

Draft regulations published on investment by Qualified Foreign Investors in Saudi listed shares



On 21 August 2014 the Saudi Arabian Capital Market Authority ('CMA') published draft regulations to permit and regulate direct investment in shares listed on the Kingdom of Saudi Arabia's stock market, the *Tadawul*, by foreign financial institutions.

The publication of the draft regulations follows the passing of a resolution by the Council of Ministers on 21 July 2014 which approved the opening of the *Tadawul* to direct investment by foreign financial institutions for the first time.

The reform raises many issues and requires an understanding of the complex matrix of overlapping rules, including those issued by the CMA over securities activities, the Supreme Economic Council's ('SEC') over economic policy (including foreign investment) and the Saudi Arabian General Investment Authority ('SAGIA') over licensing of foreign investments.

An interesting aspect of the proposed reform is the route by which the CMA has chosen to implement it. Under the Capital Market Law, the CMA is the agency responsible for issuing regulations, rules and instructions in relation to capital markets in Saudi Arabia. Arguably this means that it has the legal authority to publish binding regulations in this area without first referring the matter to the Council of Ministers for approval. We believe that the fact that it referred the matter to the Council of Ministers reflects the multitude of issues raised by the reform. This note discusses some of the key issues.

The current position

At present, ownership of shares in listed Saudi companies is limited to domestic investors, investors from the other Gulf Cooperation Council states (Bahrain, Kuwait, Oman, Qatar, and the United Arab Emirates) and resident foreigners (individuals residing in Saudi or entities incorporated in Saudi and owned by foreigners with the requisite foreign investment license). Investment by resident foreigners is permitted only up to a maximum of 5% of a publicly listed company's issued share capital for each foreign investor.

Non-resident foreign investors can currently only invest through swap arrangements with a Saudi 'Authorised Person' licensed by the CMA to deal as a principal or via mutual funds, both of which are not only less convenient and more costly than direct access, but also prevent foreign investors from exercising direct shareholder management and voting rights.

Key issues arising from the draft regulations

The draft regulations set out the procedures, requirements and conditions for registering a foreign investor with the CMA to trade listed shares and specify the obligations of Authorised Persons in their dealings with foreign investors. The CMA has adopted a cautious approach in its draft regulations with a number of significant restrictions built into the

process. There are also question marks over how these regulations fit into the existing regime on foreign investment in the Kingdom.

Share investment only – The draft regulations only refer to investments in listed shares, meaning that Saudi listed debt instruments appear to remain subject to the existing foreign investment restrictions.

Who will be permitted to own shares? – Foreign ownership is limited to qualified foreign investors ('QFIs') that register as such with the CMA. QFIs are defined as banks, brokerage and securities firms, fund managers and insurance companies that in each case are licensed or regulated by a regulatory authority in a jurisdiction that applies regulatory and monitoring standards equivalent to those of the CMA or acceptable to it. In addition, QFIs must have at least:

- > SAR18.75bn (US\$5bn) (or an equivalent amount) of assets under management (although the CMA has the authority to reduce this to SAR11.25bn (US\$3bn)), and;
- > five years' experience in securities and investment activities.

An additional restriction is that the QFI can only invest in listed shares on behalf of clients that have also been approved under the regulations as QFI clients. QFI clients are limited to either financial institutions meeting the same conditions that need to be met to become a QFI, or

a regulated investment fund. It will not be possible for any other type of investor to own shares via a QFI.

The requirement for each client of a QFI to first gain CMA approval before investments can be made on their behalf adds a time-consuming layer of administration to the process for foreign investment.

How to register as a QFI? – It was anticipated that the CMA would specify some form of registration process for QFIs, akin to the current Authorised Person requirements. However, the process envisioned by the draft regulations involves existing Authorised Persons becoming the intermediary (an ‘assessing authorised person’) in the registration process.

The assessing authorised person has extensive responsibilities, including checking the application and documents, making a decision as to whether the applicant (and where relevant, its QFI clients) meets the required criteria and submitting the application to the CMA. The assessment of the assessing authorised person as to whether it accepts or rejects the application will be (i) automatically approved by the CMA on the lapse of three days from the submission of the application or (ii) reviewed for an additional period by the CMA and the CMA will then either approve or reject the application. Where the application is approved, the CMA will then register the applicant as a QFI and notify the assessing authorised person in writing.

The assessing authorised person has an ongoing monitoring obligation over the QFI to ensure that it (and its QFI clients) continue to meet the relevant criteria. Registered QFIs are also subject to ongoing disclosure obligations to their assessing authorised person.

This adds significant administrative burden on prospective applicants, as it entails as a first step identifying an Authorised Person to carry out the assessment process and agreeing a QFI agreement with them, as well as adding a cost implication due to the fees that may be charged by the assessing authorised person for carrying out this service and taking on the ongoing monitoring obligations.

Restrictions on foreign ownership of listed shares – The draft regulations place the following restrictions on foreign ownership of listed shares:

Investment limit	Details of limitation
5%	Maximum percentage of any issuer's listed shares that may be owned by each QFI (and its affiliates) or each QFI client (and its affiliates)
10%	Maximum aggregate amount of all issuers' listed shares (assessed by market value), including interests under swaps, that may be owned by QFIs and QFI clients
20%	Maximum percentage of an issuer's listed shares that may be owned by QFIs and QFI clients
49%	Maximum percentage of an issuer's listed shares, including interests under swaps, that may be owned by all foreign investors (including resident foreigners)

Whilst the investment caps for individual QFIs and QFI clients and individual listed companies are unsurprising and reflect the measured approach the CMA wishes to take in opening up the *Tadawul*, the further restriction of 10% foreign ownership of the entire market imposes a significant limitation on the liberalisation of the foreign investment regime in

the Kingdom. It is unclear how this limit will be monitored in practice given market volatility.

Other investment restrictions – The draft regulations expressly state that QFI investments are subject to other legislative limitations on foreign ownership in joint stock companies and any instructions issued by applicable supervisory or regulatory authorities.

Foreign investment is controlled in Saudi Arabia by SAGIA, which regulates and licenses foreign investment in accordance with the Foreign Investment Law, and by the SEC, which prohibits foreign investment in various key industries set out in a ‘negative list’ (including, for instance, oil exploration and media services).

The question arises as to whether the reference to ‘other legislative limitations’ includes SEC regulations and effectively means that foreign investment into Saudi companies operating within the negative list industries will be restricted, although we note that this has not been expressly stated by the CMA. A related question is whether SAGIA licensing will also be required for Saudi publicly-listed companies if a high proportion of their shares become owned by foreign investment, particularly given the relatively high cap of 49% ownership by foreigners (20% for QFIs and their approved clients).

To date, neither of these restrictions have applied to Saudi listed companies that receive investment from resident foreigners (i.e. up to the 5% cap for each investor), but it remains to be seen whether the SEC and SAGIA continue to adopt such an approach for investments made under the new regulations.

Consultation

The CMA is consulting on the draft regulations until 20 November 2014, with the intention to implement the reform during the first half of 2015.

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