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Islamic Depositary Receipts (IDRs) as a Panacea

Norhazlina Ibrahim (Corresponding author)
Faculty of Economics and Muamalat (FEM), Universiti Sains Islam Malaysia (USIM), Bandar Baru Nilai, 71800 Nilai, Negeri Sembilan, Malaysia
Tel: +606 798 6314 E-mail: norhazlina@usim.edu.my

Obiyathulla Ismath Bacha
INCEIF, Lorong Universiti A, 59100 Kuala Lumpur, Malaysia
Tel: +603 7651 4188 E-mail: obiya@inceif.org

Abstract

Many Organization of the Islamic Cooperation (OIC) stock markets are still in their early stage of development. In this stage, several conditions such as weak legal system and regulations, a limited supply of institutional investors, lack of transparency and accountability are key hurdles. Several approaches have been taken to enhance the capacity and integration of stock markets to promote intra-investment among the OIC countries by Islamic Development Bank (IDB) and International Organization of Securities Commissions (IOSCO). They indicated an urgent need to intensify the Islamic product issuance onto the various international financial exchanges, especially the introduction of Islamic global depositary receipts (IDRs) to create liquidity in the Islamic capital market. Thus, this study is to examine the current depositary receipts in the OIC countries, the need to have IDRs, possible challenges and recommendation in implementing IDRs. The study recommends that the OIC countries with surplus capital will assist those OIC countries with capital shortage. Consequently by having IDRs, there is less reliance on the Western exchanges and disintermediation of the middle man and more value creation amongst the OIC member states' stock exchanges.

Keywords: Islamic Depositary Receipts (IDRs), cross listing, OIC countries, Islamic Finance

Introduction

A study by the Organization of Islamic Cooperation's (OIC) Committee for Economic and Commercial Cooperation indicates that many of its members' stock markets are in their early stage of development. In this early stage, the stock market is commonly associated with conditions such as weak legal system and regulations, limited supply of institutional investors, less support from the private sector and lack of transparency and accountability (COMCEC, 2018). These conditions also imply a higher cost of capital to the growing companies in these markets while affecting their competitiveness. Naturally, firms in markets with greater investment barriers will bear higher price and cost of capital (Chandar et al., 2007; Foerster & Karolyi, 1999). This is in line with the market segmentation theory, outlining that by circumventing the hurdles, the cost of capital will be less. To mitigate these negative effects, adoption of policies promoting the positive effects of international diversification is suggested.

Thus, Depositary Receipts (DRs) may be one of the means to increase competition for these firms internationally. Additionally, for international investors, investing shares via DRs may provide a platform for diversifying their portfolios. Presently, out of 57 OIC countries, only 17 countries have companies participating in the DRs instrument. Notwithstanding the small number of countries participating in the DRs instrument so far, many approaches have been implemented to enhance the capacity and integration of stock markets in order to promote intra-investment among the OIC countries. On 26-27 June 2004, for instance, the Islamic Development Bank (IDB) organized an expert meeting in Jeddah, Saudi Arabia to discuss this matter. Moreover, the International Organization of Securities Commissions (IOSCO) recommends the need to accelerate and intensify the Islamic product issuance onto the various international financial exchanges, together with the introduction of Islamic Depositary Receipts (IDRs) as a potential approach of creating liquidity in the Islamic capital market (IOSCO, 2004). In fact, the 10th Meeting of the OIC Member States' Stock Exchanges Forum

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identified the need to create IDRs among the OIC members. It proposes the general idea that those OIC members with surplus capital, usually among oil-rich member states, could assist those member states with shortage liquidity.

Presently however, the IDRs is still a desirable instrument as it is yet to be introduced in the market. Hence, the purpose of this paper is to examine the current of DRs in the OIC countries, its current development and possible challenges as well as recommendation as to the implementation of IDRs in the member states.

Depositary Receipts In The OIC Countries

The DRs instrument is important in that it represents ownership of equity shares in a foreign company. It is also one of the popular means to access the international market. This instrument enables corporations from around the world to offer international investors access to foreign shares in the form of a security local to the investor (Bank New York Mellon, 2007). Generally, when the depositary receipts are primarily traded in the United States (US), these securities are referred to as the American Depositary Receipts (ADRs). However, when they are traded beyond the US market, they are called the global depositary receipts (GDRs). These DRs may be traded over the counter (OTC) or listed on a stock exchange. In this paper, we refer to ADRs and GDRs collectively as DRs.

