February 2012

Got a CMA: What Next?
Resolving Conflicts and Issues

Research Highlights:
Analyzing the provisions and regulations of Kuwait CMA and providing suggestions.

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Our first research on the topic appeared in April 2010 under the title "Wanted a Kuwait CMA: leveraging on Saudi Experience". That was an attempt to showcase Saudi CMA as a case study of success and making a case for launch of a full-fledged capital market regulator in the second largest stock market in the region. Since then we are now in the midst of a busy CMA in Kuwait with all related stakeholders trying to gain a grip on the issue and its various implications.

CMA provisions affect different players via different modes. Major impact of CMA provisions is observed for the fund industry with implications for other players such as investment bankers, listed companies and service providers. The gamut of impact range from operational to procedural and in some cases tend to impact the business model itself.

We have identified 21 issues regarding the various regulations and laws issued by the body. The majority of these relate to Fund activities, with an even split between Business model and Operational issues.

	Business Model	Operational	Procedural & Admin	Total
Funds	4	7	1	**12**
Investment Companies	1	3	1	**5**
Corporates	0	1	2	**3**
Services Providers	1	0	0	**1**
Total	**6**	**11**	**4**	**21**

Explanatory Note:

Business Model Aspects- vital clarification
Important queries and clarification required affecting the core activities of investment companies and the overall structure of investment companies in Kuwait

Operational Aspects- Executive clarification
Clarifications regarding financing and operational services of investment companies which could lead to massive financial losses if not met

Procedural and Admin aspects- Procedural questions
Clarification regarding management practices which if not met could reduce the overall efficiency of investment companies and its corporate governance obligation

Before we go and present our findings in detail, it would be in order to make some broad contextual remarks. The Capital market in Kuwait, and to a great extent in the region, has always been one dimensional (equity focused). The organic growth of the market (measured in terms of number of companies listed and growth of liquidity) has always been weak and hence stock market (an important constituent of capital market architecture) remained a place to do some speculation and little capital raising (measured in terms of rights issue). The broad stock index composition never mirrored that of the broad economy. Banks were the main financial intermediary and were well represented in stock markets as well. However, with more than 4 years after the financial crisis, banks have developed caution (read: risk aversion). This will mean that financial intermediation will now shift in a serious way directly to capital markets with companies using the venue to raise alternative capital. Also, companies would require debt as much as equity and this means the role of capital markets will become multi-dimensional; all of which adds up to tough responsibilities for a new regulator.

The launching of a CMA is more of a flow than a stock. It gains momentum over time and gradually gains pace. A strong and rigorous coordination among various stakeholders will make sure that this is not a false start.

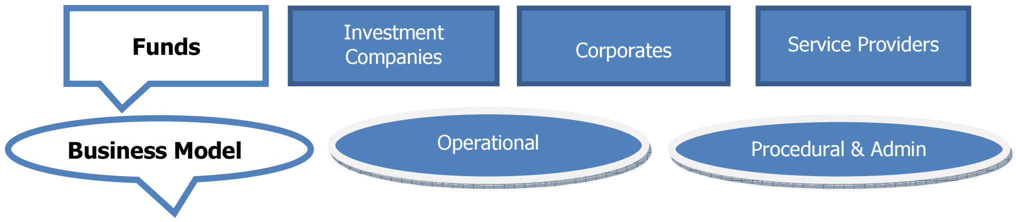
Summary of Key Recommendations
In our assessment, the CMA should;

	Business Model	Operational	Procedural & Admin
Funds	**(Article 317)** 1. The CMA should require full disclosure of board member involvement in other firms, in addition to monitoring those individuals or groups which have a wider degree of influence on the market. This would be more effective than instituting a ban on cross membership. 2. The CMA has highlighted the equity conflicts of interests. They also need to enhance clarity on debt conflicts of interest and the regulatory stance to mitigate them. **(Article 297, 309 & 310)** 3. All funds (foreign or domestic) need to be routed through CMA. Establishment of a fast track clearance for a fund vetted by a foreign regulator would be useful **(Article 321)** 4. Promotion and selling expenses of the fund are to be borne by the Fund Manager. Realistically, the fund would pay this directly or indirectly, it is essential to prevent mis-selling and regulate the items of expenditure rather than who bears it or the amount.	**(Articles 295, 301 & 346)** 5. Needs to elaborate on the role of cash as part of the Fund's objective. Holding cash is a function of the market condition and the fund's strategy. For e.g. an opportunistic fund may hold cash for a significant time waiting for the right opportunity **(Article 333)** 6. During extreme market conditions, the fund manager may have to take decision in minutes. Role clarity is needed on the ability of the Fund Manager to make unilateral decisions without waiting for the Board to convene and decide **(Articles 313 & 316)** 7. Issue explanatory circulars to fully flesh out the restrictions placed on Board members in terms of participation in Funds and entities 8. Clarify the duties expected of Board members, qualifications and any limits placed on the same in terms of membership on other Fund boards which may produce conflicts of interest. **(Article 312)** 9. Application guidelines are needed to enable the fund manager to do adequate reporting rather than over or under reporting. **(Articles 352 & 353)** 10. Concerning appointment of auditors; Kuwait may not have enough qualified external auditors to handle all the funds. This coupled with frequent changes, once in 3 years, may dilute the rigor of audit	**(Articles 362 & 364)** 12. Provide clarity on the process by which Fund Managers are chosen (by the CMA) in the event that unitholders have voted to oust the current manager

		(Article 319) 11. If a licensed person manages more than one mutual fund, they must separate the management and the operations of each fund. Segregation of the back office is a must but the CMA also needs to encourage segregation of portfolio management from trading activities.	
Investment Companies	**(Articles 161, 384 & 169)** 13. Provide clarity on margin lending regulations and whether they contradict the CBK circular requesting firms to disengage from lending activities	**(Article 147)** 14. Issue an explanatory note on Article (147) in regards to fee sharing and discounts and whether they are permissible or constitute an incentive **(Articles 130 & 132)** 15. CMA needs to issue selection criteria for the critical positions. Employee holding more than one registered function should be a stop gap arrangement rather than a norm. **(Article 133)** 16. CMA may require passing a qualifying test to fill the registered functions. The qualifying criteria needs to weigh in experience and have a provision for upgrade exams/portability of international certifications	17. Consider lowering regulatory costs related to listing, licensing, M&A etc, in order to improve compliance among firms and not discourage activity
Corporates		**(Articles 271, 274)** 18. Clarify the 30% "takeover trigger" as it could be the result of a passive action for e.g. rights issue, increased treasury shares etc	**(Articles 258, 266, 269)** 19. Issue regulations concerning minority squeeze-outs and drag-along rights, particularly as they relate to the "30% takeover trigger" **(Article 395)** 20. Share holders having portfolio accounts across firms may need to aggregate their holdings and disclose it to the regulator or Investors need to have unique investment numbers/identifiers identifying them as the beneficial owner.
Service Providers	**(General)** 21. CMA should clarify Broker business practices, Brokers should be adequately monitored with the CMA spelling out fines and penalties for unethical behavior		

Impacted Areas of the Market

The creation of the CMA, in our opinion, has impacted four distinct stakeholders. In the following sections, we discuss specifically the impacted areas for each of these four segments.



