

Saudi CMA Publishes Draft Rules to Open Tadawul to Qualified Foreign Investors

Proposal brings the Kingdom's robust stock exchange closer to major international financial institutions.

Following on from last month's announcement by the [Saudi Arabian Capital Market Authority](#) (the CMA) that it proposes to permit non-Saudis to participate directly on the Kingdom's stock exchange ([the Tadawul](#)) by foreigners, the CMA published for consultation its draft rules for *Qualified Foreign Financial Institutions — Investments in Listed Shares* on 21 August, 2014 (the Draft Rules). This *Client Alert* analyses the Draft Rules and assesses the significance of this development in the context of the capital markets of the Gulf Cooperation Council (GCC) countries¹ as a whole.

The Draft Rules represent a significant step towards the liberalisation of the Tadawul and the opening up of the Kingdom's capital markets to foreign investment.

Background

The Tadawul is by far the largest securities exchange in the GCC region by market capitalisation, which currently stands at more than US\$ 530 billion. The Tadawul is also the most liquid in terms of daily trading volumes and the most diversified in terms of issuers. However, direct investment in the shares of Tadawul-listed companies has historically been limited to Saudi and other GCC investors, including foreign investors resident in the GCC. Investors from outside the region have traditionally participated indirectly, through back-to-back swap arrangements and mutual funds. The restrictions on foreign investment have contributed to Saudi Arabia's ongoing listing as a "frontier market" in MSCI's influential annual Market Classification Framework. MSCI ['upgraded' the United Arab Emirates and Qatar to "emerging market" status](#) with effect from May 2014, generating heightened positive publicity and interest in their capital markets. Regional observers had been speculating for some time that Saudi Arabia — as the region's largest, most mature and most liquid capital market — would follow suit. In July 2014 the CMA announced its proposal to open the Tadawul to direct foreign investment pursuant to regulations the CMA would issue for consultation in due course. Those draft regulations have now been issued in the form of the [Draft Rules](#).

Overview

The Draft Rules introduce the concept (in Part 1, Article 1(a)) of a "qualified foreign investor" (a QFI) — a foreign institutional investor authorised by the CMA to invest directly in shares traded on the Tadawul. The Draft Rules introduce a registration regime whereby applicants seeking to become QFIs must apply to the CMA and satisfy certain eligibility criteria.

Qualified Foreign Investor eligibility

Article 6(a) of the Draft Rules provides that an applicant must be a foreign legal person that is either:

- A bank
- A brokerage or securities firm
- A fund manager
- An insurance company

Each such entity must be duly licensed in a jurisdiction with regulatory and monitoring standards which the CMA regards as “equivalent” to those in force in Saudi Arabia, or otherwise acceptable to the CMA. An applicant must also meet a financial size test under Article 6(c) — it must generally have assets under management of not less than SAR 18.75 billion (equivalent to US\$ 5 billion), although the CMA may reduce this amount to SAR 11.25 billion (equivalent to US\$ 3 billion) at its discretion. Plainly, this very substantial threshold will limit all but the largest and most established of foreign institutions from investing directly in the Tadawul. Similar rules of regulatory oversight (although not financial size) apply to the clients of such financial institutions. The Draft Rules also require applicants to demonstrate five years of experience in securities related activities and investment therein.

Authorised Assessing Person

The Draft Rules contain the concept of an “authorised assessing person” (an AAP) — a third party whom the CMA has duly authorised as responsible for reviewing, and liaising with the CMA in relation to, the application. The AAP has an ongoing role post-approval. The AAP will generally be a CMA-licensed Saudi financial institution and will effectively act as a sponsor or agent in relation to the QFI before the CMA. The Draft Rules contain a number of *Requirements Applicable to Authorised Persons* in Part 3 of the Draft Rules. These include a general obligation on an AAP to monitor the QFIs for which it is responsible and report violations to the CMA without delay. The CMA has the power to suspend or terminate an AAP’s ability to act as an AAP in respect of QFIs if the AAP fails to comply with its obligations under the Draft Rules.

