

Handling depositary receipts for global financial markets

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Abstract. The article analyzes the involvement of countries in the implementation of programs issuing American and Global Depositary Receipts. Special attention is paid to the depositary receipts market for securities of Russian issuers. The advantages of this instrument from the perspective of the issuer and the investor are shown. The basic strategy for the use of depositary receipts: speculation, hedging, arbitrage, defined features of these operations. Finally, to enhance the capacity use of depositary receipts, increasing range of instruments, the underlying, through financial engineering.

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Introduction

Development of the global financial market has a significant impact on the economic development of some countries. Over the past decade, there was a significant increase in the of trading in financial instruments, the possibility of entering the foreign exchange markets have expanded. Thus, an increasingly popular way to foreign markets becomes initiation depositary receipts programs.

Depositary Receipt - is an international financial instrument representing ownership of its owner to a certain amount of securities of a foreign issuer.

Market issues depositary receipts devoted to the works of such authors as: Auguste S., Chung H., Dominguez K., Eichler S., Elliott RS, Elton EJ, Heakal R., Holicka K., Kaltenbrunner A., Kamil H., Kang T., Karolyi GA, Levine R., Miller DP, Ravichandran R., Schaub M., Rudenko SA etc.

Content analysis of domestic and foreign scientists and economists on the formation and development of the depositary receipts shows that many questions are still poorly understood, but a number of provisions is debatable.

Aim of this study is to analyze the involvement of countries in the implementation of programs American Depositary Receipts (ADRs) and Global Depositary Receipts (GDRs), market analysis of depositary receipts for securities of Russian issuers, identifying the main strategies for the use of this tool by financial market participants.

Theory

The largest segment of the market is the depositary receipts market in the developed countries, presented in the form of ADRs and GDRs. Since the

issuance of depositary receipts provides an output of a foreign stock market, the issue of American and Global Depositary Receipts are many benefits for local issuers of securities: able to attract foreign capital, an opportunity to get the effect of the difference in scale between the developed markets and emerging markets; to reduce the company's dependence on the situation of the national stock market, increases the image and recognition of the company, leading to increased confidence in the issuer; helps to increase the liquidity of the securities in the local market, may help to attract foreign investors for investment projects; may increase the demand for the shares and, as a consequence, increase the market value of securities in the domestic market; can indirectly attract the attention of foreign consumers for products or services offered by the issuer [1, 2].

Big companies around the world are aggressively for the issuance of depositary receipts and view them as an important tool for its global development. Therefore, every year an increasing number of issuers from developing countries continue to implement the American and European markets depositary receipts program on securities of their companies.

Results

Today, the global stock market in the form of ADRs and GDRs traded depositary receipts for shares of issuers from 84 countries, which originated in 3875 programs of American and Global Depositary Receipts. Significant place in the market depositary receipts owned by Russian companies.

By the number of depositary receipt programs implemented as of early 2014 Russia ranked seventh, behind Great Britain, India, Japan,

China, Australia and Hong Kong, and represents 5% of the global number of programs (Figure 1).

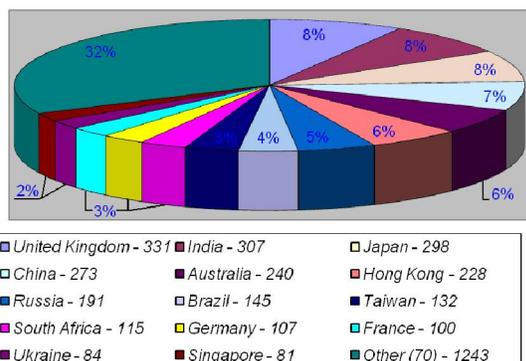


Fig. 1. Countries' share in the total number of programs ADRs and GDRs

If an analysis on the proportion of sponsored issues, Russia has the second largest number of outstanding programs sponsored ADRs and GDRs, giving India, and represents 8% of the total of the global number of sponsored programs (Figure 2).

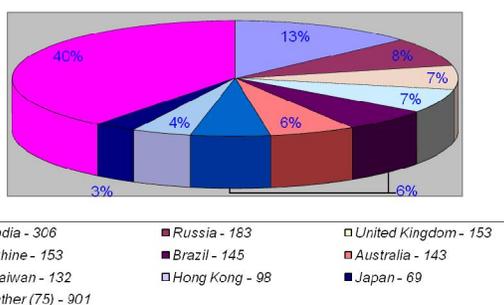


Fig.2. Number of issued sponsored ADR and GDR programs in different countries [3]

Emission mechanism itself depositary receipts for securities of issuers from different countries is largely based on trust, so the issue can only deal with the major banks with a worldwide reputation, such as J.P. Morgan, The Bank of New York, Deutsche Bank, CitiBank. The undisputed leader among the depositary banks, issuing depositary receipts, is The Bank of New York, which is the issuer of more than half of ADR and GDR programs [4]. Share of the largest depositories issuance of depositary receipts on Russian securities is presented in Figure 3.