The CMA regulates fund activities and their operations in terms of models, governance, capital raising etc through various executive regulations. There have already been a great deal of issues and questions from fund managers and investment professionals concerning a few of the articles contained within the law which either require clarification or are contentious and seen as prohibitively *restrictive*. Consequently, the CMA has been issuing explanatory papers to clarify some of these issues before the respective deadlines.

The CMA has also made efforts to create case-specific regulations to account for the different types of funds that may be employed, be they sector, index etc. These regulations are spelled out in Administrative Order No. 3 of 2012 (See Appendix 3)

Article (317)

The staff and officers of the fund manager may not serve on the Board of Directors or hold any position in a company or other entity where its securities form a part of the assets of any investment fund managed by the firm. And the independent members of the fund's Board of Directors may not serve as Board members or hold any position in a company or other entity whose securities form part of the assets of the investment fund.

The idea behind this provision is likely based on the following premise:

a) Fund manager is a director in a company and hence has access to privileged information which can be used to benefit the fund or the company to the detriment of the other entity.
b) Fund manager may be conflicted in asset allocation decision given that he is more familiar with one company by virtue of being the director.
c) Fund manager can potentially engage in front running[1] due to access to trading level details at the fund level.

The regulation is meant to safeguard against individuals being biased for or against one entity when they have a decision making role in two entities with overlapping interests. Furthermore, the regulation also aims at preventing the possibility of insider trading by specifying that if such an instance were to

[1] **Front Running:** The unethical practice of a broker trading an equity based on information from the analyst department before his or her clients have been given the information. (Investopedia). In this context, the Fund manager can trade on his personal account before placing the trade for the fund.

arise, the person would be compelled to resign from the entity. However, the provision that independent members of the fund's Board of Directors may not serve as Board members may induce reluctance on the part of eminent people from accepting board positions in investment funds as it will preclude them from being board members for several companies that form part of the investment fund. Hence, over a period of time, the quality of board of directors of investments funds may suffer to the detriment of funds performance.

However, there is some contention in complying with this rule, given the high degree of interlocked firms in Kuwait (i.e. firms which share Board members); some studies have shown that the percentage of directors serving on more than one board in Kuwait is at 15.8%[2]. Additionally, there are mutual benefits, both to the firms and the market at large, to overlapping control; companies benefit from a wider range of resources, knowledge and support. Kuwait, in particular, has a large network of cross-holdings due to the limited talent pool and the tight knit nature of the society. Furthermore, analysis shows that "the positive relationship between debt and interlocks indicate that companies use interlocks as a way to secure finance to run their business. At the same token, banks interlock with unprofitable companies due to the profit generated from the loan financing (Lang and Lockhart, 1990). Due to the positive performance of companies during 2007 in KSE, lenders were encouraged to interlock with companies who are highly profitable despite the high debt ratio. In other words, companies don't perform their due diligence on which company they link to because they are masked with high profit and market performance.[3]" Moreover, there is limited foreign investment which reduces the availability of foreign board members.

Rather than instituting a ban on multiple directorships, the CMA should require full disclosure of board member involvement in other firms in addition to regularly monitoring those persons or groups which have a wider degree of influence on the market.

While there is clarity on the issue of Equity side of the Conflict; however, the CMA has not made clear what should happen in the case of a **Debt Conflict of interest**, for e.g.

a) Bank sponsored/controlled fund has substantial holding in the equity of a company where the bank has significant debt exposure: Conflict of interest between the fund and the bank. If the debt exposure is high then the bank may sacrifice the equity interest in the fund to protect its debt.
b) Bank has substantial equity holdings through its proprietary position and has also lent to the company. Conflict of interest within the bank in its role as an equity holder and a lender.
c) Bank's fund has a minority position in the equity of a company but the bank has lent to the company. As a lender the bank would be privy to insider information and this information can influence the action of the Bank controlled fund.
d) Bank's fund has a minority position in the equity of a company but the bank has lent money to the company's competitor. Information about a competitor can be used to influence the equity sale or purchase decision.
e) Bank has lent against collateral of equity shares. It is in the Bank's interests that the equity shares receive the maximum dividend and the equity prices remain stable or keep raising gradually. It would not be in

2 Interlocking Directorates among Publically Listed Companies in Kuwait; A.AlMajid, October 2010
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the Bank's interests if the equity prices are volatile, however, other equity holders may benefit from the volatility as this is equivalent to their having a call option.

Various research articles and academic papers have deliberated on the differences in the point of view of a debt holder versus equity holder (See: Fluck 1995, Franco 2010, Becker 2010). A debt holder is worried about cash flows while the equity holder is worried about profitability. It is in the interest of the debt holder that the firm minimizes the risks taken while an equity holder may generate profit only if the firm takes measured risks. Regionally, institutional equity investors for e.g. large pension funds and the sovereign wealth funds have traditionally taken a non-interference stance with respect to the company management. On the other hand, debt holders like banks and large institutional creditors have actively sought to influence the strategy of the companies to protect their debt driven interests.

What we suggest;

1. The CMA should require full disclosure of board member involvement in other firms in addition to monitoring those individuals or groups which have a wider degree of influence on the market. This would be more effective than instituting a ban on cross membership

2. The CMA has highlighted equity conflicts of interest. They also need to enhance clarity on debt conflicts of interest and the regulatory stance to mitigate them.

Article (297)

No Fund can be established without license from the CMA.

