

# Global depositary receipts – investing in emerging markets

A Guest Article by Michael Thompson  
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### **What are Global Depositary Receipts?**

Global Depositary Receipts (GDRs) are transferable securities issued by depositary banks. They represent ownership of a given number of a foreign company's shares that can be listed and traded independently from the underlying shares.

GDRs have risen to prominence in recent years as the favoured instrument by which companies from emerging markets such as Russia, India and China choose to raise capital on western stock exchanges.

### **How GDRs are created**

GDRs are effectively created when a broker purchases a foreign company's shares on its home stock market and delivers the shares to the depositary's local custodian bank (which verifies the receipt of the shares and holds them on behalf of the depositary), and then instructs the depositary bank to issue GDRs to the stipulated amount and to update the register.

In this way, a Russian share can effectively be made to trade as an English security, a US common stock or perhaps as an Australian share. The depositary bank can issue GDRs into any jurisdiction for which there is sufficient investor demand and will tailor the terms and conditions of the GDRs to accommodate the particular legal jurisdiction concerned.

### **Reducing obstacles to international investment**

GDRs have a relatively established and respectable history, and for years have served to reduce obstacles to investment between one market jurisdiction and another. In effect they convert, for example, a UK share into a US share and, although the same share is governed by two very different regulatory regimes, it will trade comfortably in both regimes.

Importantly, too, the prices of that same share trading in the US and the UK – albeit in different currencies – remain linked.

GDRs effectively facilitate domestic investor purchases of foreign securities and, at the same time, allow foreign companies to have their stock trade in the investor's domestic market by reducing or eliminating various hurdles, such as:

- settlement delays
- high transaction costs (including costly currency conversions)
- uncertain custody services

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- poor information flow
- unfamiliar market practices
- confusing tax conventions
- other potential inconveniences and negatives associated with international securities trading.

### **Aiding global diversification**

The increasing demand for GDRs in recent years has largely been driven by the desire of individual and institutional investors to diversify their portfolios, reduce investment risk and invest internationally in the most efficient manner available.

However, while many investors acknowledge the benefits of global diversification, they also understand the challenges faced when investing directly into foreign trading markets. GDRs overcome many of the inherent operational and custodial hurdles of international investing and offer certain cost benefits and conveniences, which we highlight in this article.

### **Using familiar procedures**

The objective of a GDR, therefore, is to enable investors in developed markets, who would not necessarily feel comfortable buying emerging market securities directly in the securities' home market, to gain economic exposure to the intended company and, indeed, to the emerging economy using the procedures in their own developed markets with which they are familiar.

The GDR functions as a means to increase global trade, which in turn can help increase not only trade volumes on local and foreign markets but also the exchange of information, technology and regulatory procedures as well as market transparency.

Therefore, instead of being faced with impediments to foreign investment, as is often the case in many emerging markets, the GDR investor and company can both benefit from investment abroad.

GDRs also overcome limits on restrictions on foreign ownership or the movement of capital that may be imposed by the country of the corporate issuer.

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### **Benefits of GDRs to a company**

The establishment of a Depositary Receipt programme, through which GDRs can be issued, offers several advantages to foreign companies. These may include:

- expanded market share through broadened and more diversified investor exposure with potentially greater liquidity for the underlying shares, which may increase or stabilise the share price
- enhanced visibility and image for the company's products, services and financial instruments in a marketplace outside its home country and also greater prestige in its home market
- a flexible mechanism for raising capital and a vehicle or currency for mergers and acquisitions
- the ability to encourage investment from abroad without having to worry about barriers to entry that a foreign investor might face
- the opportunity for employees of domestic subsidiaries of foreign companies to invest more easily in the parent company
- the encouragement and promotion of an international shareholder base.

### **Benefits of GDRs to an investor**

As mentioned earlier, investors are increasingly aiming to diversify their portfolios on an international scale. However, the various hurdles associated with international securities trading, as highlighted above, may discourage institutions and private investors from venturing outside their local market by purchasing ordinary shares in the foreign company's home market.

With that in mind, the advantages of purchasing GDRs instead may, from the investor's perspective, include:

- quotation in the GDR currency and payment of dividends or interest in the GDR currency, which is usually US dollars, pounds sterling or euros
- diversification without many of the obstacles that mutual funds, pension funds and other institutions may have in purchasing and holding securities outside of their local market
- the ability to reap the benefits of these usually higher-risk, higher-return equities in emerging markets, without having to endure the added risks of

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going directly into such foreign markets, which may pose a lack of transparency or instability resulting from changing regulatory procedures

- familiar and certain trade, clearance and settlement procedures
- competitive GDR currency/foreign exchange rate conversions (as against most foreign currencies) for dividends and other cash distributions
- the ability to acquire the underlying securities directly upon cancellation.

### **How GDRs trade**

A GDR holder can sell in two ways:

- The GDR can be sold to another investor in the market in which the GDR trades. This is known as an intra-market transaction, and will be settled in the same way as any other security purchase in that market.
- The GDR can be cancelled and the underlying shares can be sold to a foreign investor through a cross-border transaction. In this case, the GDR certificate would be surrendered to the depositary bank. The shares held with the local custodian bank would be released back into the home market of the company whose shares are being released, and sold to a broker there.

Furthermore, the GDR holder would be able to request delivery of the actual shares at any time. This exchange facility – i.e. the ability to exchange the GDRs for the shares they represent in their home market – is important because it ensures a price linkage between the two markets.

Price differentials between the two markets do occur, but the exchange facility provides a channel whereby some price equilibrium can be reintroduced between the two markets, and the continuous buying and selling of GDRs in either market tends to keep the price differential between the two markets to a minimum.

### **London and Luxembourg**

The two stock exchanges that have become most associated with GDRs in recent years are Luxembourg and London.

When GDRs were first used (in the late 1980s), Luxembourg was viewed as the logical listing venue because of its historic role in the Eurobond market and its direct communications with Euroclear and Clearstream, the prime settlement providers of this market. These organisations are experienced at handling

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securities transactions in a number of foreign securities and in dealing with the complexities of corporate actions originating from economies that do not necessarily have the same traditions of corporate reporting and shareholders' rights.

Some years later, the London Stock Exchange (LSE) was successful in establishing a niche in the GDR business by applying a light-touch regulatory approach to listing and by providing secondary market liquidity through the International Order Book (IOB), a trading platform operated by the LSE.

As a result, a large proportion of listed GDRs have chosen London as their listing and trading venue, while the settlement of bargains in GDRs continues to be directed through Euroclear and Clearstream.

### **Conclusion**

GDRs offer investors the opportunity to add the benefits of foreign investment to their portfolio while bypassing the unnecessary risks of investing outside their own borders.

Furthermore, from a company's perspective, GDRs offer the opportunity for the company to obtain greater exposure and to raise capital in the world markets from among a broader, international shareholder base.

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If you would like more information on any of the points covered in this Guest Article, please contact **TCii** on **020 7099 2621**.