

**The Potential for Growth of Securities Borrowing and Lending Activities at the  
Tadawul: a Short Analysis of Financial and Regulatory Constraints and  
Opportunities**

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## Introduction

Securities Borrowing and Lending has become a market for growth in Western countries for years. During the pandemic and thereafter, and during times of volatility in general, it provides an opportunity for issuers of funds to receive an additional income besides the return on investment. At the same time market makers and proprietary trading firms are being given a chance to benefit from short-sales and find due coverage, thereby contributing to market liquidity. In 2019, the International Securities Lending Association (ISLA) reported the global value of securities lending at around €2.2 trillion.<sup>1</sup> Currently that value stands at €2.4 trillion.<sup>2</sup> Though common practice in the West already, this is not always the case in other parts of the world, or has only recently become so. In particular, several regions are subjected to restrictions under Islamic law, which limit the ability to charge interest and speculate on changes in the market, and therefore limit trading activity.

The Middle East is such a region, especially so given that Islamic laws find their roots over there. Shariah restrictions still apply to finance in several capital markets, for example in the UAE and Saudi Arabia. Nevertheless are these markets increasingly opening up to trading activity. Several aspects of Securities Borrowing and Lending (SBL) can well be made compatible with these legal restrictions, and could therefore be a potential growth market in the Middle East. So, what opportunities do Middle Eastern capital markets offer for SBL? This will be explored below, focusing on the Tadawul, the largest stock exchange in the Middle East, which has undergone several rapid transformations. There are two main questions to be answered: Which market failures exist at the Tadawul? To what extent can SBL solve these market failures?

Saudi Arabia is perhaps the most well-known country that has been highly influenced by the Islamic religion. Given its establishment in 1932 with the Quran as its proclaimed foundation,<sup>3</sup> it is not surprising that the country's financial laws have long been codified in accordance with Shariah law. One of the main limitations of Shariah is a full ban (at least originally) on receiving any compensation for speculation or profits made by charging interest, also known as usury or 'Riba' in Arabic.<sup>4</sup> A similar restriction existed in continental Europe too under Canon law, though modifications have been made centuries ago as a compensation of opportunity costs, incentivising economic activity.<sup>5</sup> Is Saudi next in line removing religious restrictions on the economy insofar as they are overdue? Section I discusses the financial and legal setup of the Tadawul, its subdivisions, their scope and scale. Section II covers recent developments in capital markets regulation in Saudi Arabia. Section III ranks market failures based on literature on the Tadawul, economic theory on market efficiency, while also drawing on information in Section I and II and documentation by Morgan Stanley Capital International, which is a benchmark for assessing global capital markets. Section IV describes the potential for SBL to solve (some) of these market failures and the possibilities for its application to CCP and Over-The-Counter trades. Our focus will now be on equities, yet other instruments such as derivatives also deserve investigation. It is worth bearing in mind that the Middle east also has plenty of region-specific financial instruments such as Sukuks, and Mudaraba and Muqarada bonds. These too are

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<sup>1</sup> International Securities Lending Association, 'Securities Lending Market Report'. 11th Edition, September 2019. <[https://www.islaemea.org/assets/smart-pdfs/isla-securities-lending-market-report/files/downloads/ISLA\\_SLReport\\_Sep2019.pdf](https://www.islaemea.org/assets/smart-pdfs/isla-securities-lending-market-report/files/downloads/ISLA_SLReport_Sep2019.pdf)> Accessed 27 March 2024

<sup>2</sup> International Securities Lending Association, 'Securities Lending Market Data' (Data as of 31 December 2023). <<https://www.islaemea.org/securities-lending-market-data/>> Accessed 27 March 2024

<sup>3</sup> Ministry of Foreign Affairs, 'About Kingdom' (Kingdom of Saudi Arabia, Data as of 2024). <<https://www.mofa.gov.sa/en/ksa/Pages/default.aspx>> Accessed 7 April 2024

<sup>4</sup> Ariel Berschadsky, 'Innovative Financial Securities In The Middle East: Surmounting The Ban On Interest In Islamic Law', 9 U. Miami Bus. L. Rev. 107 (2001) <<http://repository.law.miami.edu/umbl/vol9/iss1/4>> Accessed 21 March 2024

<sup>5</sup> Ardi A Kaars, 'The impact of the European Banking Union on risk attitudes among Global Systemically Important Institutions: Phoenix out of the ashes or ABACUS-2024-ECB in the making?' (Utrecht University, 2022). Accessed 21 March 2024, p. 15

interesting topics for additional research, covered by Berschadsky<sup>6</sup> among others, yet do not fall within the scope of this paper. Section V concludes.

## I. Establishment of the *Tadawul*

Incorporated on 19 March 2007, the Tadawul is a joint stock company acting as stock exchange in Saudi Arabia. Its roots date back to 1954, when the company started off as an informal financial market.<sup>7</sup> Currently it is among the top 10 largest exchanges in the world, with a market capitalisation of 2.72 trillion USD as of 2022.<sup>8</sup>

### *Ownership structure*

Up to early 2021, the Tadawul was fully owned through the Public Investment Fund, a sovereign wealth fund managed by the Saudi government.<sup>9</sup> After that, in March 2021, the Saudi Tadawul Group was formed and has been the full owner of the exchange, with the group being publicly tradable as well. The group has been subdivided into four divisions:

#### *(i) Saudi Exchange*

Responsible for the listing of and trading in securities,<sup>10</sup> the Saudi Exchange carried out (on average) approximately 377 thousand transactions per day in 2023, compared to 354 thousand per day in 2022.<sup>11</sup> Total trading volume in 2023 surmounted to 83 billion shares, with a total value of 355 billion USD.<sup>12</sup> There are 228 listed securities as of 4 September 2023 comprising the Tadawul All Share Index,<sup>13</sup> a steady increase compared to previous years. Currently the index stands at around 12,500 points.<sup>14</sup>

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<sup>6</sup> Ibid Supra n. 4

<sup>7</sup> Tadawul, 'About Tadawul | Shaping Contours of a New Era' (Annual Report 2019). <<https://annualreport2019.tadawul.com.sa>> Accessed 21 March 2024

