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KSA Connections

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Welcome to the First Edition of KSA Connections

As a global law firm, we take pride in using local connections to keep clients updated with legal and regulatory developments on the ground. With that in mind, in response to client demand, we are pleased to present the inaugural edition of our new quarterly newsletter, KSA Connections, covering legal and regulatory developments in the Kingdom of Saudi Arabia.

In this month's edition, we discuss a range of developments, including the new Shariah Governance Rules, the narrowing of the Capital Market Authority's exemptions and algorithmic trading on the stock exchange (Tadawul). Should you have any questions on the issues raised in the articles, please do get in touch.

New Shariah Governance Rules for Financial Institutions: Do You Need a Shariah Committee?

The Saudi Central Bank (SAMA) has issued new Shariah Governance Rules dated May 2021 (the Rules) for financial institutions operating in Saudi Arabia. The Rules apply to financial institutions engaged in one or more of the following finance activities: (i) real estate financing, (ii) asset financing, (iii) small and medium enterprise financing, (iv) lease financing, (v) credit cards, and (vi) consumer financing ("Regulated Activities"). The Rules aim to put in place a governance framework for financial institutions to ensure that Shariah principles are complied with in the context of financing transactions, and to establish clear responsibilities for the management of financial institutions in respect of such transactions. This applies even where the financial institution does not purport to be Shariah compliant and is considered to be a "conventional" finance provider.

Pursuant to the Rules, financial institutions to which the Rules apply must form a Shariah Committee (Committee) to oversee compliance with the Rules. A copy of the policies and procedures of the Committee must be submitted to SAMA, and CVs of the Committee members must be uploaded to the institution's website.

The Rules state that the board of directors is responsible for ensuring that Shariah rules and principles are adhered to in respect of the institution's financing activities, as well as the decisions of the Committee.

The board is also responsible for the implementation of policies setting out the manner in which the main units of the institutions should communicate with the senior management in respect of compliance of financing activities with the Shariah principles in accordance with the Committee's decisions.

Further, the Rules set out provisions relating to the Committee, such as functions and responsibilities, membership requirements and independence and confidentiality. The Committee must comprise a minimum of two members and not exceed five members. The election of the Committee's members is subject to SAMA's approval.

Alternatively, the rules expressly permit the outsourcing of the Shariah Committee function to external Shariah consultancies provided that SAMA is notified of such arrangement.

Next Steps For Impacted Financial Institutions

The Rules will come into effect on 1 January 2022. While finance companies operating in Saudi Arabia are generally intended to be Shariah compliant, many such companies do not have a Shariah Committee or specialist Islamic finance lawyers to vet their products. Financial institutions and credit card providers operating in the Regulated Activities are urged to (a) conduct due diligence of all of their products for Shariah compliance; and (b) establish a Shariah Committee, or put in place an outsourcing contract with a Shariah consultancy, to certify their products. Our specialist Islamic finance lawyers maintain longstanding working relationships with eminent Shariah scholars.

Foreign Alert: Removal of Institutions From Securities Advertisement Exemptions

Over the last year, there has been a gradual narrowing of the Capital Market Authority's (CMA) formal Securities Advertisement exemptions, which foreign investment managers had become accustomed to complying with when dealing with Saudi investors. This has led to an increased reliance on the CMA's reverse enquiry principles. We consider the key change, the reverse enquiry principles and how foreign investment managers can mitigate their risk.

- **Securities Advertisement to Institutions No Longer Exempt**

Previously, any securities advertisement (pre-prepared marketing material) aimed solely at "Institutions" (also interchangeably known as "Investment Companies" and broadly defined as entities that own net assets of SAR10 million or more), certain exempt persons and capital market institutions was an exempt securities advertisement. However, Institutions were removed from the exemption when the Securities Business Regulations were amended in 2020. Consequently, Institutions seeking to invest in foreign investment products will need to adhere to the reverse enquiry principles set out in the CMA's FAQs to receive marketing materials from foreign investment managers.

