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Rule 12g3-2(b) Exemption Moves to the Web and Changes the Market for Unsponsored ADR Programs

Effective October 10, 2008, the US Securities and Exchange Commission (the SEC) amended Rule 12g3-2(b) under the US Securities Exchange Act of 1934, as amended (the Exchange Act), which exempts foreign private issuers[1] from Exchange Act registration and, consequently, from the SEC's periodic reporting and the US Sarbanes-Oxley Act of 2002 (the SOX) compliance requirements. Among other things, the amendments eliminate the previous requirements that a written application and local disclosure documents in hard copy be submitted to the SEC. Instead, the rule now automatically exempts foreign private issuers that maintain a listing of equity securities in their primary trading markets outside of the United States and publish their local disclosure documents in English on their corporate Web sites or through other electronic information delivery systems.[2]

The amendments have made both obtaining and maintaining the exemption considerably easier and have significantly increased the number of foreign private issuers that are eligible to claim the exemption. After January 10, 2009, the SEC will no longer accept paper submissions from foreign private issuers to satisfy their existing Rule 12g3-2(b) obligations.[3]

The amendments can be expected to lower compliance costs and to improve US and other investors' access to material disclosure documents, and, through such access, to facilitate resales of securities in the United States to institutional investors (qualified institutional buyers) pursuant to Rule 144A under the US Securities Act of 1933, as amended (the Securities Act), without issuers becoming subject to the periodic reporting requirements of the Exchange Act or the compliance requirements of SOX.[4]

Based on events in the first months after the amendments took effect, their other immediate impact, however, appears to have been on the market practice for establishing American Depositary Receipt (ADR) programs.[5] As before, the Rule 12g3-2(b) exemption is a condition to a foreign private issuer's equity securities trading over-the-counter in the United States in the form of ADRs. The fact that the rule is now self-executing has significantly increased the number of new "unsponsored" ADR programs (essentially, ADR programs that have been set up by depositary banks without the issuer's participation or, in some instances, consent) as depositary banks no longer need the issuer to claim the Rule 12g3-2(b) exemption by way of a written application to the SEC.[6]

> "After the amended rule took effect on October 10, 2008, more than 1,000 unsponsored ADR programs have been established by depositary banks."

Obtaining and Maintaining the Exemption

Under Section 12(g) of the Exchange Act, all issuers (foreign and US) must register with the SEC under the Exchange Act within 120 days of the last day of their fiscal year if, on that date, the number of record holders of the issuer's equity securities is 500 or more, and its total assets exceed $10 million.[7] A foreign private issuer will, nevertheless, be exempt from this requirement so long as fewer than 300 of the holders of its equity securities are resident in the United States,[8] and even if the number of US resident holders exceeds 300, a foreign private issuer can become exempt from registration by claiming the Rule 12g3-2(b) exemption in the manner discussed below.

Under the amended rule, a foreign private issuer is now eligible to claim the Rule 12g3-2(b) exemption so long as it meets the following criteria:[9]

- *Electronic Publication of Local Disclosure Documents.* Since the beginning of the issuer's most recent fiscal year, the issuer must have published its material disclosure documents, in English, on its Web site or through an electronic information delivery system generally available to the public in its "primary trading market" outside of the United States.[10] The SEC did not change the scope or the materiality requirements of the information to be published,[11] although, importantly, the rule now requires English translations instead of "brief English descriptions" or "English versions," which were allowed under the old rule.[12] While the information that must be published may vary depending on the application of the rule's materiality threshold to each issuer,[13] the SEC has indicated that, at a minimum, an issuer must now publish electronically and in English the following documents to claim the exemption:
  - its annual report, including or accompanied by annual financial statements;
  - its interim reports that include financial statements;
  - press releases; and
  - all other communications distributed directly to security holders of each class of securities to which the exemption relates.
- *Foreign Listing.* The issuer must maintain a listing on one or more exchanges in its primary trading market outside of the United States. For these purposes, "primary trading market" means:
  - a foreign market that, either alone or together with another foreign market, accounted for at least 55 percent of the trading in the relevant securities on a worldwide basis in the issuer's last fiscal year; and
  - if trading in the relevant securities in two foreign markets is combined to meet the 55 percent threshold, the trading on at least one of them is greater than the trading in the United States.[14]
- *No Existing SEC Reporting.* The issuer must not be required to file or furnish reports under Sections 13(a) or 15(d) under the Exchange Act (this generally means that the issuer has not voluntarily registered with the SEC, does not have equity or debt securities listed in the United States and has not conducted a public offering of equity or debt securities in the United States).

