AS&H
شركة أبوحيمد وآل الشيخ والحقباني
ABUHIMED ALSHEIKH ALHAGBANI
in co-operation with CLIFFORD CHANCE

CLIFFORD CHANCE

NEW REFORMS TO SAUDI DERIVATIVES MARKET

The Saudi Arabian Monetary Authority (SAMA) has enacted rules on trade repository reporting and risk mitigation requirements for OTC derivatives contracts (SAMA Trade Reporting and OTC Risk Mitigation Rules) in November 2019 to introduce reforms in response to G20 commitments to regulate over-the-counter (OTC) derivatives markets in the aftermath of the global financial crisis.

Similar reforms in other jurisdictions have already fundamentally changed derivatives trading internationally in many ways and Saudi financial institutions will have already been party to the extra-territorial impacts of these global reforms.

The SAMA Trade Reporting and OTC Risk Mitigation Rules introduce similar changes, with the aims of reducing systemic risk and improving transparency in the derivatives markets, which will impact not just SAMA-regulated entities, but also corporates, other "buy-side" financial investors and regional financial institutions.

Key issues

- New regime for reducing systemic risk and improving transparency in the Saudi derivatives markets that is clearly identifiable with the IOSCO Risk Mitigation Standards
- Trade reporting obligations will need counterparty consents
- Risk mitigation requirements will need amendments to all trading relationship documentation
- Achieving legal certainty on the terms of OTC derivatives transactions is reliant on having both contractual agreement on risk mitigation techniques and supportive legislation under the wider Saudi laws.

BACKGROUND

In the aftermath of the 2008 financial crisis, the G20 Summit in Pittsburgh in September 2009 resolved to take measures to reduce risk in the financial system and, in particular, to minimise the risk of contagion from OTC derivative markets. These have culminated in standards set by the International Organisation of Securities Commissions (**IOSCO**) in consultation with the Basel Committee on Banking Supervision (**BCBS**) and the Committee on Payments and Market Infrastructures (**CPMI**) (the **IOSCO Risk Mitigation Standards**)[1].

Individual regulatory authorities within G20 and European Union states have been building national-level regulations to achieve these objectives, most notably through laws such as the EU regulation on OTC derivatives, central counterparties and trade repositories (**EMIR**), and the Dodd-Frank Act in the US.

---

1 For a copy of the IOSCO Risk Mitigation Standards, please refer to: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD469.pdf

Over the years, SAMA has passed a number of circulars to its licensee institutions to require implementation of aspects of equivalent reforms in the Saudi OTC derivatives markets, and the SAMA Trade Reporting and OTC Risk Mitigation Rules are particularly welcomed in providing a more consolidated framework that is clearly in line with the IOSCO Risk Mitigation Standards.

TRADE REPORTING

The SAMA Trade Reporting and OTC Risk Mitigation Rules supersede the trade reporting obligations enacted by SAMA under its Saudi Arabian Trade Repository (SATR) rules.

As of 1 January 2020, all SAMA-regulated banks including SAMA-regulated branches of foreign banks (**Saudi banks**) are required to report details of their outstanding OTC interest rate derivatives or OTC foreign exchange (FX) transactions that are cleared or uncleared (including such derivatives transactions that are novated from an OTC transaction to a central clearing counterparty, but excluding exchange traded derivatives) to a SAMA-authorised trade repository on a daily basis, unless an exemption applies.

The SAMA Trade Reporting and OTC Risk Mitigation Rules also require Saudi banks to obtain consents from their counterparties to enable the Saudi bank to report trade data from such derivative transactions to the trade repository. Saudi banks will therefore need to review their existing trading relationship documentation to consider whether or not their terms would already include sufficient counterparty consents to satisfy this requirement.

Whereas the reportable transactions are currently interest rate derivatives and foreign exchange derivatives transactions (other than physically-delivered spot FX transactions that are settled within 2 business days), the SAMA Trade Reporting and OTC Risk Migration Rates also contemplate other types of derivatives transactions to be reportable at a future date determined by SAMA. Saudi banks who have entered into intragroup reportable transactions will also need to report such intragroup transactions.

Derivatives transactions where the counterparty is the Saudi Arabian government, SAMA, the Tadawul, the Depositary Centre, a supranational authority, a multilateral development bank or an insurance company do not need to be reported by a Saudi bank.

RISK MITIGATION REQUIREMENTS

The risk mitigation requirements set out in the SAMA Trade Reporting and OTC Risk Mitigation Rules apply from 1 April 2020 to all uncleared OTC derivatives contracts between a Saudi bank and its counterparties.

Although not explicitly stated, it is expected that these risk mitigation requirements would also extend to equivalent transactions that have been structured in a *Shari'a*-compliant manner.

