جدوى للإستثمار
Jadwa Investment

May 2016

Recent CMA announcements related to Tadawul

Summary

- The Capital Market Authority (CMA) recently announced a number of major changes that will have a significant impact on the Saudi Stock Exchange (Tadawul) going forward.
- Whilst part of these amendments focus on increasing ownership levels of qualified foreign institutional investors (QFIs), they also outline the introduction of new types of trading options (securities lending & covered short selling) and a new settlement process (from T+0 to T+2 settlement).
- These announcements are not motivated by any concerns over the slow uptake by QFIs in the short-term, but are shaped by wider macro-economic reforms outlined in the Vision 2030.
- All the measures detailed by the CMA pave the way for the future inclusion of Saudi Arabia into the MSCI Emerging Market Index (MSCI EM) but some potential obstacles, all of which are surmountable, could delay inclusion.
- The experiences of Qatar and UAE show that developments outside the control of the regulator or the exchange can cause delays. Specifically, this relates to the implementation of the post trade infrastructure related to T+2 settlement.

Overview

A number of major developments have taken place in the Kingdom in the last few weeks underlining the government's commitment to implementing structural economic reform. In April, we saw the unveiling of the Saudi Vision 2030 and, more recently, we saw major changes on a ministerial level. Packed in between all these announcements was an equally important but perhaps less publicized announcement by the Capital Market Authority (CMA), which will have a major impact on the Saudi Stock Exchange (Tadawul). Whilst some of these amendments focused on loosening previous rules on participation and ownership levels of qualified foreign institutional investors (QFIs), another strand of these reforms introduced new types of trading options and settlement processes, in line with international standards.

As the region's largest, diverse and most mature capital market, these rules, when applied, during H1 2017, will mean that Tadawul will lead the region in being the first to introduce market instruments and processes that not only increase market liquidity, but also add to institutional confidence and investor choice. Whilst these latest set of rules/amendments form a part of a longstanding plan to further open up Tadawul, they have been given added impetus as a result of the broader reforms set out by the Saudi Vision 2030 plan.

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Latest CMA QFI-related amendments

The Capital Market Authority (CMA) approved a set of new rules/ amendments relating to Tadawul.

One strand of the CMA's recent set of amendments aim to loosen rules for the participation previously set out on QFIs. These include:

- QFIs wanting to participate in Tadawul will have to have at least **$1 billion assets under management** (AUM) (previously $5 billion) and have been operational for a minimum of 5 years.
- Each QFI (including affiliates) can only hold **a maximum of 10 percent** (previously 5 percent) of issued shares of any one listed company.
- The **elimination of the clause** relating to QFIs together only owning a maximum of 20 percent of issued shares of any one listed company.
- All foreign investors (including residents and non-residents, swaps and QFIs) will still only be able to have a **combined ceiling of 49 percent ownership** of issued shares, in any one listed company.

The results of the CMA's amendments mean that the definition of QFIs and QFI Clients now includes Sovereign Wealth Funds and University Endowments, and also offers the scope for more flexibility in the definition of other financial institutions as QFIs, subject to CMA's approval (Table 1). We view the inclusion of such entities as an overall positive, since they are major global investors with financial depth and act as a stabilizing force given their long-term investment horizons.

Table 1: CMA QFI-related amendments

	Previous	Amended
AUM	$5 billion	$1 billion
Each QFIs max. ownership of single company	5 percent	10 percent
Combined QFIs max. ownership of single company	20 percent	49 percent*
CMA defined QFI institution	banks; brokerage and securities firms; fund managers; and insurance companies	previous plus sovereign wealth funds; and university endowments

*Note: Foreign investors including residents and non-residents, swaps and QFIs

QFIs and the Saudi Vision 2030

The recent CMA amendments are not motivated by any concerns over the slow uptake by QFIs...

As we highlighted in a recently released report *The Saudi Stock Exchange (Tadawul) in 2016* (published April 2016) a number of developments, such as lower oil prices, general portfolio outflows from emerging markets (EM), and heightened regional geopolitical tensions led there to being a slow take-up by QFIs since Tadawul opened up in July 2015. We also pointed out that this had, up until recently, been exacerbated by the Tadawul All Share Index (TASI) being relatively expensive compared to many global and regional indices. Latest data shows that in the nine months to March 2016, net inflow from (QFIs) amounted to SR793 million, equivalent to 0.1 percent of market capitalization of SR1.5 trillion in March 2016 (Figure 1).