<sup>8</sup> Saudi Exchange, 'About Saudi Exchange' (Copyright 2024 Tadawul Group, Data as of 2024). <<https://www.saudiexchange.sa/wps/portal/saudiexchange/about-saudi-exchange/aboutus/saudi-exchange?locale=en>> Accessed 22 March 2024

<sup>9</sup> Saudi Tadawul Group, 'Home' (Copyright 2024 Tadawul Group, Data as of 2024). <<https://www.tadawulgroup.sa/wps/portal/tadawulgroup/invester-relations/ipo>> Accessed 22 March 2024

<sup>10</sup> Saudi Tadawul Group, 'Annual Report 2022 | Executive Summary' (2023). <[https://annualreport.tadawulgroup.sa/Resources/AnnualReport2022/download/pdf/STG%20AR22\\_Executive%20Summary%20PDF%20\(Spreads\)\\_English.pdf](https://annualreport.tadawulgroup.sa/Resources/AnnualReport2022/download/pdf/STG%20AR22_Executive%20Summary%20PDF%20(Spreads)_English.pdf)> Accessed 22 March 2024

<sup>11</sup> Saudi Exchange, 'Annual Statistical Report 2023' (2024). <<https://www.saudiexchange.sa/wps/wcm/connect/42563a22-e5a7-4cb9-a83f-6a109ab6036d/Saudi+Exchange+-Annual+Statistical+Report++2023+-+En.pdf?MOD=AJPERES&ContentCache=NONE&CACHE=NONE&CVID=#:~:text=The%20Daily%20Average%20Number%20of,year%2C%20increased%20by%206.53%25>> Accessed 22 March 2024

<sup>12</sup> Saudi Exchange, 'The Saudi Exchange - Annual Statistical Report' (1 January 2024). <[https://www.saudiexchange.sa/wps/portal/saudiexchange/newsandreports/issuer-news/news-details/?1dmy&urile=wcm:path:/Tadawul\\_en/SA-Tadawul/SA-PricesAndIndeces/SA-News/SA-MarketNews/CT-marketnews-%2001012024%20MIO&locale=en#:~:text=The%20total%20Number%20of%20trades,year%2C%20decreased%20by%200.79%25](https://www.saudiexchange.sa/wps/portal/saudiexchange/newsandreports/issuer-news/news-details/?1dmy&urile=wcm:path:/Tadawul_en/SA-Tadawul/SA-PricesAndIndeces/SA-News/SA-MarketNews/CT-marketnews-%2001012024%20MIO&locale=en#:~:text=The%20total%20Number%20of%20trades,year%2C%20decreased%20by%200.79%25)> Accessed 24 March 2024

<sup>13</sup> 'Tadawul continues to grow as 13 more companies listed over 12-month period', Arab News (4 September 2023). <<https://www.arabnews.com/node/2367081/business-economy>> Accessed 26 March 2024

<sup>14</sup> Saudi Exchange, 'Indices Performance' (Data as of 26 March 2024). <<https://www.saudiexchange.sa/wps/portal/saudiexchange/ourmarkets/main-market-watch/indices-performance>> Accessed 26 March 2024

*(ii) Edaa*

Edaa, the Securities Depository Centre Company, is responsible for post-trade services, ensuring proper settlement of transactions. Established in 2016, it is a fully owned subsidiary of the Tadawul Group, and in that capacity the subsidiary is responsible for enforcement of rules and regulations around transactions on the Saudi Exchange. This includes SBL transactions conform the 2017 SBL agreement, which has been amended in 2021.<sup>15</sup> Thus the authority determines the eligibility of any party to enter into an SBL transaction conform Article 4 of the SBL agreement, and may issue a prohibition conform Article 7 (more on that in Section II).<sup>16</sup>

*(iii) Muqassa*

The Muqassa was established in 2018 and is a full subsidiary of the group, based on Saudi Companies Law issued by Royal Decree No. M/3 dated 28/01/1437 – 11/11/2015. It is the central clearinghouse for all securities listed on the the Saudi Exchange, as well as for derivatives.<sup>17</sup> The used technology runs on Nasdaq's CCP system. With Muqassa being a CCP, it has its own Credit Risk Assessment Framework used to give Clearing Members an Internal Credit Score as an entry requirement.<sup>18</sup>

*(iv) WAMID*

As the fourth subsidiary of the group, WAMID is responsible for delivering technological solutions for the stock exchange and its stakeholders. It was founded in 2021,<sup>19</sup> and has acquired DirectFN for 35.7 million USD (51% stake).<sup>20</sup> This step was taken to largely focus on technical improvement in local markets, as well as a means of diversifying sources of income. The 2021 annual report of the group indicates that 93 million out of 1.16 billion Saudi Arabian Riyals were earned through Data & Technology Services for 2021.<sup>21</sup> Whether that amount is to increase in the future will largely depend on WAMID.

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<sup>15</sup> Securities Depository Center Company ("Edaa"), 'Securities Borrowing and Lending Regulations' Approved by the Board of the Capital Market Authority Pursuant to its Resolution Number (1-28-2017) Dated 16/6/1438H corresponding to 15/3/2017G And Amended Pursuant to Resolution Number (21-1-2021) Dated 10/7/1442H corresponding to 22/2/2021G And Amended Pursuant to Resolution Number (1-2-2022) Dated 30/5/1443H corresponding to 3/1/2022G. (Hereafter referred to as 'SBL Regulations' <<https://www.saudiexchange.sa/wps/wcm/connect/f8571f9b-7f2b-4ff2-a287-6ab665fa7a6b/Securities+Borrowing+and+Lending+Regulations.pdf?MOD=AJPERES&ContentCache=NONE&CACHE=NONE&CACHEID=ROOTWORKSPACE-f8571f9b-7f2b-4ff2-a287-6ab665fa7a6b-ooeh3eL>> Accessed 27 March 2024

<sup>16</sup> Ibid

<sup>17</sup> Muqassa, 'Our Story' (Copyright 2022). <<https://muqassa.sa/wps/portal/muqassa/about/our-story>> Accessed 30 March 2024