Determination of applications

Article 11 of the Draft Rules provides that the AAP will turn around applications for QFI status **within five days** of receiving all required information. The AAP will not grant approval unless the applicant agrees to enter into a standard “QFI Agreement”; such an agreement includes a number of representations and warranties as well as undertakings to comply with applicable laws and CMA regulations. A draft of such a standard QFI Agreement is not yet in circulation. CMA approval will lead to CMA registration for the applicant as a QFI, subject to the newly-approved QFI remaining in compliance with certain ongoing obligations. Article 4 of the Draft Rules refers to an appeal procedure in the event an application is rejected.

The AAP’s determination of an application must be communicated to the CMA within one day after the date thereof. Such determination becomes final after three days of filing the said application with the CMA, unless the CMA extends such period, at its discretion, on a case-by-case basis.

CMA Review of Applications

The onus is on the CMA to process the review and without objection or further extension within the three day period, the application will be deemed approved.

Investment limits

The Draft Rules (Article 21) provide that no single QFI may hold more than five per cent. of the shares of any company traded on the Tadawul. Moreover, QFIs in aggregate may not hold more than 20 per cent., and foreign investors (QFIs, foreign investors investing through swap arrangements, and foreign residents in the Kingdom) may not hold in aggregate more than 49 per cent. of the shares of any company traded on the Tadawul. Furthermore, the Draft Rules impose an overall “market value” limitation where foreign investment in stocks issued by all Saudi companies listed on the Tadawul may not exceed ten percent. of the “market value” of such stocks at any given time.

It should also be noted that the investment limitations cross refer “other legislative limitations on foreign ownership in joint stock companies” (Article 21 (6) and “ limitations set forth in the Bylaws...[and] instructions issued by supervisory or regulatory authorities” (Article 21(7)) of the relevant companies. These limitations will be primarily relevant to certain sectors such as, mining related services, commercial agencies, real estate investment projects in the two holy cities, Makkah Al Mukkaramah and Al Madinah Al Munawarah, media, printing, etc.

Other ongoing requirements

QFIs must remain in compliance with a number of other ongoing obligations following registration as a QFI. In particular, a QFI must not invest in any listed shares unless the QFI:

- Holds a client account
- Holds an account with the CMA’s Depository Center
- Has satisfied any conditions as may be imposed by the CMA

The Draft Rules also include ongoing reporting obligations. In particular, a QFI must immediately notify the AAP if a “notifiable event” occurs. These include:

- The commencement of insolvency proceedings against the QFI
- The commencement of criminal or legal or regulatory proceedings against the AAP (notably the Draft Rules include no materiality threshold for this trigger whatsoever, so in theory even *de minimis* legal proceedings will trigger an immediate notification requirement)
- Material changes to the QFI’s business
- The QFI ceasing to satisfy the eligibility requirements for being a QFI

Tax

The Saudi Income Tax Law (Art. 10) states that capital gains realised from disposal of securities listed on the Tadawul is exempt from income tax. It is yet to be determined whether the Department of Zakat and Income Tax (DZIT), the regulatory authority responsible for enforcing the Income Tax Law, will extend the said exemption to apply to capital gain realised by QFIs. Advice should be sought from qualified tax advisors in the Kingdom that the regime of withholding tax on dividends for foreign shareholders and the absence of a capital gains charge continues to apply.

Conclusion

While the Draft Rules will continue to restrict all but the largest international financial institutions from participating directly on the Tadawul, even this limited opening of the Tadawul represents a significant change in Saudi Arabia’s capital markets policy. The CMA will continue to consult with stakeholders on these Draft Rules for several months. We expect the final rules will not be announced before 2015. When the final rules come into force, we expect that foreign investors will benefit from the opportunity to invest directly in Tadawul-listed companies.

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Endnotes

¹ Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.