The SAMA Trade Reporting and OTC Risk Mitigation Rules do not require Saudi banks to make counterparty classifications in order to differentiate application of the extent of the relevant risk mitigation techniques. However, the SAMA Trade Reporting and OTC Risk Mitigation Rules would suggest that Saudi banks develop their own internal policies and procedures to ensure appropriate implementation.

It is not clear if the SAMA Trade Reporting and OTC Risk Mitigation Rules would only apply prospectively to OTC derivatives transactions entered into or

"All Saudi banks are required to obtain consents from their counterparties to enable reporting of trade data to the trade repository"

novated on or after 1 April 2020, but we are aware of Saudi banks taking the view that they would apply to all outstanding OTC derivatives transactions as of 1 April 2020.

"Trading relationship documentation should provide legal certainty for uncleared OTC derivatives transactions, although their legal enforceability will also be reliant on the wider Saudi legislative framework"

Trading relationship documentation

In line with the IOSCO Risk Mitigation Standards, Saudi banks are required to have documentation in place with all of their counterparties by 1 April 2020 containing all material terms governing the trading relationship between the parties, including the following:

- any payment obligations
- netting of payments
- events of default or other termination events
- calculation methods
- any netting of obligations upon termination
- transfer of rights and obligations
- the governing law of the transactions
- procedures for timely confirmations, valuation, portfolio reconciliation and dispute resolution
- matters related to credit support arrangements.

Records of the trading relationship documentation and the transactions with a counterparty need to be kept for a minimum of 10 years after the termination or maturity of any uncleared OTC derivatives transaction.

The premise for the trading relationship documentation is that it should provide legal certainty for uncleared OTC derivatives transactions, although the legal enforceability of the terms of the trading relationship documentation will also be reliant on the wider Saudi legislative framework.

There is no requirement in the SAMA Trade Reporting and OTC Risk Mitigation Rules for a Saudi bank to perform an independent legal review in order to verify the legal enforceability of the bilateral netting arrangements.

Timely confirmations

From 1 April 2020, Saudi banks will be required to confirm the material terms of all uncleared OTC derivatives transactions as soon as practicable after execution or novation of the transaction, and to have policies in place to ensure timely confirmation. Confirmations can take place by electronic means.

The SAMA Trade Reporting and OTC Risk Mitigation Rules do not prescribe a mandatory deadline by which a trade confirmation needs to be delivered and confirmed (although examples from other jurisdictions with similar regulations typically range from 1-2 business days after the trade date), or contain an express requirement for Saudi banks to internally escalate or mandatorily report transactions that are not confirmed within a certain deadline.

Portfolio reconciliation

From 1 April 2020, Saudi banks will be required to have policies, procedures and trading relationship documentation in place with all of their counterparties to govern the periodical reconciliation of the key terms and valuation of the outstanding OTC derivatives transactions between the parties.

By "reconciling portfolios", what the SAMA Trade Reporting and OTC Risk Mitigation Rules mean is that the key terms of the outstanding OTC derivatives transactions will be compiled into a data set which will be exchanged between the parties, so that both parties can check that their records match.

There are no express restrictions for Saudi banks to perform portfolio reconciliation using third parties, although we expect that Saudi banks wishing to appoint such a third party are likely to require approval from or notification to SAMA.

The frequency of portfolio reconciliation is not prescribed, but the SAMA Trade Reporting and OTC Risk Mitigation Rules require Saudi banks to take into account the risk exposure profile, size, volatility and number of uncleared OTC derivatives transactions which it has in place with a particular counterparty when formulating its policy on how frequently to perform portfolio reconciliation.

Dispute resolution

The SAMA Trade Reporting and OTC Risk Mitigation Rules require Saudi banks to agree detailed procedures and processes with their counterparties by 1 April 2020 in relation to the identification, recording and monitoring of disputes over:

- recognition or valuation of an OTC derivatives transaction
- if applicable, the exchange of collateral,

between the Saudi bank and its counterparty and in relation to their resolution in a timely manner.

Saudi banks need to have clear criteria in place to determine when a dispute is considered to be material, and to escalate material disputes to their senior management and their Board of Directors. Material disputes that remain unresolved for more than 15 business days will need to be reported to SAMA.

There is no express requirement to keep records of disputes, although we expect that it would be prudent for Saudi banks to keep such records in conjunction with its records of the trading relationship documentation with its counterparties.

> "Saudi banks will need to agree detailed procedures and processes for the identification, recording and monitoring of disputes over valuation of OTC derivatives contracts"

Portfolio compression

From 1 April 2020, Saudi banks will be required to have policies and procedures in place to regularly assess and carry out portfolio compression with its counterparties, considering factors such as risk exposure profile, size, volatility and number of uncleared OTC derivatives transactions which it has in place with a particular counterparty.