<sup>18</sup> Muqassa, 'Risk Management' (Copyright 2022). <<https://www.muqassa.sa/wps/portal/muqassa/risk-management>> Accessed 30 March 2024

<sup>19</sup> 'Wamid Company Profile' (Last updated 2 April 2024). <[https://tracxn.com/d/companies/wamid/\\_vmKfM\\_PBpaTfMwPVHW8qmhJ7s88cY7T8XQZgRBpMI2k](https://tracxn.com/d/companies/wamid/_vmKfM_PBpaTfMwPVHW8qmhJ7s88cY7T8XQZgRBpMI2k)> Accessed 4 April 2024

<sup>20</sup> WAMID, 'All Media Centre' (Last updated 8 May 2023). <[https://wamid.sa/wps/portal/wamid/media-centre/lut/p/z1/04\\_Sj9CPyKssy0xPLMnMz0vMAfljo8ziLR3NDDxMLAyMDEP8zA0Cw\\_xDnSx9jA0NLE31w\\_EqcDfRj8ljHWAC1W-AAzgaENYfhVcJyAVgBXisKMgNjTDIdFQEAPoG2Ak!/#press-releases](https://wamid.sa/wps/portal/wamid/media-centre/lut/p/z1/04_Sj9CPyKssy0xPLMnMz0vMAfljo8ziLR3NDDxMLAyMDEP8zA0Cw_xDnSx9jA0NLE31w_EqcDfRj8ljHWAC1W-AAzgaENYfhVcJyAVgBXisKMgNjTDIdFQEAPoG2Ak!/#press-releases)> Accessed 4 April 2024

<sup>21</sup> Saudi Tadawul Group Holding Company, 'Consolidated Financial Statements For the year ended 31 December 2021 together with the Independent auditor's report' (2022). <[https://www.tadawulgroup.sa/wps/wcm/connect/a39cab57-3fdf-412f-aa0f-44c33ad31c04/2021\\_FY.pdf?MOD=AJPERES&CVID=oVvMWRB](https://www.tadawulgroup.sa/wps/wcm/connect/a39cab57-3fdf-412f-aa0f-44c33ad31c04/2021_FY.pdf?MOD=AJPERES&CVID=oVvMWRB)> Accessed 4 April 2024

## II. Regulatory regime throughout the years

In Saudi Arabia, the Capital Market Authority is responsible for regulating financial markets. It was founded in 2004<sup>22</sup> following Royal Decree No. (M/30) dated 2/6/1424H - 31/7/2003.<sup>23</sup> It must be stressed that the Capital Market Authority has strict rules concerning short-selling as set out in Article 6 of the Short Selling Regulations of 2017, which demands that the short ratio to average daily traded volume must not exceed 10 days, and the net short position on an instrument must not exceed 10% of tradable volume (floating shares).<sup>24</sup> Remarkably, Article 11 gives the Capital Markets Authority the option to waive any requirement in this regulation as it deems fit. Moreover, neither the Exchange nor the Depository Centre can be held liable for losses incurred by eligible parties, as a result of settlement procedure or decisions to restrict or prohibit short-selling of an instrument.<sup>25</sup> This limitation of liability is on par with other exchanges such as Euronext as apparent from rule 1602 of the Euronext Rule Book.<sup>26</sup> Nevertheless, the CMA has a significant margin of discretion to intervene into the exchange at whim, this is also apparent from Article 10 of the latest SBL regulations:<sup>27</sup>

### Article 10 Powers of the Authority and the Depository Centre

a. The Authority, or the Depository Centre having obtained the approval of the Authority, may suspend or prohibit SBL transactions in respect of an eligible listed security, or may suspend or prohibit all SBL transactions in the Kingdom, **at any time and as they deem fit**, including but not limited to the following circumstances:

- 1) there are adverse events or developments which constitute a serious threat to financial stability or to market confidence;
- 2) for the protection of investors;
- 3) for the maintenance of an orderly market; or
- 4) trading in a listed security is suspended.

<sup>22</sup> Saudilegal, 'Saudi Arabian Law Overview | Capital Markets' (Copyright © Derayah LLC). <<https://www.saudilegal.com/saudi-law-overview/capital-markets>> Accessed 11 April 2024

<sup>23</sup> Capital Market Authority 'Capital Market Law' (Kingdom of Saudi Arabia, 2003) <<https://cma.org.sa/en/RulesRegulations/CMALaw/Pages/default.aspx>> Accessed 27 March 2024

<sup>24</sup> Saudi Exchange, 'Short Selling Regulations' *Approved by the Board of the Capital Market Authority Pursuant to its Resolution Number (1-28-2017) Dated 16/6/1438H corresponding to 15/3/2017G And Amended Pursuant to Resolution Number (21-1-2021) Dated 10/7/1442H corresponding to 22/2/2021G And Amended Pursuant to Resolution Number (1-2-2022) Dated 30/5/1443H corresponding to 3/1/2022G* (Kingdom of Saudi Arabia) <<https://www.saudiexchange.sa/wps/wcm/connect/62512544-afd5-43d6-8c53-c3969567dbd0/Short+Selling+Regulations.pdf?MOD=AJPERES&ContentCache=NONE&CACHE=NONE&CACHEID=ROOTWORKSPACE-62512544-afd5-43d6-8c53-c3969567dbd0-ooefxSD>> Accessed 27 March 2024

<sup>25</sup> Ibid

<sup>26</sup> Euronext, 'EURONEXT RULE BOOK | Book I: Harmonised Rules' (ISSUE DATE: 17 MAY 2019), p.19. Available at <<https://www.euronext.com>> Accessed 31 March 2024

<sup>27</sup> SBL Regulations, Article 10

Up until recently, speculation was strictly prohibited in the Saudi Kingdom. The Capital Market Law adopted based on Royal Decree No. (M/30) from 31 July 2003,<sup>28</sup> says the following about manipulation and prohibited market activities in Article 49:

- c) The following acts and practices shall be among those which shall be considered types of manipulation that are prohibited by paragraph (a) of this Article:
- 1) To perform any act or practice aiming at creating a false or misleading impression of an existing active trading in a Security as may be contrary to the reality. These acts and practices shall include, but not be limited to the following:
    - (a) Undertaking transactions in Securities which do not involve a true transfer of ownership thereof.
    - (b) Entering an order or orders for the purchase of a particular Security with prior knowledge that an order or orders of substantially the same size, price and timing for the sale of the same Security has been or will be entered by a different party or parties.
  - (c) Entering an order or orders for the sale of a particular Security with prior knowledge that an order or orders of substantially the same size, price and timing for the purchase of the same Security has been or will be entered by the same party or different parties.
  - 2) To affect, alone or with others, the price of a particular Security or Securities traded on the Exchange through executing a series of transactions in such Security or Securities creating actual or apparent active trading or causing an increase or decrease in the prices of such Securities, for the purpose of inducing third parties to buy or sell such Securities as the case may be.