Articles (309) & (310)

No fund may be established outside of Kuwait without prior approval from the CMA and its units may only be offered through Private Placement.

Article (302)

Private Placements must have a minimum investment of KD 200,000 offered to no more than 200 investors, companies, Government and Government related entities.

Article (321)

Promotion and selling expenses of the fund have to be borne by the Fund Manager.

The marketing of foreign funds in Kuwait will see a restrictive measure as 1% of the total value of the units offered in Kuwait must be paid to CMA which may be high in order to discourage firms from attempting to circumvent the local regulations by establishing funds abroad.

Private Equity Model

Many aspects of the Private Equity (PE) model are coming under question here as the CMA Fund regulations are almost entirely opposite to the "normal" functioning of a Private Equity Fund.

In addition to the capital raising restrictions (See b. Capital Raising below); the CMA makes no distinction between Committed Capital and Invested Capital for Private Equity funds and what investors are liable for under the same.

Moreover, PE funds will typically engage in Mezzanine Financing structures or other forms of granting credit. There is a provision that up to 10% of the NAV of a fund can be borrowed if the Article of Association of the fund permits however these are usually for liquidity/redemption pressure event and not as an investment strategy. Ordinarily borrowing is expressly forbidden by the CMA. It is worth mentioning that even during the credit crisis of 2008, the leverage level for private equity transactions remained high[4]. Various academic studies have also demonstrated that leveraged acquisitions are crucial for the extra ordinary returns enjoyed by the Private Equity industry (Kaplan 2008). In this context the borrowing/lending restrictions on funds may cripple the Private Equity model.

In terms of structuring, the PE Fund will typically employ the setting up of a Special Purpose Vehicle (SPV) in order to invest in certain assets/jurisdictions. Moreover, the Fund Manager would normally serve as Chairman or Board member of said entity, which would go against the Equity Conflict clause laid out in Article (317).

What we suggest;

3. All funds (foreign or domestic) need to be routed through CMA. Establishment of a fast track clearance for a fund vetted by a foreign regulator would be useful

4. Promotion and selling expenses of the fund are to be borne by the Fund Manager. Realistically, the fund would pay this directly or indirectly, it is essential to prevent mis-selling and regulate the items of expenditure rather than who bears it or the amount.

[4] Private Equity Leverage Ratios Rising, CNBC, May 2010

Capital Raising

The Private Equity model is called squarely into question in Article (295) which deals with capital raising for funds. Article (301) goes further by saying that all fund capital must be raised within 3 months of establishing the fund and prohibits draw-downs or capital/calls which are the traditional mode of fund raising under the PE model and can typically take between 3-5 years.

Article (295)

Amounts of the subscribed units should be paid upon subscription.

Article (301)

A person submitting a request to establish a mutual fund must fully finalise the fund's capital and issue ownership units within three months of the date of issue of the license; otherwise the license shall be revoked.

Article (346)

The Investment Fund shall invest at least 75% of its capital to achieve its main investment objectives.

Additionally, through Articles 295 and 301, the CMA is placing fund managers of new funds and vehicles on notice for a quick capital closure of the fund, once approved. On a similar note, Article 346 aims to steer the fund towards its primary objectives.

Article 346 is to counter situations where private equity funds are invested in listed equities and listed equity funds have unlisted illiquid holdings by stipulating that the majority of capital must be invested in the main objective of the fund. A fund typically raises the capital and once the capital is raised and capital closure is achieved the fund starts deploying the capital. The deployment happens gradually to ensure adequate liquidity management and identification of good opportunities. Once the capital is raised, the CMA requires the fund to invest a minimum of 75% of its capital in its main objective (Article 346) which could present a liquidity management issue. Moreover, the CMA has not provided a deadline for achieving the 75% minimum in investments; adequately explaining the role of cash as part of fund's objectives would help in clarifying the concept. The CMA has not clarified what restrictions, if any, are placed on the remaining 25%.

What we suggest;

5. Article (346) needs to elaborate on the role of cash as part of the Fund's objective. Holding cash is a function of the market condition and the fund's strategy. For e.g. an opportunistic fund may hold cash for a significant time waiting for the right opportunity.

Use of Resources

Article (333)

If the funds available in the mutual fund's account are not sufficient to cover redemption requests, the fund manager may use their personal resources or those of a subsidiary to cover such requests. In such cases, these funds may be repaid to the fund manager or their subsidiary from the account of the mutual fund designated for redemptions, plus commission determined on the basis of the prevailing market price.

This article empowers the Fund Manager to use his resources to tide over any redemption requests. However, the motivation of the fund manager needs to be aligned. A Fund Manager will protect a Fund whose reputation and success is associated with the Fund Manager. As per the new CMA laws however, the Fund takes on a quasi-company set up where the Board is responsible for the Fund and the Manager can be changed at the will of the Board. In a company set up, the Board of Directors have an option of resigning and the shareholders can appoint a new board. Similarly, can the Fund Manager also choose to walk out at a critical juncture rather than put in his proprietary funds at stake?

In such circumstances the Fund Manager would need clarity on:

- Would the loan rank higher than other general creditors of the fund since it is short term in nature, was given in an extreme situation and meant to tide over an immediate liquidity event?

- Would the commission for the financing be linked to market interest rate? Typically distressed entities have access to funds at a higher rate and overnight/liquidity arrangements are much more expensive than published rates. This act of borrowing would, ideally, also need to be authorized by the Board of both the fund and the Fund Manager to avoid conflict of interest. However in extreme market conditions, the Fund Manager may not have the luxury of time to call for respective board meetings and seek authorizations.

What we suggest;

6. During extreme market conditions, the fund manager may have to take decision in minutes. Role clarity is needed on the ability of the Fund Manager to make unilateral decisions without waiting for the Board to convene and decide.

Governance

The governance of Funds has been flipped on its head with a variety of clauses and regulations stipulating the manner in which it is managed in addition to increased unit-holder rights.

Article (313)
Each Investment Fund must have a Board of Directors appointed by the assembly of Unit Holders in the Fund after obtaining the approval of the Authority. The Board meetings are held and managed in accordance with the Articles of Association (AoA) of the Fund.

Article (316)
The responsibilities of the members of the Board of Directors include:

1. Conducting Due Diligence and work honestly for the benefit of the Fund and Unit Holders.
2. Approving all essential contracts, resolutions and reports,
3. Declaration of any transactions involving conflicts of interest,
4. Ensuring that Fund Manager complies with CMA laws and regulations in addition to AoA instructions and other documents issued by Fund Manager,
5. Ensuring that Fund Manager is carrying his responsibilities to the Fund and Unit Holders.

