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In This Issue:

A New Dawn for Saudi Arabia's Capital Markets

The Commencement of Muqassa's Operations and Implications for Market Participants

The Introduction of a Central Clearing Party

Some two years since its establishment in 2018 and just months after the issue of its license in January this year, Securities Clearing Center Company ("**Muqassa**") announced the commencement of its operations on 30 August 2020.

For the first time in Saudi Arabia, an independent central clearing party will guarantee the settlement of all centrally cleared trades executed on Tadawul, including Exchange traded and OTC derivatives. Clearing of Index Futures Contracts commenced on 30 August 2020 and the clearing of other instruments, including equities, is set to follow.

The announcement follows the introduction of T+2 trading and Tadawul's recent inclusion into the MSCI Emerging Markets Index and represents yet another significant milestone in the development of Saudi Arabia's capital markets and the realisation of one of the key initiatives in the Financial Sector Development Program 2020 (FSDP).

The benefits resulting from Muqassa's role in providing centralized counterparty risk management and developing clearing services are anticipated to be significant. The clearing framework is expected to remove systemic market risks and facilitate the introduction of new exchange traded asset classes (such as derivatives) and introduce mechanisms (such as netting and settlement finality) which will increase efficiency and certainty, and ultimately expand the investor base both domestically and internationally.

Background and Evolution of Saudi's Financial Infrastructure

Prior to the introduction of Muqassa, securities trading and settlement functions were shared between Tadawul and the Securities Depositary Center Company ("**Edaa**"), with cash settlement handled by SAMA. Trades were not centrally cleared but rather counterparty risk was managed through various tools which have evolved as the market has changed.

During the era of the T+0 market, the primary risk management tool was Tadawul's trading system which centrally pre-validated all incoming orders before placing them into order books. By blocking securities at the moment a sell order was placed, this effectively guaranteed settlement and guarded against naked short selling.

With the introduction of the T+2 settlement cycle, trades were no longer required to be pre-funded and accordingly, various custody controls were introduced to ensure that the required securities and cash were available on T+2. Independent custodians could reject the settlement of trades to avoid settlement failure where there would be insufficient cash or securities at the time of settlement. In such cases, rejected trades were transferred to the executing broker's account to execute for its own account.

However, the introduction of the rejection mechanism meant that pre-validation as a risk management tool became less efficient as a trade could still be rejected (even if an investor had the requisite number of securities), thereby transferring the settlement obligation to the executing broker with a high probability that the trade would fail to settle on T+2. It was anticipated that this problem would likely become further exacerbated as new markets and asset classes develop.

The Role of Muqassa as the Central Clearing Party

With the introduction of Muqassa and the clearing framework, the centralized pre-validation process is being replaced with Muqassa's guarantee mechanism. Muqassa, as the central clearing house, will interpose itself between a clearing member of every buyer and a clearing member of every seller, therefore guaranteeing the settlement of the trade between participants.

In general, all instruments listed on Tadawul are expected to be cleared, with Muqassa reserving the right to exclude certain instruments. However, clearing has not yet commenced in respect of all products currently traded on Tadawul as it is understood that Muqassa anticipates a three-phase market activation:

- **Phase 1** - which covers index future contracts clearing (which commenced on 30 August 2020).
- **Phase 2** - which will cover Equities, Sukuk, Bonds, ETF’s and REIT’s markets clearing (anticipated in early 2021).
- **Phase 3** - which will cover the full derivatives market clearing (anticipated in H2 2021).

For each trade (other than OTC derivatives) a clearing member will effectively have two counterparties - Muqassa and its own client - and each incoming trade will affect the settlement positions with each of these counterparties. Accordingly, separate settlement instructions will be created for the settlement position with Muqassa as the counterparty on one hand and for the settlement position with the Clearing member's clients as the counterparty on the other.

The Central Clearing House Framework

The central clearing house framework establishes the post-trade processes necessary to clear trades that have been matched in Tadawul's system and defines the roles and requirements for clearing members.

The 'Clearing Process'

The 'clearing process' sits between Tadawul's trading function (receipt and matching of orders) and Edaa's settlement function (actioning settlement instructions).