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The restrictions highlighted in blue made trading activities such as Securities Borrowing and Lending, arbitrage and other forms of active trading basically impossible by definition, indeed very much in line with Islamic law. Even as late as 2013 (though one might consider this a long time ago from a financial perspective), the Capital Market Authority issued new regulations, which included a limit of 10% price fluctuation for newly listed companies.<sup>29</sup> This was correctly anticipated by Mr. Kabbara as mentioned in an article on Meed from 22 May 2013.<sup>30</sup>

Real attempts at financial liberalisation have been made with the adoption of the tenth development plan, which was scheduled from 2015 to 2019.<sup>31</sup> Declining oil prices formed an important rationale for diversification and modernisation of the economy.<sup>32</sup> An article from 2015 by *The Trade* highlights the first transaction by a Qualified Foreign Investor taking place in June that year. Before that, foreign investors could only buy shares at the Tadawul - which was then \$564 billion in terms of market capitalisation - through indirect channels like swaps.<sup>33</sup> Based on that valuation, the Tadawul has expanded quite rapidly.

<sup>28</sup> Capital Market Authority, 'The Capital Market Law' Pursuant to Royal Decree No. (M/30) dated 2/6/1424H - 31/7/2003 (Kingdom of Saudi Arabia, 2003). <<https://cma.org.sa/en/RulesRegulations/CMALaw/Documents/CMALaw.pdf>> Accessed 27 March 2024

<sup>29</sup> Capital Market Authority, 'Annual Report 2013' (Kingdom of Saudi Arabia, 2014). <[https://cma.org.sa/en/Market/Reports/Documents/cma\\_2013\\_report.pdf](https://cma.org.sa/en/Market/Reports/Documents/cma_2013_report.pdf)> Accessed 27 March 2024, p. 21

<sup>30</sup> MEED EDITORIAL, 'New Saudi regulation expected to limit stock market speculation' (22 May 2013). Meed. <<https://www.meed.com/new-saudi-regulation-expected-to-limit-stock-market-speculation/>> Accessed 27 March 2024

<sup>31</sup> Nader Habibi, 'Implementing Saudi Arabia's Vision 2030: An Interim Balance Sheet' (2019), Brandeis university, Crown Center for Middle East Studies. *Middle East Brief, April 2019, No. 127: 1-9*. Accessed 27 March 2024

<sup>32</sup> Mo Chen, 'The Economic Adjustment of Saudi Arabia and the Docking of Bilateral Economy and Trade between China and Saudi Arabia under the "One Belt and One Road" Initiative' (2016), *Journal of Middle Eastern and Islamic Studies (in Asia)*, 10:2, 46-70, DOI: 10.1080/19370679.2016.12023282 Accessed 31 March 2024

<sup>33</sup> 'Saudi Arabia opens its doors to foreign investors' (17 June 2015), *The TRADE > News > Asset Classes > Equities*. <<https://www.thetradenews.com/saudi-arabia-opens-its-doors-to-foreign-investors/#>> Accessed 5 April 2024

Ultimately, this development plan, based on a consultation of McKinsey, was scrapped and replaced by Vision 2030 in 2016, for which Palladium Group has been a main consultant.<sup>34</sup> This change of plans has accelerated the push towards more open capital markets. Whereas the tenth development plan included measures such as the issuance of new sovereign bonds to international investors,<sup>35</sup> Vision 2030 aims at a much faster attraction of foreign capital and a more extensive overhaul of Saudi's existing market setup.

One of the more important regulatory developments took place in 2017, when the Tadawul adopted settlement cycles of T+2 in order to be made compatible with international financial markets. Previously, T+0 settlement cycles were the norm for equities, and pre-funding was required.<sup>36</sup> This meant that trades could only be placed after a client had transferred funds to a third party placing the trade on the client's behalf. A 2015 study by Rahman et al. found that 95% of the traders active on the Tadawul constituted retail (instead of institutional) investors. It was also stressed that the T+0 cycle, being atypical, made it possible to sell shares that had been bought earlier that day.<sup>37</sup>

During the era of the T+0 cycle, heavy restrictions on market access applied, as was apparent from Article 49 already. This changed in 2018, for shortly after the adoption of the T+2 settlement cycle - effective as of 23 April 2017<sup>38</sup> - came the opening of a derivatives market as well as a market for short-selling following new regulations (such as the SBL regulations referred to earlier).<sup>39</sup>

### III. Market failures

Nevertheless, there are market failures that need to be addressed. Market failures can best be described as situations in which the market cannot achieve an efficient outcome by itself. Multiple reasons can be thought of: i) Lack of clear government regulation, or ii) Missing links in market infrastructure itself. Some important market failures at the Tadawul (over time) are explored below.

#### *Herding behaviour*

Herding behaviour describes market participants engaging in transactions because other participants do so too. Nour (2023) describes the practice as "the tendency of investors to follow the actions and market fluctuations of their peers rather than their judgment and analysis."<sup>40</sup> It leads to irrational investment decisions and can therefore make the market less efficient. This kind of behaviour lays the foundation for and exacerbates asset bubbles, price downfalls, and similar market movements that do not reflect fundamentals well.