Each Fund will be required to have a Board of Directors (BoD); the CMA has not clarified the full extent of the Board's duties, what qualifications a person must have in order to be a Board member in addition to whether there is a limit to the number of funds a person can be a Board member of. Moreover, it does not clearly indicate whether there is a restriction on the Fund Manager in serving on the Board of the Fund or, alternatively, if a fund manager can also be a director of another Fund. At a conceptual level, individuals may find it more attractive to be Board members than work as a part of an institutionalized fund management team, i.e. if the BoD has substantial individual based compensation then it may be a stronger motivation than working in a investment firm for a monthly salary.

The responsibilities, as laid out in Article (316), do not make it clear whether the Board of Director has any say in the strategy of the fund or whether they only approve transactions. Furthermore, it is unclear whether their role is Executive or Supervisory or both. In many areas their roles overlap. In a typical company set up the Board represents the shareholders, gets compensated by the shareholders and is answerable primarily to the Shareholders. In a fund structure as proposed above, the Board represents the unit holders but the board faces significant constraints in terms of the rules governing the fund. This makes the structure heavy on penalties while being low on incentives for the Board members i.e. the Board members face a huge negative optionality in their payoff. If the fund does well, the fund manager being the active contributor will claim credit for the performance, however if the fund gets into troubled waters, the Board has significant liability to unit holders, regulators and counterparties.

What we suggest;

7. Issue explanatory circulars to fully flesh out the restrictions placed on Board members in terms of participation in Funds and entities

8. Clarify the duties expected of Board members, qualifications and any limits placed on the same in terms of membership on other Fund boards which may produce conflicts of interest.

Article (312)

The Investment Fund Manager must notify the CMA of any development which may subject their unit holders to risk.

The Article deals with the compliance requirements in running a fund and notes that the investment fund manager should notify "the Authority immediately of any developments in the works of the fund which may expose the interests of the unit holders to risk". However, the article does not make clear who is responsible for taking such a decision, i.e. as to whether the development warrants informing the Authority or not. In the evolving field of Anti-money laundering regulations, there is a parallel to this article in terms of the rules for filing Suspicious Activity Reports (SAR).

In a July 2003 assessment of the UK's reporting system by KPMG, auditors pointed to the obvious problem: "Although the volume of SARs is increasing rapidly, the quality of a significant number of SARs remains poor both in content and in the form (for example, handwritten) in which they are submitted. These poor quality SARs do not deliver what is desired and needed to recover assets or investigate money laundering or predicate offences." Of a sample 600 British SARs, KPMG's auditors tracked between 2000 and 2002, only 6% 'contributed to a positive law enforcement outcome'.[5]

Regulators have discovered that defining suspicious activity vaguely results in either no reporting from the financial institutions or a flood of trivial reports. In the absence of case studies or application guidelines, Investment Fund Managers may end up classifying many factors as "subjecting unit holders to risk" or may veer to the other extreme and fail to report significant risks.

What we suggest;

9. Application guidelines are needed to enable the fund manager to do adequate reporting rather than over or under reporting.

Article (352)

The external auditor of the Investment Fund is appointed for one financial year renewable annually for a period not exceeding three consecutive years.

Article (353)

The external auditor of the Investment Fund may not be the auditor of the Fund Manager

In terms of auditing, the fund and managing firm may not share an external auditor; furthermore, the auditor of the Fund is appointed for one year renewable annually for a period not extending three consecutive years, which may have operational implications considering the universe of licensed Auditors in the country.

What we suggest;

10. Concerning appointment of auditors; Kuwait may not have enough qualified external auditors to handle all the funds. This coupled with frequent changes, once in 3 years, may dilute the rigor of audit

[5] Swiss Bankers Association, 2004

Article (319)

In the event a licensed person manages more than one mutual fund, they must separate the management of each fund and the operations linked to each fund.

Worldwide there are two distinct models for fund management:

- In the **Themed Approach** a management team manages many funds with similar underlying themes. The management team would share common resources in terms of integrated back office and trading infrastructure.
- In a **Fund-specific Approach**, each fund would have its own distinct fund manager along with a dedicated support team.

The difference between the two approaches is primarily driven by the size of the fund. A larger fund can afford to have a dedicated team to handle the fund. In a themed approach, the asset allocation would be handled by a common team which does the asset allocation as per a set criteria, however to prevent any front running or self dealing there would be a Chinese wall between the traders and the fund managers.

In a fund specific approach, since each fund has its own dedicated team, the portfolio management team can also double up as the trader/order executer.

The CMA indicates that each Fund should also have a separate management team which will have staffing implications as currently the same employees for the fund manager may be managing several funds. Such a restriction would result in each firm having perhaps 2 or 3 large funds while working to eliminate micro-funds.

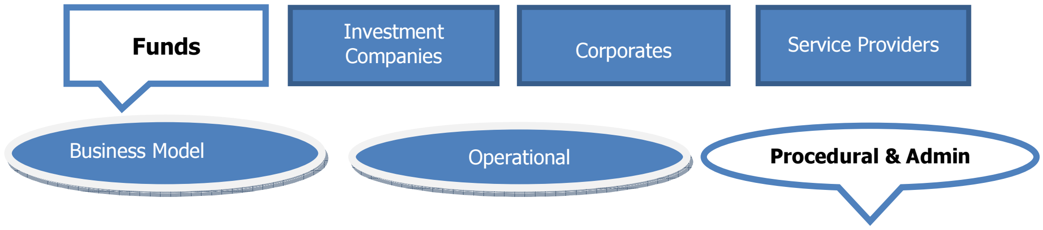
Unit Holder Activism

Some of the more contentious Articles of the CMA are those which deal with the Fund's Board of Directors (BoD) and the rights of unit holders. Under Article (313) the fund's BoD is appointed by an assembly of unit holders.

The unit holders would also be required to approve the Fund's Articles of Association; however, the CMA regulations are silent on unit holder's Assembly in terms of what their full rights are, how often the Assembly would meet etc.

What we suggest;

11. If a licensed person manages more than one mutual fund, they must separate the management and the operations of each fund. Segregation of the back office is a must but the CMA also needs to encourage segregation of portfolio management from trading activities.



