A Brighter Outlook for Russian Post-Trade Infrastructure

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Access to Russia’s markets has long been among the most liberal and straightforward of the BRIC countries. Despite this, its securities post-trading infrastructure was renowned for its inefficiency, high costs and complexity, especially for international investors. On December 7, 2011, President Dmitry Medvedev signed Federal Laws No. 414-FZ (Law on Central Securities Depository) and No. 415-FZ (Law on Amendments to Law on Securities Market) and Russia took a leap into the future. When the laws came into full effect at the end of 2012, the market infrastructure changes they mandate will revolutionize how stocks are settled, giving international investors easier access to Russia and enhancing liquidity.

To understand the scale of the historic breakthrough achieved by the new laws, it is important to understand how Russia’s market infrastructure came into being. Unlike in most countries where the advent of the stock exchange — and the infrastructure to support it — was a natural consequence of companies’ need to raise capital, in Russia the creation of a stock market was concurrent with the mass privatization of state-owned companies in the early 1990s following the collapse of communism.

Following advice from consultants employed by U.S. and European development agencies to help the Russian government open up the economy, a voucher system was adopted for privatization. These vouchers (issued as bearer certificates), were given to all citizens and could be exchanged into shares in any of the companies due to be sold or — as was more usually the case — exchanged for cash at a significant discount. The Russia market therefore started with a system that placed little importance on the real value of assets and was therefore largely unconcerned with cost.

Although some aspects of the birth of Russian stock trading were far-sighted — there have never been paper share certificates in the country; they were electronic from the outset — there was no consideration of the market infrastructure requirements of Russia when share trading began and no establishment of a central depository model. Instead, share registrars were given responsibility for maintaining shareholder lists and ensuring transfer of title when shares were sold.

Initially — as in many areas of business following Russia’s rapid liberalization — there were few qualifications to become a share registrar. Consequently, more than 500 entities were established as share registrars across Russia’s 11 time zones. Unsurprisingly, the result was a chaotic and incredibly expensive system. Although shares were electronic, transfer and settlement were paper-based and involved physical delivery of transfer orders to share registrars which resulted in settlements delays which often took weeks or even months. Moreover, registrars’ charges were based on a percentage of the trade amount.

At the time, the high cost of settlement was unimportant to market participants. Privatization had massively undervalued Russia companies and share values gained hundreds of percent in a relatively short period. Investors were therefore willing to absorb what were, by international standards, exorbitant fees of as much as 70 basis points. Similarly, while the absence of a central depository impeded liquidity, this was not investors’ primary concern. Liquidity was also less important to the government than the creation of a shareholder culture.

Depositories gain ground

Russia’s first national stock exchange was the U.S.-dollar-denominated RTS, which was based on NASDAQ software and procedures. In 1998, the Depository Clearing Company (DCC) became its settlement depository when pressure began to build among brokers to find an alternative to the expensive and cumbersome registrar-based settlement system. RTS later made it a mandatory requirement for broker members of RTS to use DCC and cease the physical transfer of orders. However, foreign investors continued to use registrars.

Meanwhile, by 2008 Russia’s other stock exchange, the rouble-denominated Moscow Interbank Currency Exchange (MICEX), operated its own National Depository Centre (NDC). Settlement was internalized on this new depository via proprietary systems or SWIFT, and there was no need to transfer through registrars. This resulted in shorter settlement times and significantly lower costs: A small flat-fee was levied rather than a percentage of the trade value. As with RTS, adoption was driven by the exchange and brokers and was not mandatory for the entire market.

For international investors, the absence of a mandatory requirement to use the DCC and NDC settlement depositories was problematic. Use of a registrar remained a legal requirement while use of a depository was not. There was, therefore, understandable caution about using settlement depositories given the lack of clear recourse should they go out of business. An important issue for many foreign investors was the fact that there was no single mandatory Central Securities Depository compliant with U.S. SEC Rule 17f-7. The lack of a mandatory Central Securities Depository resulted in certain U.S. investors not being able to use the depositories due to applicable U.S. regulations.

The use of settlement depositories by domestic brokers and investors increased significantly after 2005 as the market became more liquid following a number of IPOs and the liberalization of shares in Gazprom and banks. However, many foreign investors continued to use registrars. As a result, the market remained fragmented with two de facto settlement depositories and 41 share registrars by 2011. As a result, settlement methods cycles, costs, communications formats and times were unstandardized and costs remained significantly higher than other comparable markets.

The fragmentation of the Russian market was reinforced by the fact that one of the exchanges was denominated in U.S. dollars. Competition between exchanges for issuers and investors necessarily reduced liquidity and limited the attractiveness of Russian stock for international investors. Moreover, Russia’s domestic stock markets faced competition from London-listed GDRs or New York — listed ADRs of Russian companies, where buying and selling shares were straightforward and settlement times were T+3 via Euroclear, Clearstream or DTCC.
Hopes for change

Despite their seemingly impregnable position in the settlement process, the relative freedom of registrars to act as they wished changed as Russia’s markets developed in the 1990s and 2000s. One milestone was the issuance of the so-called Templeton “no-action” letter in 1997 (Templeton Letter) issued by the U.S. SEC, which, among other things, set forth conditions deemed acceptable to the SEC under which the U.S. investment company would allow its local custodian to use a registrar in Russia. Among the conditions set forth in the Templeton Letter were that the registrar would have to enter into a service level agreement with local custodians specifying a guaranteed timeframe for settlement and a requirement for the registrar’s books to be audited.