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<sup>34</sup> Frank Kane, 'Meet the consultant helping with KSA's transformation strategy – and quest for happiness' (18 July 2017), Arab News. <<https://www.arabnews.com/node/1131026/business-economy>> Accessed 27 March 2024

<sup>35</sup> Ibid Supra n. 32, p. 62

<sup>36</sup> Ibid Supra n. 33

<sup>37</sup> M A Rahman et al, 'Herding where retail investors dominate trading: The case of Saudi Arabia'. The Quarterly Review of Economics and Finance (2015), <http://dx.doi.org/10.1016/j.qref.2015.01.002> Accessed 2 April 2024

<sup>38</sup> 'Tadawul begins using T+2 settlement cycle today' (23 April 2017). Argaam. <<https://www.argaam.com/en/article/articledetail/id/482177>> Accessed 11 April 2024

<sup>39</sup> 'KSA Connections', (August 2021). Squire Patton Boggs <<https://www.squirepattonboggs.com/-/media/files/insights/publications/2021/09/ksa-connections/ksaconnectionsnewsletterseptember2021.pdf>> Accessed 4 April 2024

<sup>40</sup> Layali I Nour, 'An Examination of Herd Behavior: Evidence from Saudi Arabia Stock Exchange' (2023). Effat University Jeddah, Saudi Arabia. <<https://repository.effatuniversity.edu.sa/handle/20.500.14131/1074>> Accessed 3 April 2024

Nour found that herding behaviour is not present at the Tadawul as a whole, yet his cross-sectional analysis indicated that the phenomenon exists in various sectors. These include banks, financial services, real estate management, energy, media and entertainment, and health care.<sup>41</sup> In contrast to the cautious findings by Nour, a 2015 study by Rahman et. al found that pervasive herding was a major problem at the Tadawul, based on Cross-Sectional Absolute Deviation analysis, which compares deviations from average market returns across industries under different circumstances. During that time, there was still a ban on short-selling. They found that herding was significantly present among Saudi market participants under different conditions. The behaviour was found to be stronger when the market is rising than when it falls.<sup>42</sup> Two explanations for this were homogeneity among market participants, and the inability to express pessimism due to the ban on short-selling. The degree to which short-selling has been practiced afterwards is therefore all the more relevant.

*Autocorrelation as an indication of market inefficiency and information asymmetry*

Autocorrelation is the phenomenon that previous patterns in the markets are indicative of future ones. Though not uncommon, it is contrary to the requirements for an efficient market, as Chowdurry et al rightfully note.<sup>43</sup> In a 2013 study, they analysed autocorrelation through day-of-the-week, non-synchronous (as in no fixed time-intervals throughout the day) trading under various degrees of volatility, from January 2004 to March 2012. Their results indicate that stock returns in the Tadawul were subject of weak yet positive autocorrelation, and that the intensity of autocorrelation grows when volatility increases. The effects of size were found to be insignificant, yet negative feedback traders were referred to as the most likely overall cause for autocorrelation.<sup>44</sup> These traders sell to make a profit by selling as a response to the over-appreciation of assets by those who entered into transactions prior to them. Consistent with the findings on herding, the absence of short-sellers seems a main obstacle in swift adjustments in prices based on new information.

*MSCI on Saudi's market development and gaps*

Morgan Stanley Capital International publishes periodic reports on market infrastructure worldwide. Taking into consideration its findings from June 2023, Table 1 (next page) shows that the infrastructure for clearing, settlements and securities lending is increasingly in place, yet the practice of the latter one has not been well-established yet.<sup>45</sup> Other impediments to market functioning as noted in this edition of the Global Market Accessibility Review are the fact that some information can only be found in Arabic and lack of equal rights for foreign investors.<sup>46</sup> The latter one is best demonstrated given that investors from within the Gulf Cooperation Council have no requirements to meet whereas foreign entities need to have sufficient capital, and a proven track-record of financial performance in order to receive a Qualified Foreign Financial Institution licence.<sup>47</sup>

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<sup>41</sup> Ibid, p. 52-55

<sup>42</sup> Ibid Supra n. 37 (Rahman et al, 2015)

<sup>43</sup> Shah S H Chowdurry et al, 'Stock return autocorrelation, day-of-the-week and volatility: An empirical investigation on Saudi Arabian stock market' (2013). Eastern Mediterranean University, North Cyprus, May 2013. <[https://www.researchgate.net/publication/269635828\\_Stock\\_return\\_autocorrelation\\_day-of-the-week\\_and\\_volatility\\_An\\_empirical\\_investigation\\_on\\_Saudi\\_Arabian\\_stock\\_market](https://www.researchgate.net/publication/269635828_Stock_return_autocorrelation_day-of-the-week_and_volatility_An_empirical_investigation_on_Saudi_Arabian_stock_market)> Accessed 2 April 2024

<sup>44</sup> Ibid

<sup>45</sup> Ibid

<sup>46</sup> Morgan Stanley Capital International, 'MSCI Global Market Accessibility Review'. June 2023 <<https://www.msci.com/documents/1296102/087cd982-f621-2897-f65b-441e2f4dafdc>> Accessed 2 April 2024

