that the ADRs are fully fungible. This means ADRs on GlobalQuote and in the US are the same securities. You can freely transfer them at a fee between the US and Singapore. What's more, dual-listed ADRs can be converted into common shares and vice versa.

What investor profile may be suitable for ADRs? He or she should be accustomed to trading in stocks directly, as ADRs offer exposure to single companies. ADRs belong to the higher risk portion of a portfolio. Those who are accustomed to investing in managed funds, or who have no time to research the companies, or do not understand ADRs at all should probably not invest.

Says David Gerald, chief executive of the Securities Investors Association (Singapore): "While every individual's investment criteria, situation, and risk appetite is different, and I advocate seeking a financial adviser's assistance in managing their finances and developing a portfolio based on their needs. Nevertheless, I (think) that (ADRs) are suitable for the investor who already has done his asset and portfolio allocation."

The mechanics

Here are some basics that you should be aware of. First, there are a few types of ADRs. Those that are quoted on GlobalQuote are sponsored Level II and III depository receipts. A sponsored ADR is issued by a depository bank appointed by the issuer, under a deposit agreement.

An unsponsored ADR is issued by the depository bank in response to market demand, but without a formal agreement by the issuer.

Level II and III ADRs require registration with the US' Securities and Exchange Commission (SEC), and compliance with

ADRs demystified

The launch of American Depository Receipts here presents a slew of opportunities for investors. **By Genevieve Cua**

requirements for US GAAP (generally accepted accounting principles) reporting and listing regulations.

There are two variants of ADRs here – dual and single listed – which have implications on the risks. Dual-listed ADRs on GlobalQuote have common shares listed on an exchange such as Hong Kong and, as it happens, ADRs in the US. The company must comply with listing regulations in both jurisdictions. Single-listed ADRs do not have common shares listed on an exchange. They do have ADRs listed in the US.

What to look out for

Here are some risks to be mindful of:

➤ Obviously, just like a share, ADRs are

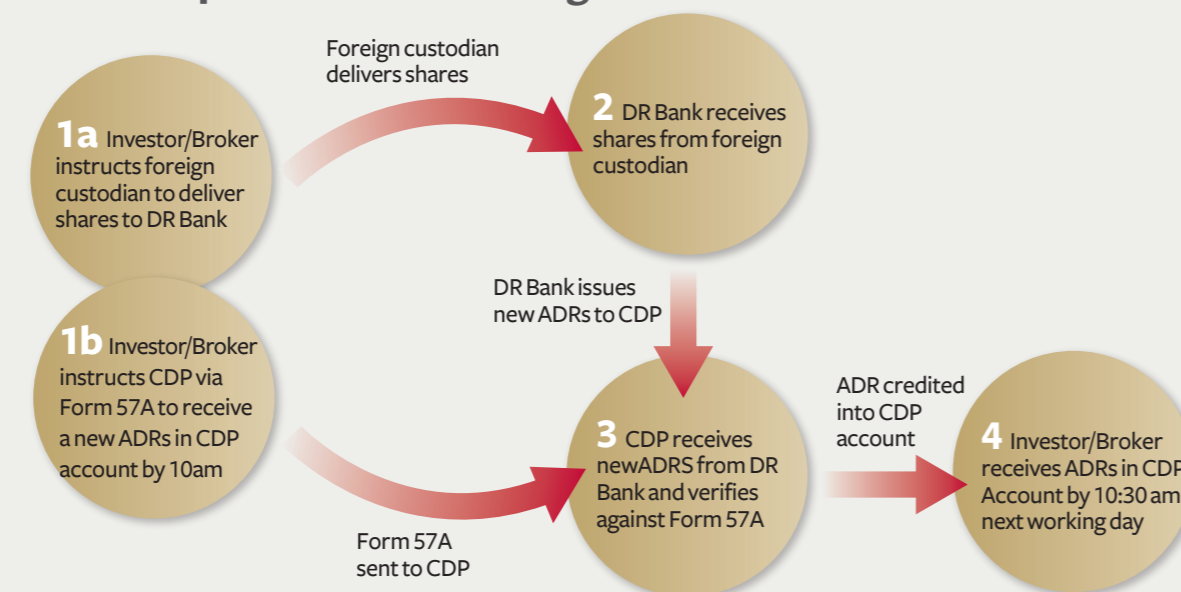
subject to market and company specific risks. There are also foreign currency risks, as trading in ADRs involves the currency in which the ADR is denominated, the currency of the underlying common share, and investors' own currency. There are other forex-related implications, relating to the type of operation and the operating currencies of the underlying businesses.

