London & Moscow – an economic embrace

Natan Tiefenbrun, commercial director at Turquoise, and Pinar Emirdag, head of professional business development at the London Stock Exchange, trace the origins and growth of Russian equity and equity derivatives liquidity on London's markets.

Launched in April 2001, the London Stock Exchange's International Order Book (IOB) is an electronic order-book market for international depository receipts (DRs) that were previously traded via SEAQ International. By creating a London-based liquidity pool for emerging market stocks, the IOB allowed international and domestic participants to meet under a common regulatory framework with high quality trading and post-trade infrastructure. Today the IOB lists DRs on 239 stocks from 46 countries, with new issuers already having raised almost US$2.5bn during 2011, and with combined volume exceeding 15% of the total value traded.

The Russian angle

The IOB has a particularly strong appeal for Russian issuers and participants trading Russian DRs. This can be attributed to the deep pool of London-based capital with an interest in the Russian economy, to the introduction in March 2009 of LCH as a central counterparty for clearing (which reduces counterparty risk and also allowed for pre- and post-trade anonymity), and to the T+3 settlement model (which contrasts with the T+0 model on domestic Russian exchanges).

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Russian DRs are the most actively traded IOB listings. Gazprom and Lukoil are now regularly placed in the top ten most actively traded stocks on the Exchange. Russian issuers Nomos, Rosagro and Etalon all raised money via DR listings on the Standard segment of the Exchange's Main Market this year. The most recent IOB addition is Russia's largest credit institution, Sberbank, via a sponsored unlisted DR under the Exchange's 'Admission to Trading Only' rules. Member diversity is also strong, with over 40 firms each executing more than US$100 million per month, and who can now offer DMA and sponsored access solutions to their clients.

Market hours have been adjusted, with the opening auction call starting at 08.00 and the closing auction call starting at 15.30 London time. During continuous trading participants can enter either anonymous or named orders (including icebergs, hidden and stop-loss/limit orders) and can report bilaterally negotiated trades for publication.

Launch of IOB derivatives

LSEG is the majority owner of Turquoise, a platform for trading pan-European equities and pan-European and emerging market equity derivatives. The Turquoise derivatives offering on depository receipts was introduced (as EDX) late in 2006. Previously, Russian counterparties found it difficult to establish OTC trading relationships with international banks due in part to counterparty risk concerns, whilst international banks were often reluctant to establish the local presence needed to trade on Russian exchanges.

The service introduced central clearing, with LCH guaranteeing trades against default, both for trades conducted on-screen and those bilaterally negotiated between members or via IDBs. Being the first market to bring together

The London Stock Exchange and Turquoise Derivatives

Russian and international banks, Turquoise generated significant liquidity and open interest in exchange-listed Russian single-stock options.

Dividend challenge

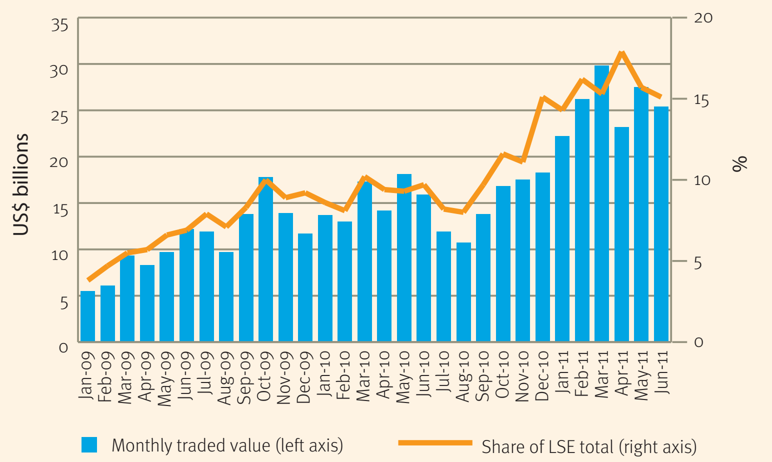
Because Russian companies typically announce intended dividends months before the final value is approved and payment is made, a specific approach is required to corporate action adjustments on derivatives. For single stock futures and options, adjustments to strikes are made only for extraordinary dividends, and not for regular dividends. The RIOB (Russian IOB) index is a price return index and as such dividend payments are excluded. Turquoise also introduced dividend futures on six IOB DRs – Gazprom, Lukoil, Norilsk Nickel, Rosneft, Surgutneftgas and VTB – to enable members to hedge exposures.

FTSE's RIOB index

FTSE introduced its RIOB index on the most liquid Russian DRs in 2006. However, market participants had already adopted a similar index (also based on IOB DRs rather than domestic equities), which has until recently remained the preferred benchmark for OTC trading despite the absence of liquidity in the listed futures and the unavailability of list options.

In Q1 2011 FTSE commenced a series of changes to the RIOB designed to make it more tradable, amending the free float criteria on several constituents. These changes, and the inclusion of Sberbank into the index on 4 July, have made the RIOB a better benchmark for the broader Russian stock market, improving its correlation to broad-based indices, whilst still emphasising tradability. Turquoise's ambition is to create a liquid on-screen market in the RIOB futures and options.

FIGURE 1: GROWTH OF IOB MARKET



Source: The London Stock Exchange

Building liquidity

The rapid growth of liquidity on the IOB has created an opportunity to develop a liquid on-screen market in IOB derivatives. Turquoise recently announced that three committed market makers would provide continuous two-way prices in both single-stock and RIOB index futures and options, as well as the dividend futures. UniCredit, who joined the platform as a market maker in index and single stock options in December 2010, was joined by VTB Capital and BNP Paribas, who together provide full market making support for all Russian derivatives products. VTB Capital is the first ever Russian company to act as a market maker on the Russian derivatives service, while BNP Paribas will introduce futures market making on the platform across all categories, including dividend futures. ■

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