Over the last decade, global trading in DRs has increased dramatically to an all-time high of 150 billion DRs, with a value of $3.4 trillion, in 2010 (JP Morgan, 2010). According to JP Morgan's report, the DR's total annual trading volume grew from 135 billion (2009) to 150 billion (2010) by 11% whilst the number of sponsored DR programs jumped up to 2,222. The US remained the preferred location for DR capital raising and was the source of 75% (or $16.5 billion) of the $21.9 billion total capital raised in 2010. Throughout this period, the number of firms listing their securities via DRs has also increased in the OIC countries (refer to Figure 1). In 1993, only five companies from OIC countries subscribed to DRs, but the number has increased to 166 companies in 2016.

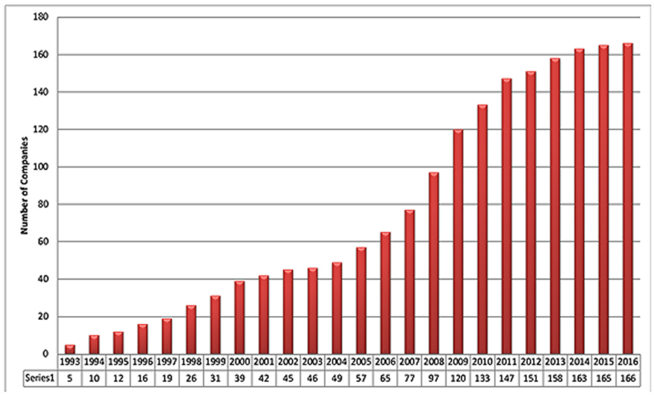

Figure 1: Number of companies that subscribed to DRs (all OIC countries) 1993 to 2016 (Source: Datastream, 2017)

According to the Sukuk Negara Sharia (SBSN) Law, Sukuk are securities that are issued in Rupiah and foreign currencies based on Shari'a principles, as evidence of the investment in SBSN assets. A party that issues a state Sukuk must be a legal entity established under the provisions of the law to issue Sukuk. Its assets are state-owned goods that have economic values that are used as the basis for the issuance of state Sukuk.

The summary of statistics of DRs in the OIC countries as of 2016 is presented in Table 1. Overall, Indonesia led the pack with 50 DRs, followed by Turkey (40), Egypt (16) and Kazakhstan (15). The breakdown by DRs comprising of ADRs and GDRs are clearly presented in Table 1. Generally, the pattern varied by country. Specifically, by looking at the pattern in Table 1, on one hand, all non-Asian countries were likely to subscribe to GDRs, except for Turkey. On the other hand, Asian countries such as Malaysia and Indonesia dominate the issuance of ADRs, with the exception of Bangladesh and Pakistan.

Table 1: The summary of OIC countries that subscribed DRs

No	Country	Companies	ADRs	GDRs	Total DRs	Effective year of DR listing
1	Bahrain	4	0	6	6	2006
2	Bangladesh	2	0	1	1	2005
3	Egypt	16	5	20	25	1996
4	Indonesia	50	50	0	50	1994
5	Jordan	2	2	2	4	1997
6	Kazakhstan	15	2	24	26	1999
7	Kuwait	1	0	2	2	2008
8	Lebanon	5	1	5	6	1997
9	Malaysia	12	12	0	12	1983
10	Morocco	1	0	2	2	1996
11	Nigeria	3	0	10	10	1998
12	Oman	1	0	2	2	2005
13	Pakistan	7	2	14	16	1994
14	Qatar	3	0	4	4	1999
15	Tunisia	1	0	2	2	1998
16	Turkey	40	26	20	46	1993
17	UAE	3	1	3	4	2006
	TOTAL	**166**	**101**	**117**	**218**	

Source: Datastream

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In Table 1, the number of companies taking up DRs may not be equal to the number of DRs. This is due to the fact that the same companies may have subscribed to both ADRs and GDRs at the same time. For example, in Egypt there were 13 companies that subscribed to DRs and yet they issued 5 ADRs and 20 GDRs. Meanwhile, the effective start-up year for DR varied across countries, as early as 1983 for Malaysia and as late as 2008 for Kuwait.