➤ Price risk. The price of an ADR may not track its underlying common share. SGX's Investors' Guide to ADRs says that foreign ownership restrictions in companies in overseas markets imposed by their governments often cause ADRs to trade at a premium to their common shares. "As a result, ADR prices may be subject to wide fluctuations even when the underlying shares are relatively stable."

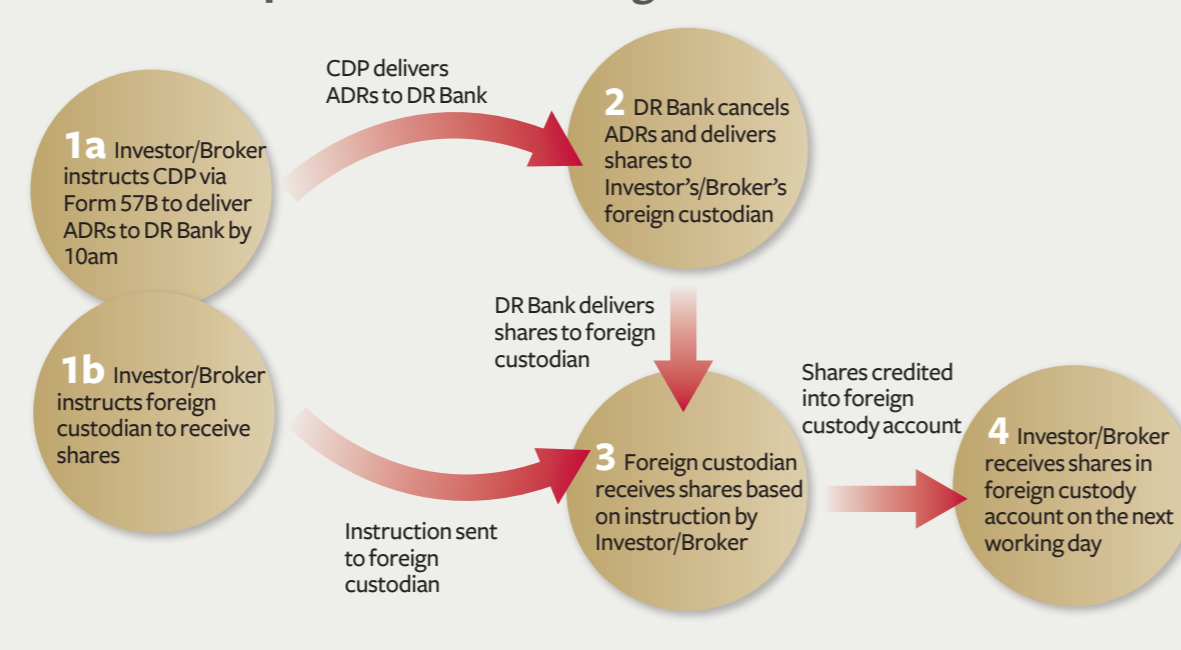
➤ Do your homework. ADRs on GlobalQuote are not subject to the listing and disclosure requirements of the SGX. Hence there is no prospectus, for instance. You should tap public sources of information, such as the companies' websites or – for those with listings of ADRs in the US – the US SEC EDGAR site (<http://www.sec.gov/edgar.shtml>) where company filings are made. Investors should also read the deposit agreement. The avenue of recourse action by ADR holders is through the US courts.

