

Saudi Arabia opens public consultation on its QFII Rules for direct foreign ownership of Saudi listed shares

In a move designed to encourage direct foreign ownership of Saudi listed shares, the Capital Market Authority of Saudi Arabia (the CMA), has opened a consultation through the publication of Draft Rules for Qualified Foreign Financial Institutions Investment in Listed Shares (the Draft Rules). In this briefing, we summarise and discuss the main aspects of the Draft Rules and highlight some of the key areas that authorised persons and foreign investors need to consider during the consultation period.

Further to the announcement made by the CMA on 22 July 2014 in relation to the Council of Ministers' resolution permitting foreign financial institutions to buy and sell shares in companies listed on the Saudi Arabian Stock Exchange (Tadawul), and the CMA's intention to publish the draft rules that will govern those investors' access to the Saudi market, the CMA, on 21 August 2014, published the Draft Rules for Qualified Foreign Financial Institutions Investment in Listed Shares for public consultation. The consultation period will last for 90 days ending on 20 November 2014. Clifford Chance will review and analyse the Draft Rules and their implications during the consultation period before sharing our views and feedback on the Draft Rules with the CMA.

What is the scope of the Draft Rules?

The Draft Rules set out the requirements and conditions that will govern (i) the registration of qualified foreign institutional investors (QFIIs)

to invest in shares listed on the Tadawul (Listed Shares); (ii) QFIIs' on-going obligations; and (iii) the investment restrictions to which QFIIs will be subject. The Draft Rules also prescribe the obligations of authorised persons when dealing with QFIIs.

The Draft Rules only apply to investments by QFIIs in Listed Shares. The Draft Rules do not apply to investment by foreigners in any other Saudi securities, for example, listed Sukuk. The most likely reason for this is that foreign investors have not been restricted from trading in listed sukuk (though we note that foreign investors may encounter some operational challenges when seeking to buy listed sukuk).

The Draft Rules do not apply to GCC citizens. GCC citizens will not be able to register as QFIIs as GCC citizens are already permitted to invest directly in Listed Shares (as if they were Saudi citizens) and hence there is no need for them to register as QFIIs. That said, the Draft Rules do not provide a definition of GCC citizens

and thus a question arises on the treatment that would apply to companies holding GCC nationality (and thus are considered GCC citizens) but with majority foreign ownership. Given that these companies are not currently permitted to invest directly in Listed Shares, it appears that they should be able to register as QFIIs (if they meet the relevant conditions) but the CMA may need to address this in the final version of the rules.

Applicants for QFII status should note the CMA's expectation (not explicitly stated in the Draft Rules) that they should not be using the QFII arrangements to on-sell Listed Shares, or interests in them, to GCC citizens.

Who is eligible to be registered as a QFII?

The Draft Rules prescribe three conditions that foreign investors need to satisfy before they can register as QFIIs. The conditions relate to the type of the investor, its size and its investment experience.

1. Type

A QFII must be either a (i) bank; (ii) brokerage/securities firm; (iii) asset management firm; (iv) investment fund; or (v) insurance company. This effectively means that neither individuals nor entities that do not fall within these categories are able to register as QFIIs.

A financial institution that falls within one of these categories must be licensed or regulated in a jurisdiction applying regulatory standards equivalent to those of the CMA or acceptable to it. It is not clear which jurisdictions will be qualified pursuant to either of these tests. The CMA has not published a draft list of jurisdictions.

2. Size

A QFII must have assets under management of SAR18.75 billion (equivalent to US\$5 billion) or more. The Draft Rules provide the CMA with unqualified discretion to reduce this amount to SAR11.25 billion (equivalent to US\$3 billion). The Draft Rules define assets under management to include assets owned for the purpose of investment by the QFII group (i.e. the QFII and its subsidiaries and affiliates) and/or assets managed by the QFII group for the account of other persons.

3. Investment Experience

The QFII (or any of its affiliates) must have been engaged in activities related to securities and investment for a minimum of five years.

Can a QFII invest for its clients?

A registered QFII can only invest in Listed Shares for its own account (i.e. it may not invest its clients' assets in Listed Shares), unless the client has been approved as a QFII client (QFII Client). For a client to be approved as a QFII Client, the client must either be (i) an investment fund that is incorporated or licensed in a jurisdiction applying regulatory standards equivalent to those of the CMA or acceptable to it; or (ii) a financial institution satisfying all of the conditions referred to above (i.e. relating to type, size and investment experience).