...but are shaped by wider macro-economic reforms outlined in Saudi Vision 2030.

In our view, the recent CMA amendments are not motivated by any concerns over the slow uptake by QFI in the short-term, but are shaped by wider macro-economic reforms outlined in Saudi Vision 2030. Specifically, the 'thriving economy' theme within the Vision 2030 reform plan focuses on diversifying the economy, improving the business environment as well as creating opportunities through encouraging investment (Figure 2). According to this theme, through a combination of initiatives, including investment, privatization, and public-private partnerships, the Kingdom will be able to develop entirely new economic sectors (to read more about the Saudi Vision 2030 please see our report published April 2016). The participation of QFIs is one way the 'thriving economy' theme will be developed and, with the recent CMA announcement, we are now seeing a shortening of previous timeframes in attracting QFIs.

We believe that encouraging QFIs entry into Tadawul has positive implications for the Saudi economy.

Institutional investors can help increase the general wealth and prosperity of citizens…

...but also improve the use of assets in generating sales in newly privatized companies.

QFIs will play a part in modernizing the Saudi economy along the lines set out by the Vision 2030.

We believe that encouraging QFIs entry into Tadawul will have positive implications for the Saudi economy. Firstly, allowing foreign investors access to the Saudi Stock Exchange will increase the participation of institutional investors. Institutional investor participation is deemed to be positive since they act as a conduit for channeling individual savings into capital markets with long term investment horizons, all of which increases the general wealth and prosperity of citizens. Secondly, as the Kingdom pushes forward with the privatization of state-owned assets, QFIs can play a role in improving these companies investment capabilities and profits. Currently, many listed Saudi companies are still relatively dependent on state spending, much like in the rest of the GCC. Profit margins in such companies are propped up by the lack of competition in certain sectors, some of which also benefit from government support, either directly or indirectly. Over the longer term, as foreign investors take up stakes in these privatized companies, we see management being increasingly held accountable for strategic decisions, which will, in turn, promote improvements in efficiency, including an improvement in the use of assets in generating sales and increasing profitability. Ultimately, we believe QFIs will play a part in modernizing the Saudi economy along the lines set out by the Vision 2030.

In the near term, we expect QFIs interest in the TASI to start picking up…

Looking at the nearer term, whilst QFI activity in Tadawul has been slow to date, we do expect foreign investor interest in Tadawul to start picking up gradually as both domestic and international developments add to already improving sentiment. On an international level, Brent oil prices have bottomed out and have been

Figure 1: Net purchases/sales by QFIs

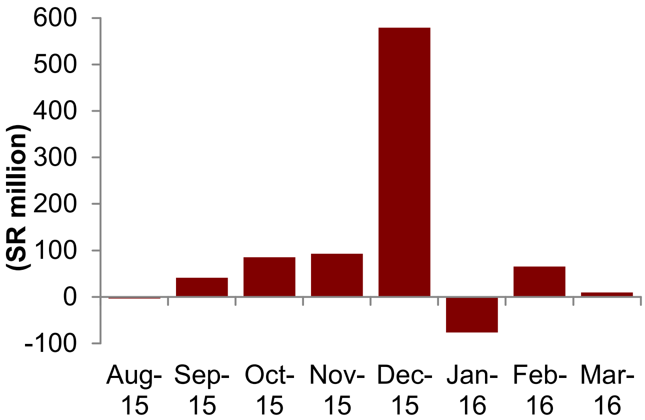


Figure 2: Saudi Arabia's Vision 2030

...as both domestic and international developments add to already improving sentiment.

trading above $40 per barrel, global stock markets have also stabilized and investor appetite for EM equities has started to pick up again (Figure 3). Domestically, the soon to be announced National Transformation Plan (NTP) will affirm the government's commitment towards structural economic reform following on from the Vision 2030. This will help the private sector make more informed and confident decisions with respect to investment, all the while increasing the attractiveness of Tadawul for QFIs.