Once established, a foreign private issuer can maintain the Rule 12g3-2(b) exemption by continuing to publish electronically its disclosure documents in English "promptly" after the information has been made public in the issuer's primary trading market.[15] Whether disclosure has been made "promptly" depends on the type of document and the amount of time required to prepare the English translation and presumably also the time required for the legal review of the translation. Material press releases generally need to be published electronically in English on or around the same business day as their original publication.

Issuers are not required to notify the SEC, or even publicly disclose, that they are claiming the Rule 12g3-2(b) exemption, although certain foreign

private issuers have opted to create separate Web pages on their corporate Web sites that identify those electronic disclosures that are made to claim the exemption.

An issuer will lose and/or become ineligible to claim the exemption if it:

- no longer qualifies as a foreign private issuer;[16]
- fails to publish promptly the required local disclosure documents electronically;
- no longer meets the foreign listing/primary trading market condition; or
- incurs Exchange Act reporting obligations (typically by voluntarily registering with the SEC, listing equity or debt securities in the United States or conducting a public offering of equity or debt securities in the United States).[17]

In practice, the new requirements mean that, in addition to promptly preparing and publishing electronically disclosure documents in English, foreign private issuers also have to monitor their foreign private issuer status, as well as analyze their relative trading volumes in the United States and their local markets on at least an annual basis to determine whether they satisfy the foreign listing/primary trading market condition.

If a foreign private issuer no longer satisfies the requirements of the rule, then it would have to either register under the Exchange Act, qualify for the exemption under Rule 12g3-2(a) (provided that it can establish that it has fewer than 300 US resident shareholders), or, if possible, re-establish compliance with Rule 12g3-2(b) in a "reasonably prompt manner."[18]

The Amendments' Impact on ADR Programs

Foreign private issuers that (i) publicly sell equity securities in the United States, (ii) list their equity securities on a US stock exchange or (iii) facilitate over-the-counter trading in such securities in the United States often do so through the use of ADR programs.[19] ADRs are issued by a depositary, usually a large multinational bank, and represent a specified number of the issuer's underlying equity securities held by the depositary or its custodian. ADRs are denominated in US dollars and the depositary, as the holder of the underlying equity securities, converts any cash distributions attributable to such securities into US dollars and passes them on to the ADR holders.

When ADRs are only traded over-the-counter in the United States, they are commonly referred to as "Level I" ADR programs.[20] ADR depositaries may establish Level I ADR programs either with the issuer's participation (a sponsored program) or without the issuer's participation (an unsponsored program). Under both sponsored and unsponsored programs, the depositary bank performs a number of services on behalf of the holders of ADRs, such as issuing and cancelling ADRs, maintaining the register of holders and distributing dividends in US dollars. The ADR holders typically pay the depositary a fee for transactions in the underlying shares, such as withdrawals from or deposits into the ADR program and currency exchanges in connection with dividends, in addition to annual fees.

Before the amendments, an unsponsored Level I ADR program could only be established if the issuer had obtained the Rule 12g3-2(b) exemption by making a written application and submitting its local disclosure documents, in hard copy, to the SEC. Accordingly, if a foreign private issuer did not want to have its shares traded in the form of ADRs, it could choose not to claim the exemption so long as it was satisfied that it had fewer than 300 US resident shareholders. Unsponsored ADR programs were established from time to time, but only in relation to issuers that, for whatever reason, had already established the Rule 12g3-2(b) exemption or were SEC reporting issuers that had not established a sponsored ADR program.

With the adoption of the amendments, which automatically grant the Rule 12g3-2(b) exemption for most foreign companies that publish electronically material disclosure documents in English, ADR depositaries can now

establish unsponsored Level I ADR programs without any action by the issuers, even doing so without their consent. The SEC made concurrent amendments to Form F-6, the form of registration statement which ADR depositary banks use to register the ADRs with the SEC. These amendments make it clear that ADR depositaries can now establish unsponsored Level I ADR programs based upon their reasonable, good faith belief, after exercising reasonable diligence, that an issuer satisfies the requirements of Rule 12g3-2(b).[21]

As a result, in excess of 1,000 unsponsored Level I ADR programs have been established by various depositary banks since the amendments to Rule 12g3-2(b) took effect on October 10, 2008.