<sup>47</sup> Ibid



Table 1: MSCI assessment of emerging markets



MSCI GLOBAL MARKET ACCESSIBILITY REVIEW | JUNE 2023

## 8.2.4 Emerging Markets

	EMEA				Asia Pacific									
	Saudi Arabia	South Africa	Turkey	United Arab Emirates	China	China A	India	Indonesia	Korea	Malaysia	Philippines	Taiwan	Thailand	
Openness to foreign ownership														
Investor qualification requirement	+	++	++	++	++	+	+	++	++	++	++	+	++	
Foreign ownership limit (FOL) level	-	++	++	-	-	-	-	++	++	+	-	+	-	
Foreign room level	++	++	++	++	++	-	-	++	+	++	-	++	-	
Equal rights to foreign investors	-	++	+	+	+	+	+	+	+	+	+	+	-	
Ease of capital inflows / outflows														
Capital flow restriction level	++	++	++	++	++	+	++	++	++	++	++	++	++	
Foreign exchange market liberalization level	++	++	+	++	++	+	-	-	-	+	-	-	+	
Efficiency of the operational framework														
Market entry														
Investor registration & account set up	+	++	+	+	++	+	-	++	-	++	++	-	++	
Market organization														
Market regulations	++	++	+	++	+	+	+	++	++	++	++	++	++	
Information flow	+	++	+	++	++	+	++	+	-	++	++	+	++	
Market infrastructure														
Clearing and Settlement	+	+	+	+	++	-	-	+	-	++	+	-	+	
Custody	+	++	++	+	++	++	++	++	++	++	++	++	++	
Registry / Depository	++	++	++	++	++	++	++	++	++	++	++	++	++	
Trading	-	++	++	++	++	++	++	++	++	++	++	++	++	
Transferability	-	+	++	+	++	-	-	+	-	+	++	+	++	
Stock lending	-	++	+	-	++	-	++	+	++	++	-	+	+	
Short selling	-	++	-	-	++	-	+	+	+	+	-	+	+	
Availability of Investment Instruments	++	++	-	++	++	+	-	++	-	++	++	++	++	
Stability of institutional framework	+	+	-	+	+	+	+	+	+	+	+	+	+	

++: no issues; +: no major issues, improvements possible; -: improvements needed

## IV. Opportunities for Securities Borrowing and Lending

As a response to Section III, Table 2 (next page) demonstrates that net short positions and short ratio/average daily volume are still far below the legal upper bounds (recall Section II) for the most prominent listed stocks.<sup>48</sup> This in itself already indicates there is plenty of opportunity and capacity left for short-selling and securities lending. It is also consistent with the MSCI report's conclusion that short-selling is not really an established practice yet. The four most liquid stocks are Saudi Aramco, SNC, SABIC and Al Rahji Bank, according to Al-Athel, acting Chief Derivatives of the Saudi Exchange, in an interview at Arab News from 18 November 2023.<sup>49</sup>

<sup>48</sup> 'A look at Tadawul's short-selling deals' (20 February 2024). Argaam. <<https://www.argaam.com/en/article/articledetail/id/1706664>> Accessed 4 April 2024

<sup>49</sup> Manal Al-Barakati, 'Saudi exchange's introduction of single stock options to woo global investors' (18 November 2023). Arab News. <<https://www.arabnews.com/node/2411211/business-economy>> Accessed 4 April 2024

**Table 2: Short Positions at the Tadawul (as reported per February 2024, Argaam)**

Short Positions			
Company	Net short positions to total issued shares	Net short positions to	Short ratio/average daily traded volume
Tadawul Group	0.0469550 %	0.1173932 %	0.1507675
Bank Albilad	0.0076902 %	0.0108083 %	0.0563082
Alinma Bank	0.0002324 %	0.0002583 %	0.0010227
Maaden	0.1230925 %	0.3756821 %	1.7077777
SABIC	0.0014086 %	0.0046956 %	0.0308884
SARCO	0.0064800 %	0.0064801 %	0.0040329
MARAFIQ	0.0195676 %	0.0652253 %	0.0406352
Saudi Aramco	0.0012223 %	0.0124557 %	0.1941040
SIIG	0.0843833 %	0.1036520 %	0.5488910
Almarai	0.0003632 %	0.0014894 %	0.0035078
Sipchem	0.0004433 %	0.0004585 %	0.0019597
Advanced	0.2203719 %	0.2224294 %	0.9275966
Saudi Kayan	0.0028577 %	0.0043965 %	0.0137314
MESC	0.0521625 %	0.0541853 %	0.0264234
Petro Rabigh	0.0246031 %	0.0984122 %	0.2165215
Northern Cement	0.0003194 %	0.0003196 %	0.0017778
Qassim Cement	0.0187678 %	0.0244869 %	0.3543176
Southern Cement	0.0275500 %	0.0440357 %	0.5245300
Al Othaim	0.0004167 %	0.0006283 %	0.0027219
Emaar EC	0.0042081 %	0.0132256 %	0.0275813
SAL	0.0488175 %	0.1627250 %	0.0262847
Riyad REIT	0.0001241 %	0.0001241 %	0.0012556
Jadwa REIT Saudi	0.0198038 %	0.0198038 %	0.3040611
Saudi Electricity	0.0050260 %	0.0195637 %	0.1709194
CATRION	0.0227927 %	0.0354481 %	0.0381395

***Established members and entry requirements***

Tadawul makes a distinction between settlement members and independent custodians, the latter of which act as lending agents.<sup>50</sup> All of these firms are either fully Saudi-Arabian, Joint Stock companies, or subsidiaries of foreign banks, including Credit Suisse and Deutsche Bank, thirty-six in total.

<sup>50</sup> Edaa (Securities Depository Centre), 'Member Directory' (Data as of April 2024). <<https://www.edaa.sa/wps/portal/edaa/participants/members/memberdirectory>> Accessed 7 April 2024

Banks authorised by the Saudi Arabian Monetary Authority to operate in the Kingdom can be found on its website.<sup>51</sup> Clearing members can be found at the Muqassa website, and as it appears, all general clearing members are either Saudi banks or joint ventures (such as The Saudi British Bank).<sup>52</sup> The only non-Arabic banks active in clearing are Deutsche Bank, active in the cash market, Meryll Lynch, also active in the cash market, and HSBC, active in derivatives clearing. The number of Non-Clearing members, which use the clearing services of Clearing members for active market positions or market making activities, stands at twenty-three, implying limited competition. Even the newest CMA regulation has rather rigid restrictions in place on licensing foreign entities to conduct business in the domain of financial securities as apparent from Article 6 (f):<sup>53</sup>

f) In order to engage in dealing, custody and managing business, an applicant must be established in the Kingdom and must be:

- 1) a subsidiary of a local bank;
  - 2) a joint stock company;
  - 3) a subsidiary of a Saudi joint stock company that is engaged in financial services business; or
  - 4) a subsidiary of a foreign financial institution that is licensed under the Banking Control Law issued by Royal Decree No. M/5 dated 22/2/1386H.
- The applicant may be of any legal form established in the Kingdom to apply for a license to conduct arranging or advising.