➤ Even though ADRs listed in the US must abide by the securities laws and listing regulations of the US, corporate governance may still be an issue, says Jeremy Goh of the SMU Sim Kee Boon Institute for Financial Economics.

Issuance process – Converting Common Shares into ADR



Cancellation process – Converting ADR into Common Shares



"There is an issue with regards to corporate governance, namely investors' rights. The underlying companies are not incorporated in the US; it will be difficult for US regulators to assert authority over these companies."

A number of local stockbrokers have research on some of the names, including Baidu and Trina Solar, a fully integrated solar power company. A listing on GlobalQuote should also not be taken as an indication of the merits of the ADR, of the issuer, its subsidiaries and securities, or its depository bank.

➤ Termination or receivership. An ADR may cease to be quoted on GlobalQuote if it is delisted in the US or if the depository bank ceases in its role and there is no replacement. No approval from ADR holders is needed for delisting of ADRs from the US exchanges or termination of the programme.

There are a few alternatives if this happens: You could sell the ADR prior to its de-quotations. You could also cancel the ADRs into common shares if the ADR is dual-listed. You will need an overseas cus-

tody account, and you can then sell the shares on the overseas exchange, provided trading of the common shares is not suspended.

After an ADR is removed from quotation on GlobalQuote, CDP will arrange to sell any remaining ADR holdings, and distribute the cash proceeds to holders in CDP. There is a risk that the ADRs could be worthless or cannot be sold.

➤ Counterparty risks. There are more counterparty risks with ADRs, than there are with shares. The depository bank, for instance, could get into financial difficulty. If this happens, the common shares underlying the ADR should be ring fenced, but this view has not been tested, according to SGX's Investors' Guide to ADRs.

ADR holders may face administrative difficulties or may not be able to take legal action against the issuer or depository bank. All the 19 ADRs are using the same depository bank, the Bank of New York Mellon.

➤ Inability to vote. ADR holders in CDP will not be able to vote through CDP, unlike direct holders of ADRs listed in the US. If you wish to vote, you will have to

transfer your ADRs to the US DTCC (Depository Trust & Clearing Corp), or convert the ADRs into common shares.

➤ Dividends and non-cash entitlements. The depository bank will pass on dividends and other cash distributions where possible, after converting them to US dollars and deducting fees of about US\$0.05 per ADR per cash distribution and any withholding tax, if applicable.

➤ Risks of single-listed ADRs. These are ADRs with unlisted underlying shares, of which there are nine on GlobalQuote. Holders who surrender their ADRs will be exposed to the risk of holding unlisted shares, which may not be liquid and will be subject to other risks. It is not advisable to convert ADRs into unlisted shares.

➤ Risk of trading halt. A trading halt may be imposed by SGX on ADRs if trading of the same ADR or corresponding underlying share is halted in an overseas market.

In cases where the underlying share is not halted or suspended, SGX may allow the ADR to trade, even if the same ADR in the US is halted. When trade is suspended, investors may suffer losses from time delay and the inability to trade.

The big question that investors are likely to puzzle over is this: Will there be arbitrage opportunities between the ADRs on GlobalQuote and the ADRs on the US or the companies' common shares listed in Hong Kong?

You'll have to take into account the trading costs. Prof Goh says: "In theory, (arbitrage) may be possible as recent research has found disparity between ADR prices and the underlying shares. However, transaction costs, time difference, and foreign exchange differences in executing the trades may be non-trivial."

Trading in ADRs will incur brokerage fees, a clearing fee of 0.4 per cent on the value of the contract, subject to a cap of \$600; and GST charges.

On whether ADRs typically trade at a premium or discount to their underlying shares, Prof Goh cites research by Gagnon and Karolyi this year on cross listings.

They found that the price discrepancies between cross-listed shares and those in the home market lie within a 20 to 85 basis point band, but for some stocks they can range from a 66 per cent premium to an 87 per cent discount.

They also found that stocks cross-listed in the US tend to be more highly correlated with US market indices than with their respective home market indices.