Based on the total issues of 218 DRs, more than half of DRs were GDRs. The higher number of GDR issues compared to GDRs indicated that these foreign companies preferred London or Luxembourg to the US. According to Doidge et al. (2009), by 2005, New York's shares exceeded London cross-listings by only 59% compared to 78% in 1998. Many argued that London has become more competitive in attracting foreign listings than New York. A popular justification for this decrease in foreign listings is that the introduction of the Sarbanes-Oxley Act (SOX) in 2002 which imposed severe costs on companies and their managers, and thus made the US listings significantly less attractive to foreign firms. Nonetheless, by referring to Table 1, countries such as Indonesia, Malaysia and Turkey still preferred ADRs compared to GDRs. The argument for this inclination of these companies listed in the US market is due to increase reputation. The US market is known for its legal structure, stringent nature of Security and Exchange Commission (SEC) requirement and most importantly higher transparency in financial disclosure (Doidge et al., 2009; Martin, 1995; Sevic et al., 2010).

There are several types of ADRs, which are traded on organized exchanges or over the counter (OTC). ADRs traded on organized exchanges such as ADRs Level II and III will have to meet more stringent listing requirements. Normally, SEC requires conformity of accounting statements with the US Generally Accepted Accounting Principles (GAAP) for these types of ADRs. However, this posits an extra burden on the companies to furnish a complete reconciliation of financial accounts with the US market standards. As a result, almost more than 80% of ADRs belong to Level I DRs programs (OTC) except two companies from Indonesia and one from Turkey, which belong to Level III DRs. The rest 20% of DRs are in the form of ADR Rule 144A and GDR Regulation S, private placement. Due to the stringent disclosure requirements, many companies opt for either Level I or Rule 144A/Reg S. This view is supported by Sevic et al. (2010) in that firm issue DRs in lower level programs because they are exempted from complying with more stringent reporting requirements. Level I DRs do not require these companies to comply with the host markets' reporting requirements, but according to their home market accounting and disclosure standards.

In Table 1, the data shows that Malaysia is the first OIC country that subscribed to DRs since 1983. Then after a decade, Turkey, Indonesia and Pakistan followed Malaysia's footstep. However, many of these companies started joining DRs later, especially 2008 onwards. Out of the 166 companies that subscribed to DRs, more than 50% came from Indonesia and Turkey.

The industrial classifications of 166 companies with DRs program can be referred in Table 2. By far, the dominant industrial category was Banks and Financial Services (31%) and Pharmaceutical and Food (30%). For the first category, 14 came from Turkey and surprisingly around half of Kazakhstan's companies were under this category. In Nigeria, Morocco, Tunisia and Oman, the companies that subscribed to DR came from Banks and Financial Services. The second largest concentration was on Pharmaceutical, Biotechnology, Drug and Food, which each comprised around 50 companies. Almost 50% of these 21 companies were from Indonesia alone.

Table 2: The summary of industries of DR companies by countries

No	Country	Banks, Financial Services, Insurance	Industrial Metal and engineers, Automobile, Constructions, Aerospace	Pharmaceutical & Biotech, Drug, Food, General Industry	Telecommunication, Technological Hardware	Oil and Gas, Mining	TOTAL
1	Bahrain	3	1	0	0	0	4
2	Bangladesh	1	0	1	0	0	2
3	Egypt	3	7	4	2	0	16
4	Indonesia	7	11	21	4	7	50
5	Jordan	1	0	1	0	0	2
6	Kazakhstan	7	1	1	1	5	15
7	Kuwait	1	0	0	0	0	1
8	Lebanon	3	0	2	0	0	5
9	Malaysia	2	2	7	1	0	12
10	Morocco	1	0	0	0	0	1
11	Nigeria	3	0	0	0	0	3
12	Oman	1	0	0	0	0	1
13	Pakistan	2	1	0	2	2	7
14	Qatar	1	0	0	2	0	3
15	Tunisia	1	0	0	0	0	1
16	Turkey	14	9	12	2	3	40
17	UAE	0	1	1	0	1	3
	Total	**51**	**33**	**50**	**14**	**18**	**166**
	Percentage	**31%**	**20%**	**30%**	**8%**	**11%**	

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The Importance of IDRs

Many bodies and organizations have identified the need to have IDRs as a solution to address liquidity and capital problems faced by companies in the OIC countries. The recommendation is that those OIC countries with surplus capital will help those who have a shortage of capital. Instead of these companies having to go out and seek funds from the West, there could be a better way in the utilization of these OIC surplus funds. This could be a proverbial win-win situation. Presently, all these companies from the OIC countries have to seek liquidity and new shareholder base from the Western financial centres. Surprisingly these are where the petro dollars are currently located. Instead of parking these funds in Western money centres, why not accumulate these funds in one of the OIC stock exchanges and use them to increase the value of these companies. Consequently, by having IDRs, there is no more reliance on the Western exchanges and disintermediation of the middle man which would lead to more value creation amongst the OIC member states' stock exchanges. These IDRs could also be one of the liquidity management instruments.