Most ADRs and GDRs of Russian issuers established by Rule 144 (a) and traded in the system PORTAL - closed the electronic trading system, which is available for institutional investors and market makers.

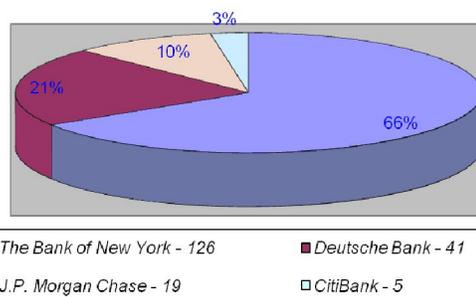


Fig.3. Share of the largest depositories issuance of depositary receipts on Russian securities [4]

One of the most important decisions to be made by the issuer of depositary receipts is the decision about where to place the listing. Listing on a recognized stock exchange is an important part of any large company.

Market for depositary receipts for securities of Russian issuers are concentrated mainly on the European site (Figure 4).

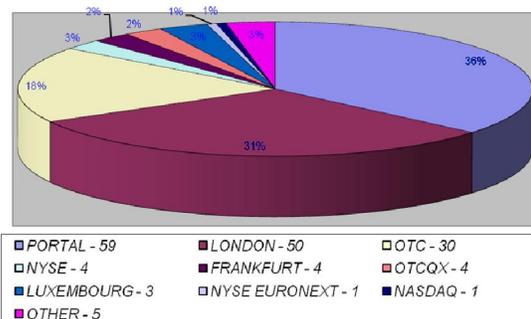


Fig.4. Major trading platforms ADRs and GDRs of Russian issuers [3]

These tools do not provide a listing in the U.S., and their requirements are limited. In this system, traded Russian companies such as JSC "MegaFon", JSC NK "Rosneft", JSC "VTB Bank" and many others. Most GDR Russian securities were listed in London, Frankfurt and Luxembourg. Listing on a recognized stock exchange by the issuer adds awareness and provides a wider potential market. High traded on the LSE depositary receipt programs for Russian securities is caused, first of all, less stringent requirements and lower costs when placing depositary receipts and their inclusion in the listings. However, according to Kim O., "listing in London is risky, and that firms should consider alternative capital-raising strategies" [5, 6].

Compared with the London Stock Exchange, the requirements to the issuers of the New York Stock Exchange (NYSE), very tough. Foreign companies listed on the passing NYSE, can claim either "Alternative listing standards" designed

specifically for non-US companies or the standards of the "Original" or "original alternative" that apply to U.S. corporations. Listed on the New York Stock Exchange have been only such Russian companies as JSC "Mechel", OJSC "Mobile TeleSystems" group of companies "VimpelCom Ltd." However, as concluded Chan K.C. and Wong A., "switching to a more prestigious stock exchange was able to create more investor interest" [7]. ADR issuers are larger and they employ more reputable underwriters than GDR issuers do [8].

At the same time, as noted by Kim O. and Pinnuck, M., "the benefits of information risk reduction for ADRs and GDRs are comparable" [9].

Many Russian issuers represented in the form of ADRs and the U.S. OTC Over-The-Counter (OTC). Among them, JSC "Rostelecom", JSC "Tatneft" and others. OTC trading is using the "pink sheets", which is published daily by the National Bureau of quotations and represent a non-automated listing of shares traded outside the major U.S. stock exchanges.

Type the desired program depositary receipts issue determines which options may be available to the issuer. For example, the listing for "pink sheets" available for unsponsored programs and sponsored the first level, while listing on the NYSE and LSE available sponsored programs of the second and third levels. Gradually raise the level of the issuer easier. Therefore, Russian issuers primarily produce programs ADR level, which is more accessible.

After analyzing the current state of the U.S. market and global depositary receipts, we can conclude that many companies have entered this segment of the financial market. However issue depositary receipts becomes claimed only by investors with an interest in the depositary receipts.