As unsponsored programs may be established without the issuer's participation, they give the issuer little or no control over features associated with the ADRs that the issuer would control in a sponsored program. In unsponsored programs, depositary banks regularly do not undertake to facilitate governance matters, such as providing voting rights to ADR holders in respect of the underlying shares, distributing shareholder communications or establishing procedures for specified corporate actions (such as rights offerings, stock splits and corporate reorganizations).

The issuer's lack of control also extends to the commercial features of the ADR program. In an unsponsored program the issuer will not participate in determining the share to ADR ratio which impacts the US dollar trading price of the ADRs, nor will the issuer have any input or control over the fees charged to ADR holders by the depositary bank. As any number of unsponsored programs may coexist for a single issuer's equity securities, the different shareholder services provided by depositary banks (such as conversion of dividend payments into US dollars at different exchange rates) may also be a source of investor confusion.

The creation of an ADR program may also result in an increase in the number of US holders of the issuer's shares. Accordingly, a possible, and somewhat counterproductive, outcome may be that the establishment of an ADR program could result in the issuer's number of US resident shareholders exceeding 300, in which case the issuer must continue to comply with Rule 12g3-2(b), even if it no longer wanted to report in English, or risk inadvertently becoming subject to SEC registration and reporting requirements.

While depositary banks are under no obligation to terminate unsponsored programs, issuers are not restricted from voicing their objection if a program is set up without issuer consent; in particular, if the issuer believes it is not eligible to claim the Rule 12g3-2(b) exemption but, instead, relies on the Rule 12g3-2(a) exemption by virtue of having fewer than 300 US resident shareholders.

Foreign private issuers may also seek to eliminate unsponsored programs by setting up a sponsored program. Unlike unsponsored programs, a sponsored program may not coexist with an unsponsored program under the SEC's current position.[22] This means that if an unsponsored program is already in existence, a foreign private issuer may not establish a sponsored program, unless the unsponsored program has been terminated and the ADR holders have been transferred to the sponsored program or their ADRs have been cancelled. In such circumstances, a foreign private issuer will either need to use the same depositary bank that created the unsponsored program to set up its sponsored program or, in most instances, agree to pay (or have a new depositary bank pay) the cancellation fees relating to the unsponsored program.

A sponsored program enables the issuer to have more control over its ADRs as the deposit agreement between the issuer and the depositary bank, which is entered into in connection with a sponsored program, typically addresses both the governance and commercial questions discussed above. The issuer's ability to interface with the

ADR holders by providing shareholder information to them should also enable the issuer to engender more positive investor relations with the ADR holders. Similar to an unsponsored program, so long as the issuer qualifies for the Rule 12g3-2(b) exemption, a sponsored Level I ADR program will not give rise to SEC registration, reporting or SOX compliance requirements. By contrast, if the issuer seeks to establish a sponsored program in connection with a public offering or listing of ADRs in the United States, such requirements will apply.

Given the significant increase in the number of unsponsored Level I ADR programs since October 2008, questions relating to unsponsored and sponsored ADR programs have become increasingly topical and foreign private issuers should continue to consider the alternatives available to them in light of their specific corporate governance and investor relations goals.

Other Key Implications of the Amendments

Other implications of the amended Rule 12g3-2(b) include:

- *Facilitating Trading Under Securities Act Rule 144A.* The increase in foreign private issuers that claim the Rule 12g3-2(b) exemption should facilitate resales of securities among qualified institutional buyers in the United States in reliance on Rule 144A. The Rule 12g3-2(b) exemption qualifies as a means of providing existing and prospective investors with the information required by Rule 144A in connection with such resales, and accordingly, the increased number of eligible issuers under the amended rule should help to further foster Rule 144A transactions.[23]

  As transactions effected in reliance on Rule 144A span from equity and debt placements and sales of existing shares by selling shareholders to qualified institutional buyers, to over-the-counter trading among qualified institutional buyers, the amended Rule 12g3-2(b) exemption can be expected to have a real impact on the US institutional investor markets for foreign private issuers that meet the requirements of the amended rule.[24] If an issuer or a selling security holder wishes to proceed with a Rule 144A transaction in reliance on the issuer's Rule 12g3-2(b) exemption, the issuer, the selling security holder and, as appropriate, their advisers will need to analyze whether the issuer complies with the requirements of the amended rule, including an analysis of the issuer's material local disclosure documents, its US and local trading volumes and the issuer's foreign private issuer and Exchange Act registration status.[25]