By comparison, in the US, there are 33 registered clearing members under ICE Clear US.<sup>54</sup> In Europe, there are 74, which have been registered under ICE Clear Europe.<sup>55</sup> Some are multiple subsidiaries of the same group. In addition, both in the US market and European markets, plenty of option and high frequency traders are active, which is not the case for Saudi Arabia (yet). Besides scrapping some past restrictions, this contrast can further be explained by the existing warnings on "the Dangers of Financial Technology Innovation" issued by the CMA, as noted by a

<sup>51</sup> SAMA (Saudi Central Bank), 'Licensed Entities' (Kingdom of Saudi Arabia, data as of 3 April 2024). <<https://www.sama.gov.sa/en-US/LicenseEntities/Pages/LicensedBanks.aspx>> Accessed 3 April 2024

<sup>52</sup> Muqassa (Clearing House), 'Member Directory' (Data as of April 2024). <[https://www.muqassa.sa/wps/portal/muqassa/membership/member-directory!/ut/p/z1/jdDBC0JAEAbgp\\_HqTLor2m0PhUSClqntJTS2VVBXdMvXT-pUljW3Gb4ffgY4ZMDb\\_FbJXFeqztpP3Ln5DEHfeKi5SOhGCX70LaSwLYCCukb2MRkAI68JVG0QqTA\\_8nij2H4O88XCAMzMK\\_4AAsddsBlrYrnP1hb2K4E3ouL6EVvXvvpXGrdDWsDDRzH0ZRKYVqYZ9UY-CISqkFD9iqhaw4ZVmGTugO7A8Xh5b4!/dz/d5/L2dBISEvZ0FBIS9nQSEh/](https://www.muqassa.sa/wps/portal/muqassa/membership/member-directory!/ut/p/z1/jdDBC0JAEAbgp_HqTLor2m0PhUSClqntJTS2VVBXdMvXT-pUljW3Gb4ffgY4ZMDb_FbJXFeqztpP3Ln5DEHfeKi5SOhGCX70LaSwLYCCukb2MRkAI68JVG0QqTA_8nij2H4O88XCAMzMK_4AAsddsBlrYrnP1hb2K4E3ouL6EVvXvvpXGrdDWsDDRzH0ZRKYVqYZ9UY-CISqkFD9iqhaw4ZVmGTugO7A8Xh5b4!/dz/d5/L2dBISEvZ0FBIS9nQSEh/)> Accessed 3 April 2024

<sup>53</sup> Capital Market Authority, 'CAPITAL MARKET INSTITUTIONS REGULATIONS English Translation of the Official Arabic Text, Issued by the Board of the Capital Market Authority Pursuant to its Resolution Number 1-83-2005, Dated 21/05/1426H Corresponding to 28/06/2005G, Based on the Capital Market Law issued by Royal Decree No. M/30 dated 2/6/1424H, Amended by Resolution of the Board Of the Capital Market Authority Number 1-101-2023 Dated 8/4/1445H Corresponding to 23/10/2023G'.

<sup>54</sup> ICE Clear US, 'Membership' (Data as of April 2024). <<https://www.ice.com/clear-us/membership>> Accessed 8 April 2024

<sup>55</sup> ICE Clear Europe, 'Membership' (Data as of April 2024). <<https://www.ice.com/clear-europe/membership>> Accessed 8 April 2024

2022 report from Squire Patton Boggs.<sup>56</sup> Though a 'progressive' move compared to previous attitudes of the CMA towards FinTech, further removing legal and cultural barriers to these type of non-clearing members will be helpful in increasing trading activity.

#### *Reducing herding, autocorrelation and information asymmetry*

As apparent from section II, herding, autocorrelation, and information asymmetry, particularly in times of volatility, are persistent market failures. SBL can solve, or to say the least, reduce these problems, since the lack of short-selling activity was found an important contributing factor to these problems at the time of the ban. A 2021 study by Palia and Sokolinski found that securities lending by passive owners is associated with reduced dynamic short-selling risks (short-selling risks over time), by improving predictability in lending fees, recall risk, and contributing to longer held short stock. The overall conclusion was that price efficiency improved as a result.<sup>57</sup> The presence of foreign non-clearing members can be helpful in actively involving non-Saudis in the market for short-sellers. Once information provision improves, there is less room for herding and autocorrelation, and better spontaneous adjustment in the market. Inclusion of general clearing members that are also well-established in other regions such as the EU and Northern-America will be helpful, as the non-clearing members taking positions in the market tend to stick with their most trusted clearing bank, and clearing banks tend to 'grow' with their clients.

#### *Settlement cycles, OTC pass through and T+0 Buy-ins*

According to the Depository Centre Procedures, effective as of 6 March 2022, SBL trades are cancelled on S+3.<sup>58</sup> If we take into account the T+2 regime, that means clients who wish to borrow securities have until S+1 to cover their short positions. Muqassa, acting as the clearing house for the Tadawul, has recently developed OTC pass-through services.<sup>59</sup> These ensure that unlisted securities or those that have been determined otherwise as non-clearable through the exchange, can still find their way over the counter to settle trades over there, in accordance with Article 41 of the Securities Clearing Centre Rules.<sup>60</sup> This can be of use to SBL too, particularly in the case of securities for which the market is not very liquid. Moreover, a separate order-book is used for Buy-in trades, which all settle at T+0.<sup>61</sup>

<sup>56</sup> Ibid Supra n. 39, p. 4

<sup>57</sup> Darius Palia and Stanislav Sokolinski, 'Strategic Borrowing from Passive Investors: Implications for Securities Lending and Price Efficiency' (2021). Rutgers Business School <[https://sites.rutgers.edu/darius-palia/wp-content/uploads/sites/218/2021/08/PassiveShort\\_August-2021.pdf](https://sites.rutgers.edu/darius-palia/wp-content/uploads/sites/218/2021/08/PassiveShort_August-2021.pdf)> Accessed 4 April 2024

<sup>58</sup> Edaa (Securities Depository Centre), 'The Depository Centre Procedures Approved by the Board of the Capital Market Authority Pursuant to its Resolution Number (1-2-2022) Dated 30/5/1443 H corresponding to 3/1/2022 G'. <<https://www.saudiexchange.sa/wps/wcm/connect/11f572ea-3ab6-47a2-a561-9306d1624b56/The+Depository+Centre+Procedures%28Effective+from+06-03-2022%29.pdf?MOD=AJPERES&CVID=>>> Accessed 9 April 2024