Article (362)

Anyone holding at least 10% of the units in a fund may request the fund's Board of Directors to convene a unitholders' assembly to discuss appointing a replacement manager or liquidator to the fund.

The above Article, which stipulates that unit-holders owning 10% may convene a General Assembly to remove the Fund Manager, i.e. a Fund which was established by one firm might be taken over by another should the unit holders disapprove of management. The decision to remove a Fund Manager would require the approval of unitholders' representing at least 50% of the Fund's capital; Article 363 specifies the circumstances under which the fund manager can be replaced, namely:

1. If the mutual fund manager stops performing securities activities or is unable to meet their obligations in such a way as to threaten the interests of the unitholders.

2. If the mutual fund manager commits a fundamental violation of the Law or these Regulations, or the fund's Articles of Association

However, lack of performance or incompetence of the fund manager is not covered. Unit holders may be hard pressed to prove that an underperforming fund manager "is unable to meet obligations in such a way as to threaten the interests of the unitholders." If Fund Managers get the confidence that they cannot be removed for underperformance but only if they commit a fundamental violation then one strategy for the Fund Manager would be a passive risk avoidance, i.e. no activity in the fund implies very little chance of committing a fundamental violation.

What we suggest;

12. Provide clarity on the process by which Fund Managers are chosen (by the CMA) in the event that unit holders have voted to oust the current manager

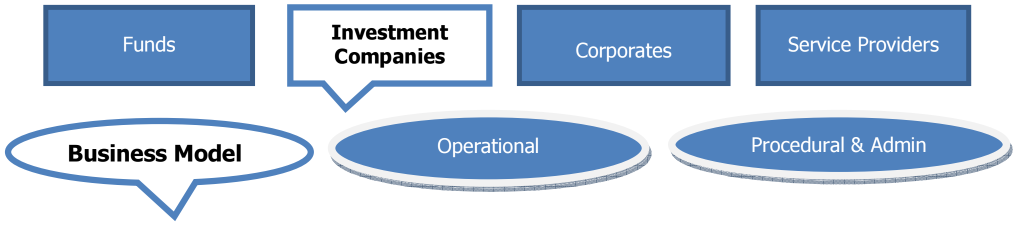
Article (364)

The fund's Board of Directors may present the Authority with a request to appoint a replacement manager or liquidator by virtue of a decision of the unitholders' assembly, making clear the contents of and reasons for such a decision. In such cases, the Authority may appoint a replacement manager or liquidator to the fund or take any other measures or steps it deems appropriate.

Furthermore, provided the replacement of the Fund Manager is voted upon and accepted by the Authority, the CMA would be charged with appointing a replacement manager. It is unclear on what basis the new Fund Manager would be chosen; would it be in compliance with unitholders' recommendation? Would unitholders vote to approve the new Fund Manager, as recommended by CMA?

Typically, if the unit holders elect to change the fund manager it implies either a conflict in viewpoint between the unitholders and the fund management team or a distress situation. In both cases a good quality fund manager would be loathe to get in to the thick of the action. If we look at Fund Managers as rational economic entities then they should demand higher compensation for managing complicated or distressed funds. Their efforts would be higher and there is the possibility of lawsuits from the unit holder or counterparties. International practices see distressed fund managers taking distressed assets on their books and gradually working out the assets without the pressure of investors for quick returns. In the case of a distressed fund being liquidated by a fund manager compensated on a typical AUM based fee percentage, there is a conflict of interest as the Fund Manager has no incentive to liquidate quickly (since it would hurt his fees). On the other hand, a fixed fee liquidator may end up harming the fund by fire sale of assets.

There seems to be a high risk of conflicted interests here in terms of the required objectivity in deciding on the 'new' Fund Manager.



a) Portfolio Management

The CMA regulations provide many guidelines and stipulations which will affect the portfolio/wealth management industry in the country. A few of the more notable Articles include;

> **Article (161)**
>
> 1. Licensed persons must obtain from their clients information on their financial position, their expertise in the field of investment, their investment aims relating to the services the licensed person will provide and any other information stipulated by the Authority before offering them brokerage services, investment consultancy or investment portfolio management services.
> 2. Licensed persons must request updates of the information stipulated for in Para. (1) of this Article from their clients at least once a year.

One of the first articles made clear in the regulation is an expansion of the Know Your Client (KYC) rule. In addition to a full financial background, the CMA will require that firms obtain information about their client's experience in the investment field in addition to their investment goals and objectives as it relates to the firm's services. Under this Article, the onus of product suitability shifts to the investment manager who would need to match products and services with the client's level of industry knowledge and risk appetite. This would also provide the investment manager with documentation with which to demonstrate the basis of product recommendations.

> **Article (384)**
>
> The interested person must notify the Authority, the exchange and the issuer if they realize an interest (5% or more) within 5 days of doing so.

This Article states that interested person has to disclose. Under this Article, it is unclear whether the portfolio manager is responsible for making such notifications on behalf of his client or whether the client must undertake the notification independently. Further can the investment manager disclose on behalf of its discretionary clients based on client authorization.

> **Article (169)**
>
> The licensee upon execution of a margin deal with the customer or for the customer's account should do the following:
>
> 1. Request the customer to pay a margin of no less than 25% of the deal value before execution thereof,
> 2. The margin should be in cash or in the mode of investment positions in securities fully paid up or by acceptable guarantee,
> 3. Monitor, daily, the margin provided by the customer to ensure it remains equal to the 25% minimum of the current value of each investment position in the related security.

By regulating margin deals, the CMA is sending a clear message that all activities related to the securities industry are under its purview.

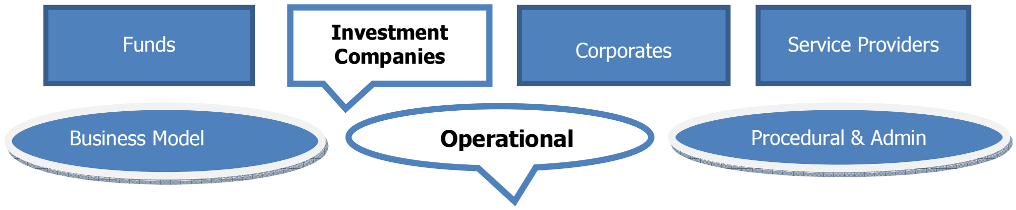
There are two areas where the CMA would need dynamic management to enforce the margin transaction regulations.