Other CMA amendments

CMA's recent announcement also relates to the introduction of…

...i) the movement from settlement of trades from the current T+0 to T+2...

...ii) approval of securities lending and covered short selling.

Another strand of the CMA's recent announcement relates to the introduction of two major additions to Tadawul, moving the bourse more in line with international best practices. The first of these measures is the movement from settlement of trades from the current T+0 (same day settlement) to T+2 (trade plus two day settlement). The second of these is the approval of securities lending and covered short selling, a major step forward, which, once implemented, would make Tadawul the first regional bourse to have such trading practices.

T+0 to T+2 settlement:

Currently, the Tadawul operates in a T+0 system where the transaction date is the same as the settlement date…

...but this can generate liquidity pressures on market participants.

More crucially, T+2 is a key criteria for being listed on MSCI emerging market index.

In any transaction involving a sale or purchase of a stock there are two important dates: the transaction date and the settlement date. Currently, Tadawul operates in a T+0 system, that is, the transaction date is the same as the settlement date. One drawback of the T+0 set-up is that since it requires clients to pre-fund their securities account when an order is entered into the trading system, it can generate liquidity pressures on market participants. Whilst the current setup has worked well for the Saudi bourse, there is a possibility that as QFIs increase their participation in Tadawul, having large amounts of money at hand before trading may strain such investors. This issue is further complicated by the fact that the Saudi Stock Exchange's working days, between Sunday and Thursday, and shorter opening times, do not correlate with occidental markets. More crucially, one of the key requirements for being listed into the MSCI emerging market index, a stated objective of Tadawul, includes the existence of a T+2 settlement cycle system, in line with more mature equity markets.

Figure 3: Net non-resident purchases of EM stocks improved in the last few months

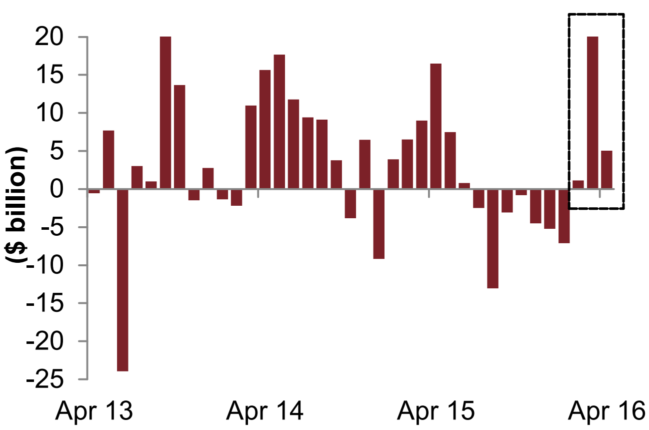
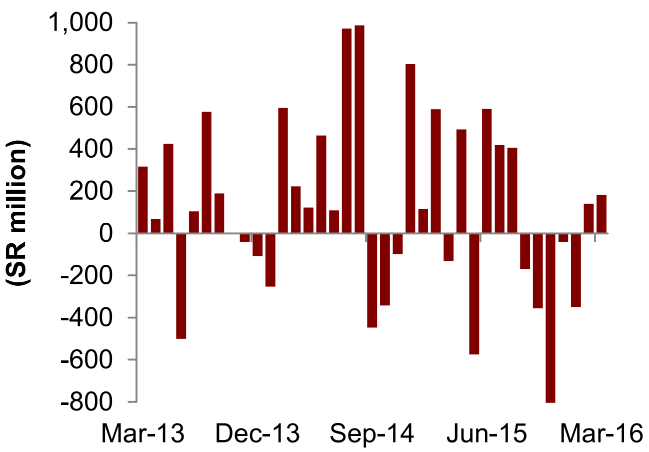


Figure 4: GCC net purchases/sales in Tadawul



Once Tadawul moves to T+2 it could see a rise in cross-border transactions.