DOCUMENTATION IMPACT

In line with the approach adopted in jurisdictions with similar rules on risk mitigation requirements for OTC derivatives transactions, we expect that it will be necessary for Saudi banks to amend their trading relationship documentation with their counterparties, and in time for 1 April 2020.

The International Swaps and Derivatives Association, Inc. (**ISDA**) has published a number of protocols in response to the trade reporting and risk mitigation requirements for OTC derivatives transactions to facilitate documentation amendments in line with the rules prescribed in certain other jurisdictions, whereby parties can adhere to a relevant protocol to incorporate by reference the relevant changes to designated "protocol covered agreements". The ISDA protocol approach has considerably streamlined so-called "re-papering" exercise for financial institutions and corporates globally, but Saudi banks who wish to rely on existing ISDA protocols to satisfy their compliance obligations under the SAMA Trade Reporting and OTC Risk Mitigation Rules will need to carefully consider whether using the available ISDA protocols which were prepared for compliance with the rules in other jurisdictions would be sufficient for their compliance with the SAMA-specific requirements.

SAMA-mandated standardised treasury documentation

By circular number 34100020344 dated 17/02/1434H (corresponding to 30 December 2012) on treasury agreements (the **SAMA Customer Treasury Agreement Circular**), SAMA had mandated the use of standardised documentation by Saudi banks on treasury products with their customers in the Kingdom of Saudi Arabia.

The documentation prescribed by the SAMA Customer Treasury Agreement Circular are:

- the Master Agreement and Schedule thereto; and
- for *Shari'a*-compliant treasury products, the *Tahawwut* Master Agreement and Schedule thereto,

substantially replicating the terms of the industry-standard templates published by ISDA and, in the case of the *Tahawwut* Master Agreement, by ISDA and the International Islamic Financial Market (**IIFM**), except for adopting Saudi law as the governing law.

Although the SAMA Customer Treasury Agreement Circular allows parties to agree to amendments to the prescribed master agreements in accordance with transaction-type and/ or customer profile, these legacy master agreements are unlikely to already contain all of the contractual provisions mandated by the SAMA Trade Reporting and OTC Risk Mitigation Rules.

The SAMA Customer Treasury Agreement Circular is applicable to Saudi banks entering into treasury products or derivatives transactions with counterparties who are domiciled in Saudi Arabia.

Existing ISDA 1992 and 2002 Master Agreements

Where the trading relationship documentation between a Saudi bank and a non-customer Saudi counterparty or another financial counterparty follows the 1992 ISDA Master Agreement or the ISDA 2002 Master Agreement, such existing ISDA Master Agreement may already incorporate some of the terms of the relevant ISDA protocols for compliance by the non-Saudi bank counterparty with similar rules on risk mitigation requirements for OTC derivatives transactions from that counterparty's relevant jurisdiction(s).

However, Saudi banks will still need to assess whether such existing contractual terms addressing compliance with the rules in other jurisdictions would be sufficient for their own compliance with the SAMA Trade Reporting and OTC Risk Mitigation Rules.

***Shari'a*-compliant Hedging Master Agreements**

A significant volume of *Shari'a*-compliant hedging arrangements which constitute OTC derivatives transactions between Saudi banks and other financial counterparties will be documented on "house-style" documentation

"Legacy master agreements are unlikely to already contain all of the contractual provisions mandated by the SAMA Trade Reporting and OTC Risk Mitigation Rules" that may include provisions akin to industry template documents such as the ISDA 2002 Master Agreements, but will need to be examined by Saudi banks for compliance with the SAMA Trade Reporting and OTC Risk Mitigation Rules.

Where the trading relationship documentation between a Saudi bank and a non-customer Saudi counterparty or another financial counterparty follows the ISDA/IIFM 2010 *Tahawwut* Master Agreement, Saudi banks will need to satisfy themselves on making the necessary amendments to their trading relationship documentation to address compliance with the SAMA Trade Reporting and OTC Risk Mitigation Rules, as well as the views of their own *Shari'a* advisers.

"Amendments of trading relationship documentation will affect corporates, other "buy-side" financial investors and regional financial institutions"

WHAT NEXT?

Amendment of trading relationship documentation

Counterparties to Saudi banks should expect to be contacted by Saudi banks in the coming weeks as part of a review and/ or amendment of the terms of the existing trading relationship documents by the Saudi banks for compliance with the SAMA Trade Reporting and OTC Risk Mitigation Rules.

These counterparties will include corporates, other "buy-side" financial investors and regional financial institutions.