- A margin transaction has an initial margin (say 160%), a maintenance margin (say 140%) and a liquidation margin (say 125%). This enables the margin lender to perform an orderly liquidation if the maintenance margin has been reached and the client is unwilling to top up to the initial margin level. Without a sufficient margin between the maintenance margin and the liquidation margin, most lenders would gravitate towards liquid, well-traded stocks in order to minimize risk and would ignore the low volume scripts.
- Article 170 mentions that the CMA can change margin requirements. Margin requirements are dynamic across product categories and are fixed by a market committee from time to time to ensure orderly trading. For example, to reduce irrational speculation on a particular script and thereby the volatility on its share price, the market committee may increase the margin requirements, making it unattractive to indulge in through a margin trade. During May 2011, a similar action was undertaken by the Chicago Mercantile Exchange (CME), which routinely sets margins based upon contract prices for Silver commodity trading to curb unnecessary speculation. The action was to ensure that margin requirements were sufficient for large movements (i.e. brokers remained solvent) and contagion possibilities for other commodities were avoided (i.e. a crash in silver prices may trigger a crash in gold and other metals as precious metal dealers typically deal in many metals.)

The margin lending segment also needs to factor in that the Central Bank has sent a circular to investment firms requesting them to segregate the investment management aspect from the lending aspect. It is unclear if margin lending would also be construed as lending.

What we suggest;

13. Provide clarity on margin lending regulations and whether they contradict the CBK circular requesting firms to disengage from lending activities.



b) Investment Banking

In terms of Investment Banking, there are articles within the new regulations which will impact the way business is conducted. Many of the articles dealing with Investment Banking overlap with those governing all other companies; such as Capital raising laws, M&A etc, these issues are illustrated in the section below dealing with all listed companies.

Further to that, and akin to the regulations on Funds, a clear separation must be made between Back Office, Portfolio Managers and Traders whereas under the current scheme, the same individual might undertake or participate in all of these actions.

Article (147)

The licensee or his ally or any third party directed by him may not urge any customer to enter into a deal by offering or giving gifts or incentives.

The regulation is admirable in its aim of preventing unfair trade practices and an inducement based structure which distracts the customer from a risk return based analysis of the product. From the investment firm's end, the CMA regulations are unclear as to whether fee sharing or the discounting of fees is permissible or whether the same is to be considered an incentive. Most financial institutions also have employee incentive schemes linked to sales. Furthermore, it is common industry practice to have selling agents and institution level sharing of referral fees.

What we suggest;

14. Issue explanatory note on Article (147) in regards to fee sharing, discounting etc and whether they are permissible or constitute an incentive.

c) Segregation of Company Roles & Chinese Walls

The CMA makes it clear that there needs to be a clear separation of roles throughout the company, especially in terms of upper management and Risk functions. CMA regulations also stress the need for impenetrable Chinese walls across the organization in order to regulate the movement of information through the firm which may benefit one party while harming another.

Article (130)

The following positions held by a license applicant or any other licensed person must be registered and must be performed by persons resident in the State of Kuwait:

1. Chief Executive or similar
2. Financial Director or similar
3. Senior Executives or Directors or similar
4. Risk Management Officer or similar
5. Internal Auditing Officer or similar
6. Sharia Auditing Officer or similar, for persons licensed to operate according to the provisions of Islamic law
7. Compliance Officer
8. Reporting Officer for money laundering and terrorism financing
9. All employees offering services to clients, including marketers, investment consultants, investment portfolio managers and corporate finance specialists
10. Any other positions which the Authority believes should be registered

Article (132)

One employee may hold more than one position requiring registration for the account of one licensed person. As an exception to this, however, the Compliance Officer may not hold any post involving offering services to clients, and the Chief Executive, the Financial Director and the Compliance Officer must all be different people.

Several positions must be created in the Risk & Compliance department in order to comply with regulations. Independent and non-overlapping, positions include Risk Manager, Anti-Money Laundering officer and Compliance Officer. There will also need to a nominated Regulatory Interface Officer who will be the sole employee dealing with the CMA. This may prove logistically difficult in terms of attracting the required talent coupled with the additional costs placed on the company in doing so. Many small firms may not have the volumes or the AUM to justify the incremental costs of these individuals.

Article (133)

Any employees serving clients including marketing, investment, consultants, portfolio managers etc will need to be registered with the CMA with some employees being required to take special certification exams in their fields.

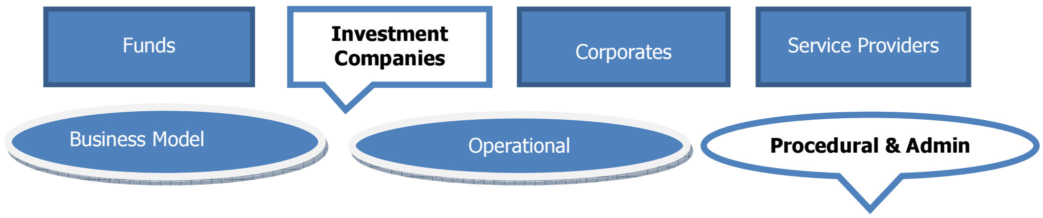
A general constraint placed on all employees of a firm is the inability to open a trading account with another firm unless their firm does not offer that service. Additionally, the employee must disclose to the Compliance Officer all outside dealings.

In addition to the clear segregation of company roles within a firm, the investment company must have Chinese walls in place to prevent the dissemination of information across company functions, such as between investment banking and asset/wealth management in addition to back/front office separation.

What we suggest;

15. CMA needs to issue selection criteria for the critical positions. Employee holding more than one registered function should be a stop gap arrangement rather than a norm.