Back in 2014, the European Union (EU) implemented T+2 settlement across all member states. One of the reasons for this was to integrate and harmonize the settlement infrastructure and reduce overall costs of cross-border settlement. Currently, UAE, Qatar and Oman have T+2 settlement. Once Tadawul moves to T+2, in sync with most other GCC markets, we expect to see a rise in cross-border GCC transactions (Figure 4). The harmonization of regional settlements could also facilitate the consolidation into a GCC-wide market in the longer term, much like the Euronext in Europe.

<u>Securities lending and short selling:</u>

Short selling allows investors to make gains in a declining market and/or offers the option to hedge.

The CMA has also approved the introduction of securities lending and covered short-selling in Tadawul. Both these decisions go hand-in-hand since short-selling is usually executed by borrowing and then selling the borrowed security with the intention of buying it back later at a lower price. Short selling therefore allows investors to make gains in a declining market and/or offers the option to hedge themselves.

There has been hesitancy in introducing short-selling to equity markets across the Gulf…

...but empirical evidence suggests there is no benefit from banning short selling.

We see the introduction of short selling as a net positive for the Tadawul.

A number of credible studies have pointed to the benefits of short-selling in providing greater transparency and efficient price discovery. There has been hesitancy in introducing short-selling to equity markets in Saudi Arabia and across the Gulf due to the perception that downward movements in markets would be accentuated by this type of practice. This idea held sway especially in the aftermath of the global financial crisis where a number of countries temporarily banned short selling (US) while others increased regulation related to the activity (EU). Empirical evidence however does not seem to back up this belief. A study by the New York Federal Reserve Bank in 2011 concluded that there was 'no harm….from short selling during market downturns and no benefit from banning short selling'. This was further supported by a more recent study, in 2014, by the Turkish Stock Exchange (Boursa Istanbul) which concluded that 'results show that short sales indeed contribute to efficient markets by avoiding any over-valuation in stock prices. The popular view that short sellers destabilize the stock market seems to be unfounded'. Accordingly, we see the introduction of short selling as a net positive for Tadawul since it moves the Saudi bourse in line with major developed and emerging equity markets, and is another step in moving towards more institutional investor involvement.

MSCI Emerging Market Index inclusion

The MSCI EM, tracks the performance of stock markets in 23 developing countries.

The Morgan Stanley Capital International Emerging Market Index, or MSCI EM, tracks the performance of stock markets in 23 developing countries, with a number of active and passive investment funds benchmarking against it. Passive funds will invest according to the proportional weight of each country's stock market size relative to the MSCI EM index as a whole. Therefore, once a country's stock market is included in the index, passive funds automatically adjust their portfolios to buy into it, resulting in an inflow of foreign funds.

All of the above steps pave the way for the future inclusion of Saudi Arabia into the MSCI Emerging Market index…

According to the Market Classification Review published in June 2015, the MSCI stated it would be seeking feedback from MSCI participants on some key areas in relation to Tadawul. These included the 20 percent ownership cap on QFIs and the pre-funding requirements associated with T+0. Both of these issues were

...but potential delays emanating from the implementation of the post trade infrastructure, especially DvP.

Issues related to adoption of DvP delayed both Qatar and UAE's entry into MSCI EM.

addressed in the recent CMA announcement which paves the way for the future inclusion of Saudi Arabia into the MSCI EM. That being said, some obstacles, all of which are surmountable, could delay inclusion. We see the main area for potential delays as emanating from the implementation of the post trade infrastructure related to T+2 settlement. Specifically, this relates to the introduction of delivery versus payment (DvP), as per MSCI's accessibility criteria. DvP refers to a settlement system which requires cash payments being made prior to or simultaneously with the delivery of security. DvP is essential in reducing the risk of losing the full value of a transaction as a result of a counterparty default or insolvency. In its recent announcement, the CMA said it would introduce proper DvP. In most instances, once DvP has been introduced, in Saudi Arabia's case by H1 2017, a review period is allocated for QFIs to make an assessment of the DvP and address any concerns they have. Looking at the experiences of Qatar and UAE, DvP was introduced, amongst other things, prior to their respective entry into MSCI EM, but both countries entry was delayed due to the slow adoption by custodians and brokers. Whilst we are confident that all necessary steps will be taken to ensure the efficient implementation of DvP and related operational infrastructure, the experiences of Qatar and UAE show that developments outside the control of the regulator or the exchange can cause delays.