How to apply to become a QFII?

A foreign investor wishing to become a QFII must submit an application to an authorised person licensed by the CMA to carry out the activity of dealing in securities (the Assessing AP). The application must be accompanied with supporting documents and information that are specified in the Draft Rules (Annex 2.1). If the QFII is also seeking to invest for its clients, the Draft Rules require the submission of similar documents and information that should evidence the eligibility of the clients to be approved as QFII Clients.

The supporting documentation includes written disclosure consents allowing the CMA and other Saudi government agencies to obtain information from QFIIs and QFII Clients. The precise scope of these provisions should be examined closely by prospective applicants.

The Assessing AP must not be in common ownership with an applicant for either QFII or QFII Client

registration. The CMA is seeking to apply a measure of independence in the assessment process which the CMA is delegating to authorised persons. This point is likely to attract comment from international banks and securities firms to the CMA during the consultation period.

The Assessing AP will have to study the application to ensure that the applicant and, where relevant, its clients are eligible pursuant to the registration conditions referred to above. The Assessing AP will have to make its decision on the application within five business days from receiving a complete application.

The Draft Rules seem to force the Assessing AP to accept an application if all registration conditions are met. This requirement raises the question of how should Assessing APs discharge the obligations imposed on them by the Draft Rules in relation to eligible applicants if they do not wish to deal with them for commercial reasons. This point is likely to attract comment from authorised persons to the CMA during the consultation period.

What is the role of the CMA in the application process?

The Assessing AP will have to notify the CMA of its decision in relation to the application (whether it was to accept or reject the application) within one business day from making such decision. The Assessing AP's decision becomes final three business days after the CMA have received the notice of the decision. During the three business days, the CMA is able to notify the Assessing AP that it has extended such period for a specified time. Following such extension, the Draft Rules provides the CMA with

the right to require the Assessing AP to reverse its decision e.g. if the Assessing AP accepted the application, the CMA would be able to require the AP to reverse its decision and reject the application, and vice versa.

If the final determination (whether as originally submitted by the Assessing AP or as reversed based on a request from the CMA) was to accept the application, the CMA will register the applicant as a QFII.

The Draft Rules provide more details on the application process including the relevant notices and periods. Although the Draft Rules are silent on the question of language, the CMA's current practice in relation to other notification procedures (for example, private placement of securities) is to

require an authorised person's covering letter to the CMA to be written in Arabic but to accept supporting documentation in English.

When can a QFII commence trading in Listed Shares?

Once an applicant has been registered by the CMA as a QFII, the Assessing AP must accept the QFII as a client and sign with it an agreement that must contain a minimum set of provisions that are prescribed in the Draft Rules (QFII Agreement). The Assessing AP should then open the necessary cash and securities accounts for the QFII and, if relevant, each of its QFII Clients. Trading may commence thereafter.

There appears to be no restriction on a QFII opening additional cash and securities accounts at authorised persons other than the Assessing AP.

What ownership limitations will apply to the QFIIs' investments in Listed Shares?

As is the case for Saudi investors, QFIIs and their QFII Clients will be subject to the Capital Market Law (CML) and its implementing regulations when trading Listed Shares. In addition to that, the Draft Rules prescribe additional foreign investment ownership limits. Such limits are represented by various maximum ownership thresholds which are detailed in Table 1.

TABLE 1	
Maximum ownership Threshold	Holdings included in calculating the Threshold
5% of the Listed Shares belonging to a single issuer	Each single QFII (or a single QFII Client) together with its affiliates will be subject to this threshold.
49% of the Listed Shares belonging to a single issuer	All categories of foreign investors will be subject to this threshold i.e. QFIIs and QFII Clients; foreigners resident in Saudi Arabia; investors holding interests in Listed Shares via swap contracts; and non-resident foreign shareholders who owned stakes in companies prior to their listings.
20% of the Listed Shares belonging to a single issuer	All QFIIs and QFII Clients will be subject to this threshold.
10% of total market capitalisation	All QFIIs, QFII Clients and investors holding interests in Listed Shares via swap contracts will be subject to this threshold.

The Draft Rules provide that QFIIs will also be subject to (i) any legislative limitations on foreign ownership in joint stock companies; (ii) limitations imposed by regulators of specific industries; and (iii) any limitations that could be set out in the relevant company's by-laws.