By having the IDRs, these companies are able to tap into foreign markets with a lower cost of capital and increase competition. Basically any institution that acts as a depositary bank can derive profit and revenue from these DR programs related to the administration of this IDR program. Furthermore as mentioned earlier not only this institution can cut out the middle man (Western exchanges) but also increase the added value among the OIC member states' stock exchange. Additionally this activity could open up more opportunities for these stock exchanges to increase income.

Our study (Ibrahim, 2013) shows that DRs promote the development of OIC stock market and consistent with the findings made by earlier studies (Hargis, 2000; Ian Domowitz et al., 1998; Foerster & Karolyi, 1999). Basically there are several advantages if IDRs is implemented. According to the bonding hypothesis, cross listing may be associated with improved firm-level corporate governance. Consequently, when these firms cross list, they are required to disclose greater transparency, which reduces the agency cost. Moreover, these firms have to follow certain legal and regulation requirement by the host market. As a result, by participating in IDRs, it will subsequently promote the jurisdictions with better investor protection laws, better run stock exchanges, and better reputation for sharia compliance (Ali, 2005).

Furthermore, there is a need to balance between the cost-effective finance and the requirement to be sharia-compliant. As a result, a potential location for all these firms to do cross listing that adhered to similar belief and sharia-compliant are direly demanded. This could be a further reason why the IDRs is considered necessary to cater for this need. On a similar pattern, there were suggestions to increase the possibility of tapping the capital markets across countries through the issuance of IDRs (IOSCO, 2004) which will increase the liquidity of Islamic markets and lower the cost of funds. A system of IDRs on sharia compatible products will prove to be very useful and appears promising in expanding their markets and integrating them (Ali, 2005). Not only will it promote better legal enforcement, it can also lead to regulatory competition between jurisdictions with each jurisdiction trying to improve the level of investor protection as well as being sharia-compliant . Only those jurisdiction that can offer certain degree of corporate governance and sharia compliance in the underlying asset of the IDRs, will succeed (Ali, 2005).

Current Development in Islamic Depositary Receipts

While no exchanges has yet to offer the IDRs, two initial developments may create the path to IDRs issuance amongst the OIC member countries. Firstly, the United Kingdom (UK) launched the London Sharia Ummah Securities Information Exchange (UMEX) in May 2010 to provide a platform for sharia-compliant companies with a capital value of at least £20 million ($31 million). UMEX was also planning to offer the Islamic version of American and GDRs, called the Islamic Sharia Depositary Receipt (ISDR). Secondly, the OIC Member Stock Exchanges Cooperation committee meeting held in Tehran on 5 May 2009 suggested that the IDRs to be offered among the OIC member states. Figure 2 is the proposed IDRs by the working committee.

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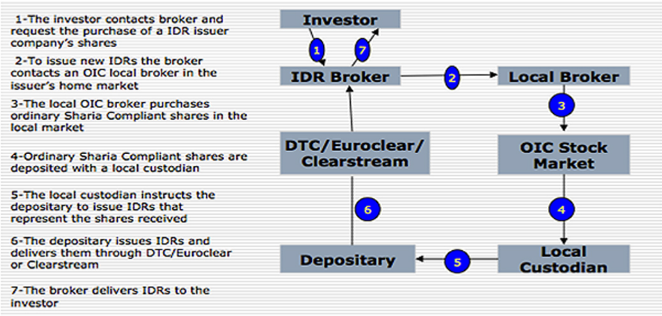

Figure 2: Islamic Depositary Receipts (Source: The OIC Member Stock Exchanges Cooperation, 2009)

Basically, the process is similar to the existing DRs in the US and UK (ADRs and GDRs), but the only exception is that the IDRs should be a sharia-compliant instrument. Moreover, the committee also suggested Euro as a common monetary unit.