- **Reverse Enquiry Principles Applicable to Institutions**

The FAQs provide that investment managers that are licensed by a foreign regulator to perform the relevant regulated activity in any other capital market in countries that apply supervisory and regulatory standards similar to the standards applied by CMA may conduct business with an Institution in the Kingdom provided that:

- The enquiry is initiated by the Institution with no marketing of products by the foreign investment manager
- The reverse enquiry does not relate to securities or funds issued or listed in Saudi Arabia except bonds issued by the government; or any structured product, in which 50% or more of the underlying assets are securities or funds issued or listed in the Kingdom

- **Status of the CMA's FAQs**

The CMA clearly states that the content of its FAQs shall not prejudice, or be considered as an alternative to, the provisions of its laws and regulations. In the event of any conflict between the FAQs and the provisions of its laws and regulations, those laws and regulations shall prevail.

Considerations for Foreign Investment Managers

Foreign investment managers that had been relying on the formal Securities Advertisements exemption to liaise with Institutions will need to reassess their bespoke pattern of doing business. When relying on reverse enquiries from Institutions, the use of appropriate disclaimers on marketing materials is recommended.

Algorithmic Trading on Tadawul: Permitted or Not?

As algorithmic trading becomes the norm in many capital markets around the globe, it is still a relatively new concept on the Tadawul, which capital market institutions continue to observe with intrigue. Although there has been no formal guidance on algorithmic trading from the Capital Market Authority (CMA) or Tadawul, in recent years, there have been a number of developments that indicate a shift towards an optimal environment where high-frequency trading methods (such as algorithmic trading) could potentially thrive.

Shift Towards an Optimal Environment for High-Frequency Trading

2018: Short Selling Regulations

Short selling is an important component of high-frequency traders' activities. The Short Selling Regulations in 2018 allowed short selling on Tadawul for the first time in 2018. This can be viewed as a pioneering step towards facilitating activities such as algorithmic trading, although the regulations do not refer to high-frequency trading of any type.

2021: Amended Market Conduct Regulations

The Market Conduct Regulations were amended earlier this year to clarify that the prohibition on manipulative and deceptive acts applies when an order is executed by using any means – including "technical tools" to generate and enter orders automatically based on pre-defined instructions or calculations. This clarification implies that the market is preparing for an increase in high-frequency trading such as algorithmic trading.

Tadawul's "G Channel"

The Tadawul's Trading & Membership Procedures refer to a dedicated channel for placing automated orders based on pre-defined calculated instructions – known as "G Channel". However, market participants cite limited use of the channel thus far.

Potential Hurdles: CMA Plan 2021 to 2023

While the CMA Plan 2021 to 2023 states a strategic goal of "facilitation of development of data solutions and financial technology", it also notes the risk associated with "Dangers of Financial Technology Innovations". Although there is no express mention of high-frequency trading, it is a broad concept based on the principle that fast technological advancement may impact supervision and stabilization in the market, which may, in turn, impact the attractiveness of the market and its feasibility.

Vision 2030: Will High-frequency Trading Volume Increase on Tadawul?

In order to thrive, algorithmic trading requires sufficient trading volume driven by institutional investors. The overall volume traded on Tadawul per day in 2021 is at its highest at US$2.7 billion (up from only US$1 billion per day in 2019) – although it is still majority retail driven rather than institutional. One of the stated aims of Vision 2030 is to increase the participation of institutional investors to 44% by 2025. If that is achieved, the environment may gradually become optimal for algorithmic trading.

Considerations for Legal and Compliance Teams

As interest in high-frequency trading grows, legal and compliance teams should conduct appropriate due diligence bespoke to their institution's proposed high-frequency trading activity on Tadawul.

CMA Resolution Emphasizes Responsibility of Fund Managers

In late May, the Capital Market Authority (CMA) issued a routine resolution approving the public offering of a real estate fund. However, in doing so, the CMA also emphasized the importance of clearly drafted terms and conditions (T&Cs), and placed the burden on fund managers to get this right.