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Before you take the ADR plunge

➤ What is your risk appetite? The risk of ADRs is similar to that of a single stock exposure, with additional issues including counterparty risk, foreign currency risk, and risk arising from the type of ADR – whether single or dual listed. If your investments consist mainly of unit trusts, you may be more comfortable with a professionally managed portfolio. Make sure to understand the technicalities and unique risks of ADRs before you invest.

➤ As with any stock investment, ask questions on the underlying company's business, its growth outlook, and what valuations you are buying into. Request for research from your broker; check the company's website, and peruse filings in the US SEC EDGAR site. Also, read the deposit agreement.

➤ For now, the ADRs are all mainland Chinese companies. Those with dual listings are listed in Hong Kong. Be vigilant on China-specific risk on the macroeconomic as well as political side that may impact the underlying company, such as policies on currency, interest rates, and capital controls.

➤ Check on the costs of trading ADRs, in particular the bid/ask spread which is an implicit cost. It is still early days for ADRs on GlobalQuote, but the SGX has said that the first day of trading on Oct 22 saw an ADR turnover of US\$10 million with spreads ranging between 10 and 40 basis points, which is in line with the broad SGX securities market.

➤ What are the transaction costs? Typical brokerage costs and clearing fee of

0.04 per cent of the contract; and GST charges will apply.

➤ Is the ADR dual or single listed? The common shares of a single-listed ADR are not traded on an exchange. At the worst case, if the ADR programme is terminated you could end up with illiquid unlisted shares which will be hard to value. Single listed ADRs are denoted with a "+" sign on the SGX.

➤ Trade round the clock. You can transfer your ADRs in your CDP account to your account Depository Trust & Clearing Corp (DTCC) in the US. You can buy or sell in your choice of the Singapore or US exchange.

➤ The worst case scenario is that an ADR could be terminated. In that case the ADR could become worthless.

Issuance and conversion

FUNGIBILITY is a major benefit of the ADRs listed on GlobalQuote. This means that the ADRs in Singapore can be freely transferred for a fee to the US.

For dual-listed ADRs whose common shares are listed on an exchange, the ADRs can be converted into shares and vice versa. For single-listed ADRs, their common shares are not listed in any overseas market and hence it is not advisable for investors to convert the ADR into unlisted common shares. Here's what happens in the issuance and conversion process. Note that there are costs involved.

Issuance process

Issuance (converting common shares into ADRs) starts with you sending an instruction to your overseas custodian to deliver the shares to the depository bank. You will need to inform the CDP to expect receipt of ADRs into your CDP account.

When the depository bank receives your common shares, the bank will issue new ADRs of equivalent value less fees to CDP, which will credit the ADRs into your account. The process takes 24 hours to complete.

The fees are: CDP transfer fee of \$10.70 including GST per transfer instruction. The ADR depository bank charges an issuance fee of up to US\$0.25 per ADR issued. You may also be charged fees by your overseas custodian.

Cancellation process

Cancellation converts ADRs into common shares. You will have to send an instruction to CDP to deliver ADRs to the depository bank. You will also need to inform your overseas custodian to expect receipt of common shares in your overseas custody account.

When the depository bank receives your ADRs, the bank will cancel the ADRs and deliver common shares of equivalent value less fees to your overseas custody account. The process takes 24 hours to complete. You will need an overseas custody account to receive the shares.

Similar fees will apply, as with issuance: CDP will charge a transfer fee of \$10.70 per transfer instruction, and the ADR depository bank charges a cancellation fee of US\$0.25 per ADR cancelled.

Glossary of terms

➤ Depository receipts: A security that represents equity issued by a foreign company. Investors gain exposure to a company that may not be accessible through their local market. Issuers may seek an international shareholder base.

➤ American depository receipts: A US security that represents ownership of shares in a foreign company.

➤ GlobalQuote: SGX quotation board for international securities including ADRs

➤ Sponsored Level II and III ADRs: Both are issued under a deposit agreement with a depository bank. Level II ADRs do not involve raising new capital. Level III ADRs allow new capital raisings.

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