ADVICE TO ESMA

SMSG own position paper: Depositary Receipts and Geopolitical Risks

I. Introduction to Depository Receipts[1]

1. A depositary receipt (DR) is a negotiable certificate issued by a bank representing shares in a foreign company traded on a local stock exchange or sold directly to investors. The depositary receipt gives investors the opportunity to hold shares in the equity of foreign countries and gives them an alternative to trading on international markets. One of the most common types of DRs is the American depositary receipt (ADR) listed on American stock exchanges, which has been offering foreign companies, US investors, and traders global investment opportunities since the 1920s.

2. A depositary receipt is an alternative to trading directly with the stock exchange in the foreign market. Instead, investors transact with a major financial institution or exchange within their home country, which is often more convenient than purchasing stocks directly in foreign markets.

II. Types of Depositary Receipts

3. Depositary receipts are available around the world in different local flavours: American depositary receipts (ADRs), global depositary receipts (GDRs), European DRs, and international DRs. While ADRs are traded on a U.S. national stock exchange, GDRs are commonly listed on European stock exchanges such as the London Stock Exchange or the Frankfurt Stock Exchange. Both ADRs and GDRs are usually denominated in U.S. dollars, but can also be denominated in euros.

4. A foreign company intending their share to be available to investors in the EU without listing here can accomplish this via a GDR. The foreign company enters into a depositary receipt agreement with a depository bank. In turn, the depositary bank issue shares in regulatory compliance with both jurisdictions, the country of domicile of the company and the EU for European investors. DR holders do not have to transact in foreign currencies because DRs are usually traded in the home currency of the investors (e.g. Euro) and are processed by the local clearing and settlement systems.

5. Depositary receipts provide investors with the benefits and rights of the underlying shares, which may include voting rights, dividends, and open up markets that investors would not have access to otherwise. Depositary receipts may be more or less convenient (transposing e.g. taxation, currency and other aspects to the jurisdiction of the investor) and can be more or less expensive than purchasing stocks in foreign markets. Depositary receipts help international companies to raise capital globally and encourage international investment.

[1] https://www.investopedia.com/terms/d/depositaryreceipt.asp

6. In order to establish any type of DR program, the issuer assembles a team of advisors that typically includes investment bankers, lawyers and accountants. The issuer also selects a depositary bank, a key partner that enlists the services of a local market custodian and other key support service providers to assist in the implementation of the program. The issuer and the depositary execute a deposit agreement, a contract which sets forth the terms of the DR program. Based upon the contract, the depositary performs certain specific services on behalf of the issuer and the DR holders. Many of these same parties may play key roles in the long-term development and day-to-day management of the issuer's DR program.

7. It is the responsibilities of the depositary / issuing bank guaranteeing that there are underlying original shares backing the issuance of the DR. The way the depositary bank will manage the DR, which jurisdictions are involved, whether the holding is direct in the CSD of the country of origin of the issuer or via omnibus or nominee account through an ICSD /Euroclear or Clearstream) will differ between the various DR programs and is usually stipulated in the terms of the DR program, which are difficult to find for retail investors and which are not clear, intelligible and concise given their length, legal verbiage, and technicality.

8. Disadvantages of depository receipts can be that investor access is restricted to certain group of investors, that they may trade at relatively low liquidity and they may also come with significant administrative/custodial fees. Sometimes cumulative taxes are to be taking into account. Depositary receipts do not eliminate geopolitical risks including currency risks for the underlying shares in another country. Dividend payments made in local currency are converted for example to Euros, net of conversion expenses and foreign taxes. The conversion is done in accordance with the deposit agreement. Finally, the depositary receipt may be withdrawn at any time, and the waiting period for the shares being sold and the proceeds distributed to investors may be complex. DRs are complex and risky instruments, notably taking into account the protection of less informed end investors.

III. Depository Receipts on Russian Companies under EU Sanctions

9. In several European markets, notably Germany and the UK, DRs on Russian shares were sold to both institutional and end investors. These DRs were issued by investment /depository banks, for which original shares are held in custody by those issuing banks and the DRs certify the ownership of the shares. On 24 February 2022 Russia illegally invaded Ukraine. This war and the resulting crimes triggered international sanctions which have disrupted the DR market.

