In our series *Learning Outcomes Decoded* we break down a single Learning Outcome Statement (LOS) from the CFA level 1 curriculum. This article is written by Dave Kaczorowski, CFA. Dave is the Content Manager of the CFA team at the Princeton Review, and teacher of the live online review sessions. He is a professor of finance at the University of San Francisco.
EQUITY INVESTMENTS:
OVERVIEW OF EQUITY SECURITIES

LOS: Describe methods for investing in non-domestic equity securities

The primary focus of this LOS is the concept of depository receipts, a complicated and important part of the investment industry. The characteristics of these securities and their different categories can be easily formatted into exam questions.

Foreign investing is on the rise
Many countries regulate investment from foreigners to preserve domestic control, allow domestic investment in foreign companies, and smooth the capital flows into and out of the domestic market. In recent years we have seen increased investments in companies outside investors’ home markets. Technology has made the process more accessible, and companies are increasingly listing their securities in foreign markets.

Direct investing
The most obvious way to invest in foreign securities is to establish a financial presence in the country and trade directly in that market. Transactions must be conducted in the native currency, meaning the foreign investor takes on currency risk. Foreign investors must be familiar with local securities practices and regulations and may have to deal with less available information than in their home countries.

Depository receipts
Shares of Volkswagen trade in the Frankfurt equities bourse under the ticker symbol VOW. An American investor who intends to buy the shares would have to open a German trading account with access to the Frankfurt exchange. In 1988 JP Morgan (the depository) bought shares of VOW and issued shares of a depository receipt (DR) on the American market under the ticker VWAGY. Shares of VWAGY are backed by JPM’s holding of VOW, with ten shares of VWAGY representing each share.
of VOW (ratios of DRs vary). Using this structure, a depository bank can provide an investor in any country with exposure to any security anywhere.

If a DR is sponsored, then the issuer of the underlying shares is involved in the issuance. Investors holding the DRs have all the privileges of common shares, including voting and collecting dividends. The VWAGY securities were created without the participation of Volkswagen and are unsponsored. JP Morgan retains the voting rights and collects the dividends of the underlying shares.

A global depository receipt (GDR) is listed in a market other than that of the underlying company and outside the United States. They are often priced in USD and have the advantage of avoiding the regulations of the country where the issuing company is located.

An American depository receipt (ADR) is sold in the US market and priced in USD. Sponsored ADRs fall into four major categories:

<table>
<thead>
<tr>
<th>Category</th>
<th>Traded</th>
<th>Characteristics</th>
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</thead>
<tbody>
<tr>
<td>Level 1 sponsored</td>
<td>Over the counter</td>
<td>Lightly regulated</td>
</tr>
<tr>
<td>Level 2 sponsored</td>
<td>Public market</td>
<td>Regulated, uses existing shares</td>
</tr>
<tr>
<td>Level 3 sponsored</td>
<td>Public market</td>
<td>Regulated, issue new shares (raises capital)</td>
</tr>
<tr>
<td>Rule 144A/Reg S</td>
<td>Private placement</td>
<td>Not regulated, qualified institutions only</td>
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A global registered share (GRS) is a full-fledged common share of a company that trades in different markets and in different currencies throughout the world. Such shares are often traded in multiple markets and quoted in their respective currencies.

A popular strategy involving DRs is investing in a basket of listed depository receipts (BLDR). This vehicle is structured as an exchange traded fund (ETF), with DRs as its underlying securities. The basket of DRs may be compiled to reflect a single country or a region spanning multiple countries.
PRACTICE QUESTION
Which of the following statements regarding depository receipts is most accurate?

A. A DR represents an economic interest in a domestic company
B. DRs allow publicly listed foreign companies to be traded in a domestic market
C. Unsponsored DRs have more strict reporting requirements than sponsored DRs

B is correct. A DR is a security that trades on an exchange or market that represents a claim in a foreign company. It allows investors in a domestic market to gain exposure to a foreign company.

A is incorrect. A DR represents an interest in a foreign company rather than domestic.

C is incorrect. Unsponsored DRs have lighter reporting requirements than sponsored.