The key points highlighted by the CMA were as follows:

- Investors should read carefully the T&Cs before making any investment decision. Not reading the T&Cs carefully or fully reviewing its contents was specifically noted as "high risk".
- T&Cs should include detailed information on the fund, investment strategy and risk factors.
- If the T&Cs prove difficult to understand, investors must refer to the fund manager for more information.
- While much of this reiterates the existing position, the emphasis on the responsibility of the fund manager is pertinent, as is the forcefulness with which the CMA highlighted the risks of not reading the T&Cs correctly. In a growing domestic investment market, this is timely encouragement to investors to raise queries, which, in turn, exposes fund managers to the risks inherent in providing additional information to prospective investors.

Fund managers will need to exercise caution when responding to further enquiries. The marketing document for a fund will be its prospectus and the attached T&Cs. However, further enquiries as suggested by the CMA resolution could create a secondary level of marketing information upon which an investor relies. This creates risks in that prospective investors do not all receive the same information, and that some investors receive information that has not been through the same verification or approval process as will have been carried out on the main T&Cs. If a fund investment were to subsequently underperform, this may create heightened risk for fund managers who have provided additional "clarification" outside of the principal fund documents.

Fund managers can protect themselves in the following ways:

- Include on all documentation an appropriate disclaimer that investment decisions are deemed to be based on the prospectus and T&Cs alone
- Use plain and simple language in T&Cs
- Avoid recycling old documents – simply reusing what might have passed on a previous investment without appropriate review could mean that imperfections in the drafting are compounded or repeated

Additional time taken at the inception of the fund to review the clarity of fund T&Cs and drafting of appropriate disclaimers is time well spent if it protects a fund manager.

CMA Cracks Down on “Pump and Dump” Schemes on the Saudi Stock Exchange

The Capital Market Authority (CMA) has increasingly demonstrated its willingness to make use of advanced technology to supervise, monitor and take the necessary actions where it is required to uphold the Saudi stock exchange’s (Tadawul) reputation. The efforts are in line with the strategic plan to achieve the objectives of Vision 2030, in a bid to position Tadawul as a leading market in the Middle East, attracting foreign investors in keeping with international best practices and diversifying Saudi Arabia’s sources of income.

For example, on May 2 2021, the CMA referred a suspected violation to the Public Prosecution concerning two suspects alleged to have been involved in manipulation and fraud during the trading of shares of a number of listed companies on Tadawul, violating the Capital Market Law. The practices included the suspects entering both purchase and sell orders for a security without the intention for execution, also violating the Market Conduct Regulations (MCR). The suspects were also reported to have promoted opinions of a number of listed companies on the online Hawamer Saudi Stock Forum for the purposes of taking advantage of the subsequently increased price of the security, in violation of the MCR.

The impact of a CMA referral to the Public Prosecution includes:

- Potential criminal penalties (as determined by the CMA Committee for the Resolution of Securities Disputes)
- Reputational damage following the public announcement of the identities of the violators on the CMA’s website
- Liability to pay compensation to any person affected by the violation

These endeavors to clamp down on unfair and unsound actions are comparable to the Securities and Exchange Commission’s efforts in the US to regulate the recent frenzy of so-called “pump and dump” schemes, where social media has been used to drive up share prices. Most notably, the *GameStop* share price was driven up from US$4 to US$347 over the past year. The CMA’s efforts to regulate misleading and fraudulent practices in this regard are increasingly analogous to international standards.

Impact of the Amended Market Conduct Regulations on Capital Market Institutions – Are You an "Insider"?

Earlier this year, following a consultation period, the Capital Market Authority (CMA) issued the amended Market Conduct Regulations (MCR). While much of the amendments clarify the scope of the prohibition on market practices involving manipulation or deceit in the trading of securities, the prohibition on insider trading and disclosure of inside information has been expressly extended to apply to directors, senior executives and employees of capital market institutions (CMIs).