Trades of Muqassa cleared instruments will be novated by 'open offer' at the time of matching, meaning that Muqassa will substitute the original trade contract between counterparties with two replacement contracts between each of the parties and Muqassa as a counterparty immediately after the orders are matched. This makes Muqassa a buyer to every seller and a seller to every buyer.

Following this:

- Tadawul will forward the trades to Muqassa to be enriched with further details for the purposes of generating settlement positions.

- Muqassa will convert trades into settlement positions, calculate total margin requirements, and issues margin calls.
- The Clearing Member will transfer collateral (as necessary) to Muqassa to satisfy the margin calls.
- The Exchange Member may manage its trades before settlement (e.g. by splitting, applying average price, or rectifying).
- Muqassa will generate settlement instructions and send these to Edaa who makes these available to custodians and executes them on the settlement date.

Following execution of settlement instructions, Muqassa will update settlement positions, reduce margin requirements and release collateral as appropriate.

Clearing Member's Account Structure

Clearing members are offered the following account structure which they can use to facilitate trading, keep positions and meet and maintain margin, collateral and default fund requirements:

(a) **Trading Accounts** - trades captured from Tadawul are enriched and stored in trading accounts. There are two categories of Trading Accounts:

(i) *House Trading Accounts* - these generate settlement positions for the purpose of clearing proprietary trades.

(ii) *Client Trading Accounts* - these generate settlement positions for the purpose of clearing clients' trades. Depending on the method of generating settlement instructions these may be either 'Net Trading Accounts' or 'Gross Trading Accounts'.

Trade management activities (e.g. split, average price, and rectify) are performed in trading accounts.

(b) **Settlement Position (SP) Accounts** - these calculate and keep settlement positions from the trades in the linked trading accounts. As all types of trading accounts are linked to settlement position accounts, each Clearing Member will have:

(i) *House Position Account* - to calculate settlement positions from the trades in the linked House Trading Account;

(ii) *Client Position Account* - to calculate settlement positions from the trades in the linked Client Trading Account. These may be either an Omnibus Client Position Account (for multiple clients where collateral requirements are calculated on an omnibus basis) or Individual Client Position Account (for single clients only).

Additional types of accounts may be opened to facilitate trading and trade management activities, including Market Maker Accounts, Allocation Accounts and Average Price Trading Accounts.

(c) **Collateral Accounts** - to keep records of collateral posted against the margin requirement arising from positions. There are a number of types of collateral accounts offered by Muqassa, such as Margin Calculation Accounts (which calculate margin from open settlement positions) and Margin Requirement

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Accounts (which aggregate the margin requirements from linked Margin Calculation Accounts). Other available collateral accounts include Free Cash Accounts, Intraday Funding Accounts and Default Fund Accounts.

Changes in Roles of Market Participants

Under the new framework all Exchange Members, acting as executing brokers, will become primarily responsible for the trading, clearing and settlements of their clients' trades.

Each Exchange Member will be required to become one of the following:

1. Direct Clearing Member ("**DCM**"): a Muqassa member, which can manage and clear its proprietary and its clients' trades.

2. General Clearing Member ("**GCM**"): a Muqassa member, which can manage and clear its proprietary and its clients` trades as well as the trades of Non-Clearing Members.

3. Non-Clearing Member ("**NCM**"); an Exchange Member who will not or cannot become a DCM or GCM can become a NCM who must appoint one GCM to clear its transactions.

To facilitate securities settlement each Exchange Member must be a Custody Member or appoint a separate custodian to interface with Edaa to establish the necessary securities accounts and managing settlement instructions.

Key Considerations for Market Participants

With clearing operations currently limited to index future contracts, trading and settlement of other securities on Tadawul continues outside of the Muqassa framework.

However, with clearing operations soon to cover equities and other listed securities traded on Tadawul, market participants will need to determine whether they wish to become a clearing member and, if so, which form of membership would be appropriate for their business needs.

Moreover, for those Exchange Members who become Clearing Members and are not in a position to settle their own trades, decisions will need to be made as to whether they wish to implement their own settlement systems or whether they will choose to appoint a separate custodian to manage the settlement of their cleared trades.