16. CMA may require passing a qualifying test to fill the registered functions. The qualifying criteria needs to weigh in experience and have a provision for upgrade exams/portability of international certifications



d) Regulatory Cost

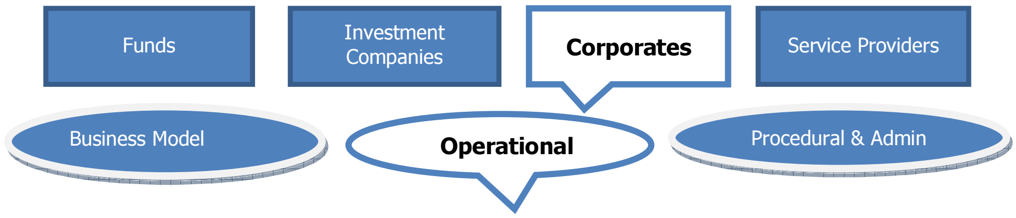
There will be a degree of Regulatory Costs incurred by the firms in implementing the new law. These costs range from listing fees to fees incurred upon launching funds in addition to those related to M&A activity. The firm will also incur some staffing costs for the creation of Risk Management positions coupled with additional fund management personnel as per the law.

Some notable fees include;

- License of securities investment advisor: KD 15,000, at licensing and upon renewal every three years,
- License of Fund Manager activity: KD 15,000, at licensing and upon renewal every three years,
- Application for market license for foreign investment fund: 1% of total value of units offered,
- Application of M&A offer: 0.10% of transaction value (max. KD 50,000),
- Request for approval on acquisition between 5%-30%: 1% of share acquisition value (min. KD 5000).

What we suggest;

17. CMA should consider lowering regulatory costs related to listing, licensing and M&A etc in order to improve compliance among firms and not discourage activity.



Although investment companies have their hands full complying with the new regulations, all companies (listed or unlisted) also have to comply with CMA rules in terms of listing, conflict of interest regulation, Merger & Acquisition and capital raising.

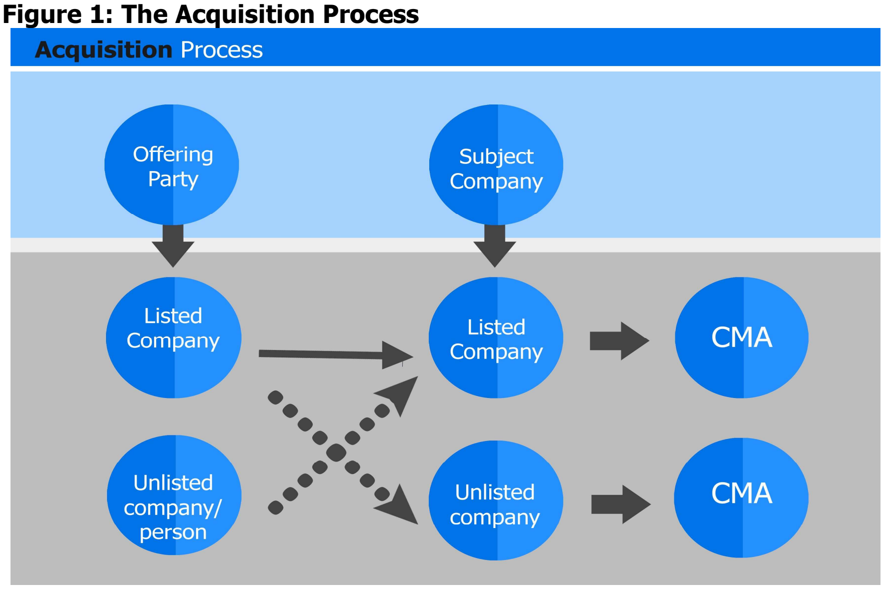
Mergers and Acquisition

Prior to CMA, Mergers and Acquisitions were not regulated efficiently meaning that small investors did not always have all the information to act on offers. The current regulation has protective clauses to safeguard the interests of small investors.

Acquisition of a significant stake in a listed company tends to bring change in management and hence warrants regulation and fair play. During such acquisitions, it is important to protect the interests of minority shareholders by treating them in an equitable manner while at the same time avoiding the tyranny of a small malevolent minority.

The provisions of acquisition will involve both listed companies and unlisted companies. It is quite possible that a listed company takes over an unlisted company and vice-versa. The CMA regulations will come into play in all such circumstances except where an unlisted company takes over another unlisted company.

Figure 1: The Acquisition Process



The offering person must present to the CMA an offer document which contains (but is not limited to) the details of the offering person, the total amount of the offer, the financing method of the offer, and the time schedule of the offer (Article 258). Once approved by the CMA, the target company must within 7 days publish their comment showing opinion and recommendation (Article 266).

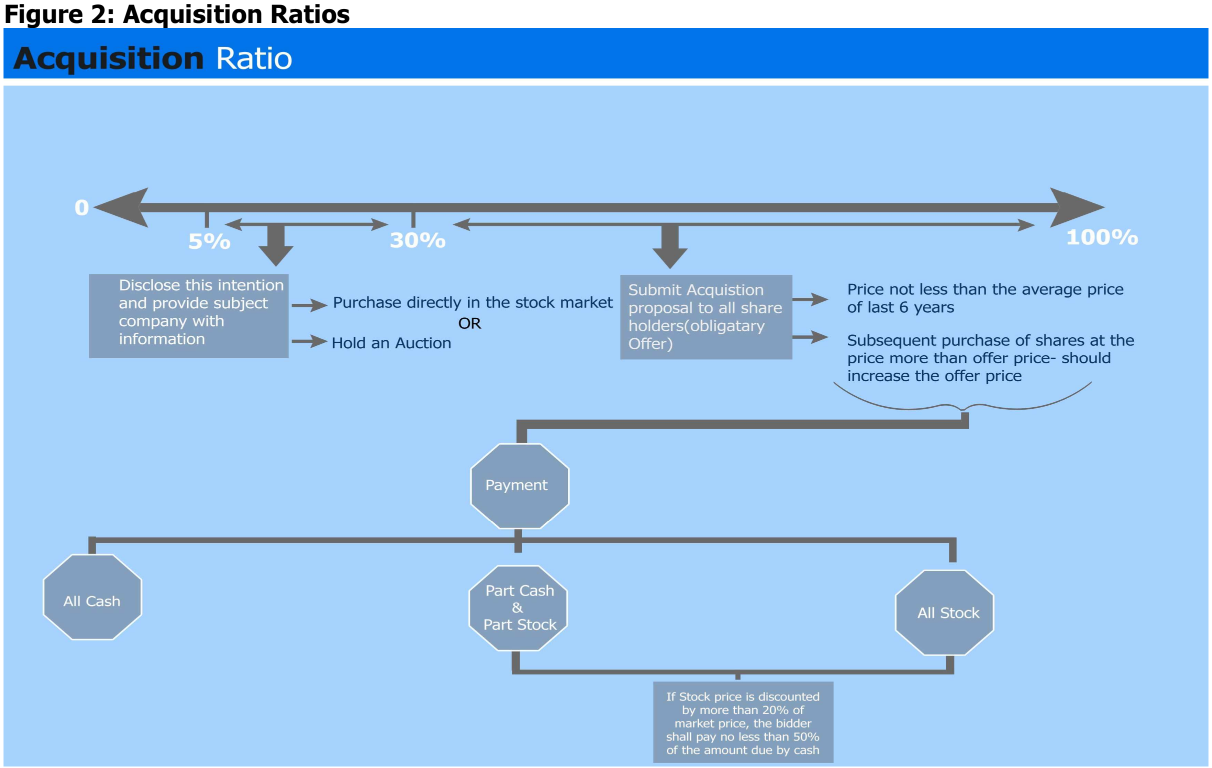
Article (271)