10. Trading in these DRs was already suspended in March 2022 as a result of EU sanctions. As a counter sanction, the Russian legislature enacted Law no. 114-FZ, according to which Russian companies had to suspend the agreements with the depositary banks with regard to their ADR/GDR programs. Subsequently most Russian issuers complied with this regulation and terminated their DR programmes.

11. The depositary banks then offered investors to exchange the DRs for ordinary shares in the Russian companies. The procedure for the exchange was supposed to be as follows: The depositary bank opens a nominee account with a Russian bank that is not sanctioned, such as the Gazprom Bank. Such an exchange would at least change the ownership position of the respective investor in a direct shareholding in the Russian company, hoping that after a regime change in Moscow it would regain value and trading would again be possible. Thus, EU Investors would at least maintain the asset rights for the future.

12. This exchange was subsequently made more difficult by further sanctions:

    a) Due to the sixth EU sanctions package published on 03.06.2022 the exchange program for the DRs with Russian shares as the underlying security was suspended. DG FISMA clarified that due to the Council Regulation (EC) No. 269/2014, all trading activities with Russian securities and Depositary Receipts conversions that benefited Russian entities (such as the Russian Central Security Depository NSD) are prohibited. NSD announced in July that it will not charge any fees during a certain period and that NSD would not derive any economic benefit from the exchange. The period during which NSD does not charge any fees had in the meantime been extended until 15 October 2022.

b) In July, Moscow finally offered investors a supposed solution, the so-called "Russian way”. The holder of the securities may apply to the Russian depository, where the foreign nominee holder's securities account is held, an application for "compulsory transfer of the accounting rights." While a number of investors have taken this route and DRs could be exchanged for ordinary shares, this has largely been unsuccessful due to notaries, among others, refusing to certify documents with reference to the EU sanctions, and banks refusing to issue the necessary documentation due to the EU sanctions. It also has created significant uncertainty of actual ownership with several DR issuers suspending any conversions.

c) On 1 August 2022 the Securities and Exchange Commission (SEC) issued order A22090 limiting the conversion by possibly including DRs under the rules of so-called Low Priced Securities (LPS). These are defined as securities traded over the counter that cost less than USD 5.00. The risks associated with such LPs (strong price volatility, susceptibility to market manipulation) justify, according to the U.S. authorities justify special investor protection.

d) Furthermore, all dividend and interest payments made by Russian entities have not been received by the beneficial investors in the EU, due to the EU sanctions.

IV. SMSG opinion

13. For the SMSG this raises strong concerns of investor protection and the more general questions on the regulation of DR programmes in the European Union. The specific issue of Russian DRs also raises some specific questions to EU authorities, especially ESMA and the EU Commission.

14. The SMSG fully supports the EU Sanctions against Russia and condemns the illegal aggression and the war on Ukraine.

15. However, in the particular question of how to ensure asset rights of EU investors are maintained to the largest extent possible, we think it is important to ensure that the trust into the EU system of investing is maintained and that sanctions to the largest extent possible punish Russian actors, but, whenever possible, not EU citizens’ rights seen on a longer term perspective/end of war. As such we would ask ESMA and the EU Commission to provide guidance and a clear harmonised approach to EU citizens maintaining at least their asset rights (incl. rights to dividends) in Russian companies.

16. On the more general question of DRs the Russian example has shown that investors are not fully aware of the risks inherent to DRs such as the operational, conversion and geopolitical risks. Next to the quickly changing sanction rules, also a lack of transparency on DR programs, e.g. regarding the custody of underlying shares, is contributing to this.

17. The high complexity of these programmes, the divergent practices and legal frameworks, in the view of the SMSG call for clear regulation on DR programmes sold in the European Union.

18. As regards EU DR regulation, while DR are not unknown for EU regulations there is not a specific DR regulation (contrary to the US) that governs how DR should be structured and how EU or national authorities may react to specific situations affecting DR as in the current case. An EU DR regulation would be a measure to protect clients' assets.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

Adopted on 25 November 2022

[signed]	[signed]	[signed]
Veerle Colaert Chair Securities and Markets Stakeholder Group	Christiane Hölz Rapporteur	Rainer Riess Rapporteur