Due to the generality of these constraints, there could be some

ambiguity as to which restrictions QFIIs will be subject. For example, legislative limitations could include inability to invest in companies owning real-estate in Makkah and Al-Madinah as well as companies conducting any of the activities that are not opened for foreign investment (which are included in the Negative List issued by the Supreme Economic

Council). Perhaps further guidance will help foreign investors identify the exact investment limitations to which they will be subject.

The responsibility for monitoring the investment limitations is not clear in the Draft Rules. Due to the nature of the limitations, QFIIs will not be able to monitor and ensure compliance with them e.g. a QFII may not be

aware that the aggregate foreign ownership of a particular company has reached, or is about to reach, 49%. Therefore, it seems that such limitations will be applied by the Tadawul directly, i.e. if a certain threshold is reached, the Listed Shares of the relevant company will not be available for purchase by QFIIs or QFII Clients.

What are the obligations of Assessing APs under the Draft Rules?

An Assessing AP must be licensed by the CMA to conduct the activity of dealing in securities. An Assessing AP must not be an affiliate of the QFII, which effectively means that a foreign bank or securities firm wishing to become a QFII will not be able to engage its own authorised person (if it has one) as its Assessing AP. An Assessing AP is not required to be a member of the Tadawul.

The Assessing APs will also be responsible for receiving applications as described above. It will also be their responsibility to ensure, on a quarterly basis, that the QFII (and its QFII Clients) continue to meet the relevant registration conditions and the other requirements set out in the Draft Rules. The Draft Rules also set out certain notification and reporting requirements on Assessing APs with respect to their dealings with QFIIs.

A QFII must have an Assessing AP at all times. A QFII can change its Assessing AP without affecting its registration provided that it executes a QFII Agreement with the new Assessing AP within a specified short timeframe from terminating the relationship with the former Assessing AP. The new Assessing AP will have to notify the CMA of its appointment

but no registration application will be submitted to the CMA.

Can QFIIs trade in Listed Shares through more than one authorised person?

The Draft Rules do not restrict the number of authorised persons with whom a QFII can deal. In fact, the Draft Rules imply that QFIIs may engage with more than one authorised person as the Draft Rules require a QFII to notify its Assessing AP once it becomes a client of another authorised person for the purpose of investing in Listed Shares.

What enforcement actions can the CMA take against QFIIs?

QFIIs will be subject to the CMA's general enforcement powers as set out in the CML. These would include, inter alia, the imposition of financial penalties if a QFII or a QFII Client breaches the CML or any of its implementing regulations (including the Draft Rules). In addition, the CMA will be able to suspend or revoke the registration/approval of a QFII or a QFII Client in certain events. Such events include: the QFII or the QFII Client ceasing to meet the registration conditions; the QFII having not commenced trading in Listed Shares within 30 business days of its registration; the QFII having breached the CML or its implementing regulations.

If a QFII's registration is suspended or revoked, the QFII (i) will not be able to buy any Listed Shares; and (ii) will not be able to dispose of any Listed Shares (which were acquired during its registration) without the CMA's approval.

What is the impact on the current swap framework?

For several years, the CMA has permitted foreign access to Listed Shares through the use of total return swaps. These swaps have provided foreign investors with economic, but not legal, ownership of the underlying Listed Shares. Authorised persons have been permitted by the CMA to offer swaps on prescribed terms, with documentation requiring CMA approval. Authorised persons have been required by the CMA to purchase and hold Saudi listed shares to match the commitments made by them under the swap contracts. The CMA has instructed that the shares should be held by authorised persons as client assets in compliance with relevant provisions of the Authorised Persons Regulations.

The Draft Rules include swaps in the foreign investment limits so we expect the swaps regime to be left in place for some time to come. Swaps have a maximum duration of four years. Whether foreign investors will wish to continue using swaps when the QFII rules take effect remains to be seen. Whether the CMA will wish to allow foreign investors who cannot satisfy the QFII criteria to continue to use swaps remains to be seen too.

What is next?

The consultation period on the Draft Rules will conclude on 20 November 2014. Clifford Chance will, in consultation with its local and international clients, consider the content of the Draft Rules and provide its comments to the CMA. The CMA indicated in its previous announcement that it plans to open the market for QFIIs in the early part of 2015.

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