- *Applicability to Successor Issuers.* As part of the amendments, the SEC removed the prohibition on foreign private issuers to claim the Rule 12g3-2(b) exemption if, following a merger, consolidation, exchange of securities or asset acquisition, a foreign private issuer succeeds to the SEC reporting obligations of another issuer. This amendment flows logically from the SEC's previous amendments adopted in March 2007 (which permitted successor issuers to terminate Exchange Act reporting obligations under the new deregistration provisions and to simultaneously avail themselves to Rule 12g3-2(b)) by providing similar treatment if a successor issuer qualifies for deregistration under one of the older exit rules.[26]

Endnotes

[1] Exchange Act Rule 3b-4 defines a *foreign private issuer* as any foreign issuer other than a foreign government, except an issuer that meets the following conditions: (1) more than 50 percent of the outstanding voting securities of such issuer are directly or indirectly owned of record by residents of the United States; and (2) any of the following: (i) the majority of its executive officers or directors are United States citizens or residents; (ii) more than 50 percent of its assets are located in the United States; or (iii) its business is administered principally in the United States. Therefore, an issuer organized outside of the United States which has 50 percent or less of its outstanding voting securities held by US residents qualifies as a foreign private issuer. If more than 50 percent of such issuer's outstanding voting

securities are held by US residents, but the issuer does not satisfy any of the conditions of subsection (2) above, then the issuer also qualifies as a foreign private issuer. Pursuant to amendments to Rule 3b-4, which were adopted in September 2008, an entity's foreign private issuer status is now measured annually as of the last business day of the issuer's second fiscal quarter (SEC Release No. 33-8959 (September 23, 2008)). *See* Latham & Watkins *Client Alert* 744 for a more detailed discussion on this topic.

[2] *See* SEC Release No. 34-58465; International Series Release No. 1309; File No. S7-04-08 (September 5, 2008) (the *Adopting Release*), available at http://www.sec.gov/rules/final/2008/34-58465.pdf.

[3] While the amendments do not include a grandfathering provision, the SEC has established a three-year transitional period to provide sufficient time for any current Rule 12g3-2(b)-exempt issuer that no longer qualifies for the exemption under the amendments either to comply with all of the conditions of amended Rule 12g3-2(b) or to register under the Exchange Act. The SEC also established a three-month transitional period following the effective date of the amendments (October 10, 2008) during which the SEC will accept and process any non-US disclosure documents submitted in paper by Rule 12g3-2(b)-exempt issuers.

[4] Securities Act Rule 144A(d)(4). *See Adopting Release* at 17.

[5] An ADR is a negotiable instrument that evidences American Depositary Shares (ADSs). ADSs, in turn, represent an ownership interest in a specified number of an issuer's equity securities, which the securities holder has deposited with a designated depositary bank. As used in this *Client Alert*, the term "ADR" means both the ADR and the ADS evidenced by the ADR. Under a sponsored ADR program, the issuer of the deposited shares is a party to the deposit agreement along with the depositary and can therefore exercise some control regarding the terms and operations of the program. Under an unsponsored ADR program, the terms and operations of the program are controlled only by the depositary. *See Adopting Release* at 5 n.14, 43 n.108.

[6] Under concurrent amendments made to Form F-6, the SEC's form of registration statement which depositary banks must use to register the ADRs, depositary banks are now able to establish unsponsored Level I ADR programs based upon their reasonable, good faith belief, after exercising reasonable diligence, that an issuer satisfies the requirements of Rule 12g3-2(b). Depositary banks may also register ADRs in respect of an issuer's equity securities on Form F-6 if the issuer already is an SEC reporting company.

[7] Exchange Act Section 12(g)(1) and Exchange Act Rule 12g-1.

[8] Exchange Act Rule 12g3-2(a). The exemption is valid for one fiscal year, at which time the issuer must reassess the number of its US shareholders. In calculating whether a class of equity securities is held by 300 or more residents in the United States, Rule 12g3-2(a) requires that a foreign private issuer include not only record holders, but also conduct a "look-through" analysis of shareholders beyond its record holders.

[9] While the SEC adopted substantially all of the amendments to Rule 12g3-2(b) as they had been initially proposed in February 2008, the SEC did not adopt, in response to comments, the requirement that the average daily trading volume of the subject class of securities in the United States for the issuer's most recently completed fiscal year be no greater than 20 percent of its worldwide average daily trading volume. Many commentators pointed out, and the SEC seemingly agreed, that a foreign private issuer cannot control the US volume of trading of its securities because, for example, a US investor can purchase a foreign private issuer's securities in the issuer's local market and subsequently trade them in the United States or it can purchase a foreign private issuer's securities through an unsponsored ADR program. Therefore, the SEC adopted a trading volume measure as part of the foreign listing/primary trading market condition. *See Adopting Release* at 12-14, 43 n.108.