Legal certainty on netting and material terms of derivatives contracts

A key premise underpinning the IOSCO Risk Mitigation Standards is that there is legal certainty of the terms of non-centrally cleared OTC derivatives transactions.

The trading relationship documentation requirements prescribed in the IOSCO Risk Mitigation Standards and reflected in the SAMA Trade Reporting and OTC Risk Mitigation Rules are essentially to address a lack of legal certainty due to inadequate contractual provisions on the material terms of an OTC derivatives transaction, but cannot override matters of wider Saudi laws that would be relevant to a legal analysis on matters such as bankruptcy-robust close-out netting, calculation methods, early termination upon bankruptcy, or recognition of the types of title transfer and security interest collateral arrangements contemplated by credit support documents.

Margining for uncleared OTC derivatives transactions

Following circular number 37100010114 dated 15/091437H (corresponding to 20 June 2016) on margin requirements for non-centrally cleared derivatives, SAMA has already passed further rules (the **SAMA Uncleared Margining Rules**) mandating Saudi banks to adopt variation margining under standardised documentation with all counterparties to outstanding OTC transactions documented.

We are aware of the documentation prescribed by the SAMA Uncleared Margining Rules being:

- a credit support annex substantially replicating the terms of the industry-standard template ISDA Credit Support Annexes governed by English law providing for the title transfer of credit support; and
- for *Shari'a*-compliant treasury products, a credit support deed substantially replicating the terms of the industry-standard template ISDA/IIFM 2017 Credit Support Deed for Cash Collateral (VM) providing for English law governed security interest arrangements over posted cash collateral.

A closer alignment of the regime for margining of uncleared OTC derivatives transactions with the BCBS-IOSCO minimum standards for non-centrally cleared derivatives[2] would, amongst other things, bring further certainty to the scope of application for Saudi banks with their counterparties.

As a general rule, the title transfer collateral arrangements contemplated by the industry-standard documentation rely on legal certainty of close-out netting if the collateral arrangement is to serve as an effective credit risk mitigation technique. Further, industry collateral opinions that underpin risk assessments by international financial institutions will also require legal certainty on recharacterization between title transfer and security interest collateral arrangements which act as credit support to derivatives contracts. These are often achieved in other jurisdictions through legislation on a financial collateral regime.

While the position on close-out netting and financial collateral under Saudi laws remain under review, we believe it is prudent that the current SAMA Trade Reporting and OTC Risk Mitigation Rules have not sought to change the *status quo* under the SAMA Uncleared Margining Rules. However, the drive to reform the Saudi OTC derivatives market would also be an opportunity to re-visit the SAMA Uncleared Margining Rules once there are further developments on close-out netting and financial collateral under Saudi laws.

CONCLUDING REMARKS

The SAMA Trade Reporting and OTC Risk Mitigation Rules are a significant step in progressing the Saudi derivatives market to enhance international confidence and encourage both cross-border investment and liquidity into the Kingdom of Saudi Arabia.

The enactment of the SAMA Trade Reporting and OTC Risk Mitigation Rules also mark an opportunity to continue efforts on alignment with international standards for promoting legal certainty on derivatives contracts, as well as serving as an important gateway for fostering the onward development of further market infrastructure such as CCPs, payment systems, and a domestic repo market that will facilitate liquidity creation for the Kingdom of Saudi Arabia.

[2] For a copy of the BCBS-IOSCO standards on margin requirements for non-centrally cleared derivatives, please refer to: https://www.bis.org/bcbs/publ/d317.pdf

CONTACTS

AS&H

Mansoor AlHagbani
Partner

T +966 11 481 9760
E mansoor.alhagbani
@ashlawksa.com

Yasser Al Hussain
Partner

T +966 11 481 9700
E yasser.alhussain
@ ashlawksa.com

Abdulkhaliq Elshayyal
Senior Associate
(seconded from Clifford
Chance)

T +966 11 481 9769
E abdulkhaliq.elshayyal
@ashlawksa.com

CLIFFORD CHANCE

Cheuk-Yin Cheung
Counsel

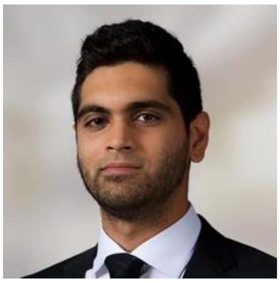
T +971 4503 2722
E cheukyin.cheung
@cliffordchance.com

Caroline Dawson
Partner

T +44 207006 4355
E caroline.dawson
@cliffordchance.com

Simon Gleeson
Partner

T +44 207006 4979
E simon.gleeson
@cliffordchance.com



Uzair Khan
Associate

T +971 4503 2758
E uzair.khan
@cliffordchance.com