Similarly, there were various changes made during the 1990s and 2000s to tighten licensing requirements for registrars and raise their capital requirements. These changes helped to bring about the consolidation of the market. Nevertheless, a lack of political will meant that many regulations were not strictly enforced, and that registrars had relatively low levels of capitalization and inadequate insurance coverage. Moreover, in many instances governmental supervision of registrars was not consistent or effective.

Local and global custodians met with regulators on a regular basis from 2008 onward to discuss their concerns and find ways to improve the domestic market post-trading infrastructure. However, regulators did not have the political will to make changes. Then, early in 2010, there was a breakthrough and the government decided to improve the operations of the domestic securities market. A major part of the reforms was to be the creation of a central depository. However, despite the announcement, change did not occur and momentum for reform appeared to have been lost.

Finally, at the end of 2010, President Medvedev announced an ambitious plan to transform Moscow into an international financial center by 2020. As part of the initiative, he created a task force with multiple working groups and subgroups involving local and international market participants (including Citi) to address specific aspects of market reforms, including infrastructure. The groups were charged with helping to create new laws that would harmonize and improve market infrastructure in the country.

Registrars put up resistance

The working groups focused on three key changes that they believed were essential for the more efficient operation of the Russian post-trading infrastructure. The first was the creation of a mandatory Central Securities Depositary (CSD) to satisfy the requirements of SEC Rule 17f-7. The second change was that the CSD be applicable for all stocks and bonds – not just the most liquid. Thirdly, the working group pushed for a foreign nominee concept to be adopted in Russia. At that time, all foreign entities, including global custodians and brokers, were considered final ultimate beneficiaries under local law. Votes on shareholder meetings, for example, could not be split to reflect different investors’ views while – crucially – if shareholders using a particular registrar took an aggregate 25% or more of a Russian company, they would have to apply to the monopolies commission.

Despite steady progress in drafting the new laws, working group participants’ hopes were dashed when registrars, working through the Professional Association of Registrars, Transfer-Agents and Depositories, successfully lobbied the Ministry of Finance to rule that the proposed CSD would not have any special power or position and use would not be a mandatory requirement. The change ensured that registrars would not lose their privileged position and sizeable revenues. However, it also meant the reforms lost most of their importance. Moreover, the proposals were amended so that they would cover only the most liquid stocks, rather than all shares as originally planned.

Supporters of the original plans quickly regrouped. Citi, which had been a leader in the campaign for a CSD through its Securities and Fund Services (SFS) and Russian Government Affairs units for a decade, now brought in senior support – both Vikram Pandit, CEO of Citigroup, and Francesco Vanni d’Archirafi, head of GTS, met with government officials – as part of the effort to win meaningful reform of Russia’s market infrastructure.

Furthermore, Citi, through the bank’s membership of the National Stock Association and the National Association of Securities Market Participants (NAUFOR), worked with other participants to build a powerful alliance to ensure that the opportunity to create a mandatory CSD would not be lost. The alliance included the MICEX and RTS stock exchanges, the National Settlement Depository (NSD – the reorganized NDC) and DCC settlement depositories, the Central Bank of Russia, the Federal Service for Financial Markets and the Ministry of Economic Development; its goals were shared by the vast majority of market participants.

Alliance success begins a new era

In December, the government relented and Russia’s market infrastructure began a new era. Federal Laws No. 414-FZ and No. 415-FZ meet all of alliance’s expectations. Once they come into full effect, the CSD will legally prevail over registrars ensuring standardization and finality of settlement. Its use will be mandatory for the more than 7,000 stocks in Russia; and the new laws will allow for the creation of nominee accounts for foreign global custodians, foreign brokers and foreign banks so that underlying investors can be disclosed. The new laws will also enable the creation of special Depository Receipts Program accounts.

The changes will markedly improve efficiency and increase transparency in Russia. They will enhance liquidity, lower settlement costs and ensure that domestic broker-dealers and international investors are operating on the same post-trading platform, in the same way. Crucially, the reforms are expected to be acceptable to U.S. investors and meet the requirements of SEC Rule 17f-7. The CSD will not only be obliged to produce audited financial information but will also be required to produce an organizational audit and ensure transparency of fees.

Incidentally, the merger between RTS and MICEX, which was first announced in February 2011, was finalized on December 19, creating MICEX-RTS. In 2012, the integrated exchange will launch T+n trading and select a technological trading platform to facilitate the introduction of a single account for trading on the spot and derivatives markets. In addition, existing indices will be merged into a single family of indices with uniform rules and single calculation bases. From a post-trading infrastructure market perspective, the most important advancement will be the merger between NSD, DCC and RTS Settlement Chamber. Ultimately, it is expected that the entire Russian market will move to local currency settlement.

Taken together, the post-trading infrastructure market reforms and the creation of a single exchange could herald a golden era for Russian stocks. While international investors continue to have concerns about corporate governance among Russia companies and taxation and regulatory consistency, the changes represent a significant advance in the capacity of international investors to manage the risks associated with investing in the country. Many of the most significant hurdles to increased international investor participation in the Russian market have now been addressed and as access to the market is broadened, the hope is that valuations will increase.