<sup>59</sup> Saudi Tadawul Group, 'Saudi Tadawul Group Launches a Bundle of Enhancements to Develop Post Trade Infrastructure' (2022). <[https://www.edaa.sa/wps/wcm/connect/b06fe1a5-c6ae-4aa4-b9ed-5c678ad2e27e/MuqassaPTTFFactSheetEN.pdf?MOD=AJPERES&CONVERT\\_TO=url&CACHEID=ROOTWORKSPACE-b06fe1a5-c6ae-4aa4-b9ed-5c678ad2e27e-oRglQHj#:~:text=Saudi%20Tadawul%20Group%20and%20three,financial%20instruments%20to%20local%20and](https://www.edaa.sa/wps/wcm/connect/b06fe1a5-c6ae-4aa4-b9ed-5c678ad2e27e/MuqassaPTTFFactSheetEN.pdf?MOD=AJPERES&CONVERT_TO=url&CACHEID=ROOTWORKSPACE-b06fe1a5-c6ae-4aa4-b9ed-5c678ad2e27e-oRglQHj#:~:text=Saudi%20Tadawul%20Group%20and%20three,financial%20instruments%20to%20local%20and)> Accessed 9 April 2024

<sup>60</sup> Muqassa (Central Counterparty Clearing House), 'SECURITIES CLEARING CENTRE RULES Approved by the Board of the Capital Market Authority Pursuant to its Resolution Number (1-137-2019) Dated 12/4/1441H Corresponding to 9/12/2019G And Amended Pursuant to Resolution Number (1-2-2022) Dated 30/5/1443H corresponding to 3/1/2022G'. <<https://www.saudiexchange.sa/wps/wcm/connect/12cff4cc-f009-432f-b587-f9d9f3334a8b/Securities+Clearing+Centre+Rules.pdf?MOD=AJPERES&ContentCache=NONE&CACHE=NONE&CACHEID=ROOTWORKSPACE-12cff4cc-f009-432f-b587-f9d9f3334a8b-opr0QoS>> Accessed 9 April 2024

<sup>61</sup> Ibid Supra n. 59

**Table 3: Excerpt from Securities Clearing Centre Rules**

15.3. The following table specifies Settlement Instructions mechanism:

Transaction Type	Instructed by			Beneficial ownership change	Counter Party Account Mandate	Additional Rule Criteria
	The Depository and Settlement System	CCP	Custody Member			
<b>TRAD (Trade)</b>		X		Accept	No	Rejected if the instrument has Mecca/Medina flag set and delivering/receiving securities account holder's citizenship is not Saudi.
<b>BIYI (Buy-in)</b>		X		Accept	No	
<b>SECB (Securities borrowing)</b>			X	Accept	No	Rejected if the instrument has Mecca/Medina flag set and delivering/receiving securities account holder's citizenship is not Saudi.
<b>SECL (Securities lending)</b>			X	Accept	No	

#### *Religious partitioning in stock lending*

From a religious perspective, one might say that anything related to speculation and trading is undesirable and imprudent. However, this does not match very well with today's reality in financial markets. Table 3 gives an overview (excerpt from Securities Clearing Centre Rules) of how the Tadawul deals with these differences.<sup>62</sup> Clearly (some) instruments with a religious nature remain shielded from SBL practices. Moreover, the fact that securities account holders involved in the transactions have to be a Saudi citizen may explain why it has not become an established practice yet, for the practice does not come naturally to their culture.

#### *A final note on capital restrictions and financial conservatism*

It is noteworthy that some restrictions on the free flow of capital can offer benefits to the market too. If the Global Financial Crisis has taught one thing, it is the dangerous consequences that spill-over effects in global financial markets can have. During the GFC of 2008 and thereafter, the Saudi banking system was relatively well-shielded from global shocks, which has largely been attributed to conservative management in this sector. In fact, Saudi banks saw an average return on equity of 20% in 2008 and carried a Basel capital adequacy ratio of 16%, as noted by the Bank for International Settlements.<sup>63</sup> As for the stock exchange, A healthy mix between Saudi and

<sup>62</sup> Ibid Supra n. 58, pp 13-14

<sup>63</sup> Abdulrahman Al-Hamid, 'The global financial crisis: impact on Saudi Arabia' (2009). Bank for International Settlements | BIS Papers No 54 <<https://www.bis.org/publ/bppdf/bispap54u.pdf>> Accessed 4 April 2024

non-Saudi Clearers as well as for non-Clearers can help build a market infrastructure that is technologically advanced yet protected against unfettered speculation and sudden liquidity dry-ups. Despite the pace of regulatory updates, partition between Shariah and non-Shariah compliant securities and financial practices, as well as Saudi versus non-Saudi remains. Some of this conservatism will likely remain visible in the foreseeable future based on the track of regulatory changes thus far.

## **V. Conclusion**

Under current legislation, there is plenty of room for expansion of Securities Borrowing and Lending at the Tadawul. Clearly the foundations have been laid for more active participation by foreign participants in the market and more diverse trading activity. Now it largely depends on the execution, preferably best execution. The more internationalised approach to economics on paper offers options to SBL that have not fully been taken advantage of, and are therefore not really embedded into Saudi Arabia's and the Tadawul's culture yet. The main barriers that seem to remain for now are the strict distinction between Saudi versus non-Saudi, and legal barriers that have a religious connotation. Once these are accounted for, the introduction of foreign non-clearers in particular will allow SBL to flourish and contribute to more efficient markets, less prone to tribal behaviours such as herding, and more spontaneous in nature.

### *Caveats and implications*

It must be stressed that the literature on short-selling comes largely from Western financial markets, precisely because it has been well-established. A one-on-one extrapolation to the Tadawul and Saudi's economy is difficult to make, yet this makes introduction of the concept all the more interesting. Moreover, there are plenty of aspects around the Tadawul that have not been covered, such as the parallel Nomu market. Further research is required to really grasp this financial ecosystem.

I have no interests to declare.