Key Amendments

There are three key amendments that increase the responsibility of CMIs in any insider trading scenario and the impact of which compliance officers at CMIs should consider carefully:

- **Broader Definition of "Insider"**

  Previously, the definition of an "Insider" in the MCR specifically included directors, senior executives and employees of the issuer of the relevant security. However, for the first time, the definition of "Insider" now also expressly includes directors, senior executives and employees of CMIs related to the relevant inside information.

  Similarly, the previous definition of "Insider" referred to persons who obtain inside information through a business relationship, including from the issuer of a security related to the inside information. However, the new broader definition extends this to information obtained from a CMI related to the inside information.

- **Client Approval for Disclosure of Insider Information**

  Despite the general prohibition on disclosure of inside information, it had widely been assumed this does not prevent a CMI from conducting its ordinary course of business. However, the amended MCR clarifies that a CMI and a registered person may only disclose its client's orders for the purpose of negotiating a private transaction for such client, provided that (a) the disclosure is in the client's interest to complete the transaction, and (b) the client's prior approval has been obtained and documented.

- **New Retrospective Market Manipulation and Insider Trading Reporting Obligation**

  Previously, the reporting obligation was preventative in that a CMI had to notify the CMA within three days of any client order that it has declined to execute based on reasonable grounds to believe that its client is engaging in market manipulation or insider trading. While that remains the case, the reporting obligation has now been extended to a retrospective notification whereby the CMI, having accepted an order and subsequently believing, on reasonable grounds, that its client was engaging in market manipulation or insider trading, must notify the CMA within three days of becoming aware of such grounds.

Considerations for Capital Market Institutions

In light of these additional responsibilities, it would be prudent for compliance officers at CMIs to consider revising their policies and procedures and client terms and conditions to comply with the amended MCR and in order to mitigate the increased scrutiny faced by their directors, senior executives and employees.

The Kingdom of Saudi Arabia Approves New Law for Combating Financial Fraud and Breach of Trust

On 30 April 2021, ministers in Saudi Arabia approved a new law, due to come into force in September of this year, which is designed to enhance the Kingdom's efforts to combat financial crime.

Cabinet Decision and New Law

According to the Saudi Arabian Central Bank (the Saudi Monetary Authority, or SAMA), a fraud is "any act involving deceit to obtain a direct or indirect financial benefit by the perpetrator or by others with his help, causing a loss to the deceived party".

The new law for Combating Financial Fraud and Breach of Trust, approved by Cabinet Decision No. 534/1442, builds on that definition with the following significant provisions:

- Convicted fraudsters shall be subject to jail terms of up to seven years and fines of up to SAR5 million (approximately US$1.3 million) (Article 1)
- Anyone convicted of inciting fraud shall be subject to the same maximum penalties, where the fraud occurs and loss is suffered, or up to half the same maximum penalties (e.g. imprisonment for up to 42 months and a fine of up to SAR2.5 million (approximately US$650,000)), where the fraud does not occur (Article 3)
- Anyone convicted of attempting to commit fraud shall be subject to up to half the maximum penalties (e.g. imprisonment for up to 42 months and a fine of up to SAR2.5 million (approximately US$650,000)) (Article 4)
- Importantly, reoffenders and groups of organized financial criminals shall be subject to up to double the maximum penalties, meaning jail terms of up to 14 years and fines of up to SAR10 million (approximately US$2.6 million) (Article 5)
- Courts may, at their discretion, grant exemptions to these penalties, but only where individuals come forward and report the crime before there is any loss, or where individuals report the crime afterwards but where the reporting leads to the arrest of all the other parties involved (Article 8)

Additional Considerations

This new law is an important step towards the "transparency and accountability", "effective governance" and "responsible enablement" anticipated by Vision 2030. It should help to deliver the strategic objectives of His Majesty King Salman bin Abdulaziz and Crown Prince Mohammed bin Salman Al Saud of a "thriving economy" and a "vibrant society" by "creating an attractive environment for local and foreign investment".

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