To achieve this, there are two possible alternatives;

i) Propose an institution or entity (similar platform as The International Islamic Liquidity Management Corporation (IILM) or could act as Depositary Banks such as Bank of New York or JP Morgan) that provides a platform for the listing of IDRs. This institution will be governed by certain accounting rules and regulations. For example, the Islamic Development Bank (IDB) could be appointed to represent this institution or entity. Any company from the OIC countries who wishes to raise capital or increase liquidity can approach the IDB for this extra liquidity. IDB, after screening the company's qualification, can raise funds by issuing IDRs. These IDRs can be issued or listed on several stock exchanges of the OIC member states. However, in doing so, IDB needs to form an agreement among several stock exchanges (e.g., UAE, Turkey, Malaysia and Bahrain) in term of listing requirements and exemptions.

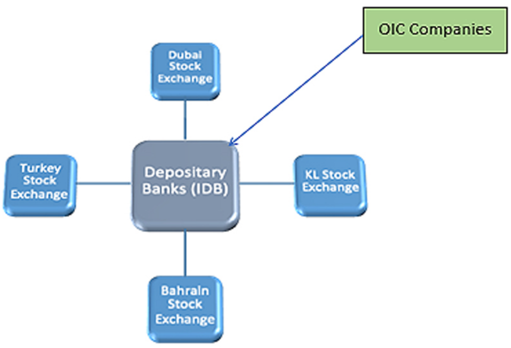

Figure 3: Proposed IDRs' structure

ii) Another possible solution is to propose this instrument (IDRs) to the existing IILM as one of the products that can be offered to its members.

Challenges

Despite many advantages, there are several challenges associated with implementing IDRs as presented below.

1. Diversity in Legal and Regulatory Framework

While there are increasing number of demands in the sharia compatible products, these OIC markets are segmented across countries and regions. There are many factors contributing to this diversity such as foreign investments restrictions, nationality based ownership policies, economic and political risks, and transactions costs. In addition, the divergence in legal, regulatory and listing requirements, different trading rules, lack of transparency and corporate governance structure, and non-uniformity in sharia opinions contribute to this diversity.

On the other hand, according to Ali (2005), such diversity will not necessarily produce identical rules, practices and governance standards but might lead to jurisdiction specializing in certain kinds of products. The important thing is to ensure that the rules governing those products will be accepted by all the participating parties. Furthermore, the support and backing from sharia approving institutions such as the International Islamic Financial Market (IIFM), the International Islamic Liquidity Management Corporation (IILM) and the OIC Member State's Stock Exchanges could be an added advantage to the IDRs' implementation.

2. The Possible Center of IDRs

The implementation of IDRs will require a center or probably hub to operate. The issue of which exchange among the OIC members will be considered the best possible center for IDRs must be resolved as a common marketplace for all the OIC members. As mentioned earlier, the IDB could be appointed as an entity that could act as a depositary bank that provides all the stock transfer and agency services in connection with IDR program. Alternatively, there are exchanges that could be considered suitable to

3. Common Monetary Unit

Once the center has been selected, then the next crucial step is to identify the common monetary unit that will be deemed appropriate for IDRs. The OIC Member Stock Exchanges Cooperation suggests the Euro as a common monetary unit. However, Ibrahim (2013) found that quite a number of the GDRs in London or Luxemberg uses the US Dollar as their common monetary unit.

4. Screening Sharia-Compliant Companies

Similar to the shariah-compliant shares, these DRs must also satisfy the requirement of screening process. The question is, which screening process should we adopt (for example, Dow Jones or FTSE) and be well accepted by the majority of OIC members?

Conclusion

IDRs have been identified as a solution to liquidity and capital problems faced by companies in the OIC countries. By creating cooperation among the OIC countries; those OIC countries with surplus capital will assist those with shortage of capital. Instead of having to obtain funds from the West, the companies may resort to better utilization of the OIC surplus funds. Implementing IDRs may create less reliance on the Western exchanges and disintermediation of the middle man. Consequently, this would lead to more value creation amongst the OIC member states' stock exchanges. The institution that acts as depositary bank can derive profit and revenue from the IDRs programs and open up more opportunities to increase income. Furthermore, the companies or issuers are able to tap into foreign markets with a lower cost of capital.

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