In this regard, consider the advantages provided by the depositary receipts to investors. So, in essence depositary receipts give investors the opportunity to purchase foreign securities on a national stock market, that broadened the range of securities for investment, diversify the portfolio securities, including minimize country risk. Diversifying a portfolio helps to overcome losses in times of market crashes and extreme volatility [10, 11]. Quotes are displayed in their native language and the payment of dividends or interest is made in the currency of the investor, thereby minimizing the cost of acquiring the asset. For investor also important to increase the liquidity of the financial instrument compared with the liquidity of the securities of the issuer itself in the local market.

Identify the major strategies for using depositary receipts with an investor's perspective and present their brief description.

Undoubtedly, the main strategy for the use of depositary receipts is speculation, that is, the receipt of income due to changes in prices receipts. Here we put the same investment to participate in the management.

The second most important strategy is the use of depositary receipts hedging. First, buy depositary receipts - is hedging the currency risk. Secondly, the investor can apply local market depositary receipts to hedge portfolio risk. This is possible thanks to the strong correlation between the prices on the local market and the depositary receipts. So, opening a short position in the market of depositary receipts, you can expect that a loss in the local market will be offset by gains in the market depositary receipts. This is similar to selling a futures contract or buying a put option.

However, in this case, a number of difficulties. First, it is necessary to regulate the practice and allow a short sale of such instruments. Secondly, you need to pay for a short position percentage. Third, we need to go to the foreign market therefore have sufficient magnitude to account funds.

The key point will also be spread formed between the depositary receipts and costs a certain number of local securities. If the difference is the result of legal restrictions, the holding of hedging is impractical due to the weak correlation between depositary receipts and local papers. If the difference is small and can be reduced to zero pressure arbitrage, the hedging portfolio risk more attractive in the case when the market value of the depositary receipts exceeds the market value of local securities.

Depositary receipts can be used for arbitrage. This is the third possible strategy. The difference in price can be attributed to the foreign currency component and legislative reduced.

The observed strong tendency of pricing disequilibria to mean-revert, along with the two-way convertibility between stocks and ADRs, mean that arbitrageurs face minimal risks toward price divergence [12]. However, as noted by Eichler S., more investor attention significantly reduces ADR mispricing [13].

Note some features of arbitrage. Arbitrageur must remember that the transfer of securities from the local market into depositary receipts - more long-term and costly operation. Similarly with hedgers, arbitrageurs must have access to the foreign market and cash in foreign markets in large.

When selecting securities for arbitrage operations must also take into account the legal restrictions. So if the limit is exhausted issue of depositary receipts, issue new depositary receipts will be impossible, and the arbitration will be impossible. However, in the case of the abolition of restrictions will be able to make a profit commensurate with the current value of the discount on the securities. This question is relevant today for the Russian market.

Conclusions

Thus, our analysis suggests that the market for depositary receipts today is mature and developed. Both investors and issuers find many advantages of using this tool.

However, the financial market is not in place. With the development of financial engineering in the global financial market, there are new financial instruments [14]. At the same time in terms of the elements used in constructing the process of financial engineering virtually nothing is unlimited.

In this regard, the question arises about the possibility of depositary receipts in financial engineering because of derivative nature of depositary receipts.

Each country interprets the concept of depositary receipts in accordance with its laws. For example, U.S. law provides a definition of the American Depositary Receipt, Russian legislation - Russian depositary receipts. There is not a common definition for depositary receipts as a financial instrument, definitions vary greatly with each other.

Most economists restrict the underlying asset underlying the depositary receipts of shares. Perhaps this is due to the fact that the depositary receipts in other securities, including bonds, are not widespread in the modern global financial markets.

In our view, it is advisable not to limit the circle of local securities, which can provide the right depositary receipt. So, for example, in 2013 the Russian legislation expanded the list of tools that may underlie Russian depositary receipts. However, legislation in many countries, this list is still limited stocks and bonds.

There are three main approaches to financial engineering: 1) combining several derivatives into a single product, 2) decomposition of the derivative, and 3) the combination of the combination and decomposition, implying the creation of a synthetic product [15]. On the basis of these approaches, we can conclude that the depositary receipt can be a tool of financial engineering and, in addition to stocks and bonds to the underlying assets may include a plurality of other financial instruments, among them the convertible bonds and depositary receipts themselves.

Improving the legislative framework of the market depositary receipts and their use as a tool of financial engineering will help expand market opportunities depositary receipts, and, consequently, the capacity development of its members.

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