[10] The SEC has indicated that if the issuer's local stock exchange or securities regulatory authority permits the issuer to publish electronically a required report on such stock exchange's or regulatory authority's electronic delivery system, and the public has ready access to the report and other documents maintained on the system, that electronic publication solely satisfies Rule 12g3-2(b)'s electronic publishing requirements. *See Adopting Release* at 31.

[11] The issuer must publish the information that it (i) has made public or been required to make public pursuant to the laws of the country of its incorporation, organization or domicile, (ii) has filed or been required to file with the stock exchange in its primary trading market and which has been made public by that exchange and (iii) has distributed or been required to distribute to is security holders. *See* Rule 12g3-2(b)(iii).

[12] Exchange Act Rule 12g3-2(b)(4), as in effect prior to October 10, 2008. An issuer may, however, provide an English summary for

a non-US disclosure document if such a summary would be permitted for a document submitted under Form 6-K or Exchange Act Rule 12b-12(d)(3). *See Adopting Release* at 15.

[13] The issuer is only required to disclose such information to the extent that it is material to an investment decision regarding the subject securities, such as (a) results of operations or financial condition; (b) changes in business; (c) acquisitions or dispositions of assets; (d) the issuance, redemption or acquisition of securities; (e) changes in management or control; (f) the granting of options or the payment of other remuneration to director or officers; and (g) transactions with directors, officers or principal security holders. *See* Note 3 to Paragraph (b)(3)(i) of Rule 12g3-2(b).

[14] *See Adopting Release* at 14.

[15] *Id*. at 30-31.

[16] *See supra* text accompanying note 1.

[17] *See* Note 3 to Paragraph (c) of Exchange Act Rule 12g3-2.

[18] *See Adopting Release* at 37. In other contexts, the SEC has indicated that the term "promptly" means that an issuer act "as soon as reasonably practicable." Whether this position would apply to reinstating a Rule 12g3-2(b) exemption remains untested.

[19] Foreign private issuers frequently access the US institutional investor markets also through so called "Rule 144A placements." Rule 144A placements of new securities involve two steps. In a side-by-side transaction, the Rule 144A placement of the new securities to institutional investors (qualified institutional buyers) in reliance on Securities Act Rule 144A is accompanied by an initial sale of the securities by the issuer to the managers of the Rule 144A placement under Securities Act Section 4(2) or Securities Act Regulation S. Rule 144A placements of existing securities do not require this side-by-side transactional approach as the resale element is automatically satisfied. While Rule 144A placements may be conducted in the form of ADRs, they do not always include an ADR component. In such cases the issuer's securities are resold to the qualified institutional buyers as such and, unless the securities are denominated in US dollars, they will not be settled through any US dollar based settlement system, but typically through the settlement system(s) of the issuer's primary trading market(s). The amendments to Rule 12g3-2(b) could actually facilitate resales of foreign private issuer's securities to qualified institutional buyers in reliance on Securities Act Rule 144A. *See Adopting Release* at 17.

[20] By contrast, ADR programs established in connection with US public offerings are known as "Level III" ADR programs and ADR programs established in connection with a listing or quoting of existing shares (without a concurrent public offering) in the United States are known as "Level II" ADR programs.

[21] Form F-6, note to Item 2.

[22] SEC Release Nos. 33-6894, 34-29226; International Series Release No. 274; File No. S7-14-91 (May 23, 1991).

[23] Securities Act Rule 144A(d)(4).

[24] In addition, the Exchange Act and the rules promulgated thereunder require broker-dealers to obtain certain information from non-registrant issuers before quoting their securities on over-the-counter markets to deter fraudulent or manipulative schemes. This obligation can be satisfied by obtaining information provided by issuers pursuant to Rule 12g3-2(b). Since foreign private issuers will be publishing the necessary information electronically, this will allow broker-dealers to access the information more easily and should, in turn, make it easier for non-registrant issuers to be quoted on the over-the-counter market. Exchange Act Rule 15c2-11.

[25] The SEC will no longer publish an annual list of companies that claim the Rule 12g3-2(b) exemption. *See Adopting Release* at 34.

[26] Exchange Act Rules 12g-4 and 12h-3 and Exchange Act Section 15(d).

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