Any person, or group of their subsidiaries or allied parties, must lodge a takeover bid within thirty days of directly or indirectly coming into possession of more than 30% of shares granting voting rights in a company listed on the exchange for all remaining shares of the same class, in accordance with the conditions specified in these Regulations and the directives issued by the Authority. Excluded from this provision shall be any acquisition which the Authority decides to exempt out of consideration for the public interest and the interests of the remaining shareholders, in which regard it shall issue a written and justified exemption decision.

Article (274)

Bids lodged as mandatory offers must be cash bids covering at least the weighted average daily price of the target company's shares on the exchange during the six months prior to the start of the bid period. This price shall be calculated by the exchange.

Figure 2: Acquisition Ratios



The 30% takeover trigger is unclear. While insuring small investors' rights, the implication of such regulation bring to mind several questions:

- If the target company undertakes a right issue to which Company X subscribed while others do not, thereby increasing Company X's holding to more than 30%, will the takeover trigger be hit?
- If the target company increases its treasury shares thus pushing Company X above the 30%, will Company X still have to issue an offer for all stock?

- Are there squeeze out rights in case a group owns more than 90% and some small investors are holding out. In Germany, a pool of shareholders owning at least 95% of a company's shares has the right to "squeeze out" the remaining minority of shareholders by paying them an adequate compensation. This procedure is based on the German Securities Acquisition and Takeover Act. The compensation value is determined by the company's economic situation at the date of the general meeting, the minimum compensation being the share's average stock exchange price during the past three months. In United Kingdom, section 979 of the Companies Act 2006 gives a takeover bidder who has already acquired 90% of a company's shares the right to compulsorily buy out the remaining shareholders. Conversely section 983 (the "sell out" provision) allows minority shareholders to insist their stakes are bought out.

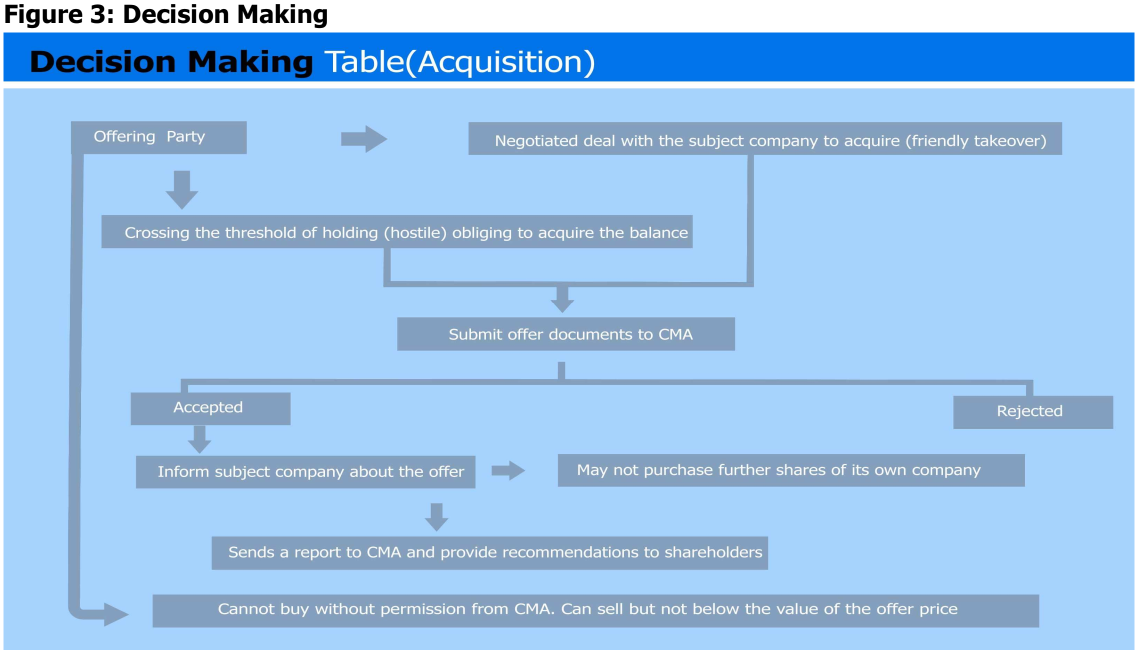
What we suggest;

18. CMA should clarify what would happen should the 30% trigger be hit by external forces, i.e. rights issue, treasury shares,

The CMA is also silent on Drag-along rights whereby minority holders are forced into a deal by the majority.

In a nutshell, the following picture represents the flow of decision making to judge the acquisition process and provides for both friendly (negotiated) takeovers as well as hostile takeovers. The restriction of further purchase or sale of shares pursuant to the announcement of intention to acquire by the offering company is very interesting and relevant.

Figure 3: Decision Making



The law goes beyond "vanilla" M&A by stipulating that the acquirer should announce the financing method of the deal which is usually arranged in the latter stages of the acquisition. Moreover, the CMA requires 10 days to review the proposal before accepting/rejecting; having a timeline is very important and progressive, however the law does not say what happens if the CMA delays through a series of queries or if the offer is withdrawn by the acquirer. Could the acquirer change his mind and resubmit the following month?

The obligation for public announcement does not envisage a scenario of a bid offer, which may give rise to share price manipulation. In this context, it is worth noting the Saudi CMA which has the following provisions:

Article: 6 b (4)-Saudi Mergers and Acquisitions Regulations

"A public announcement is required when following a bid approach; a company's shares are the subject of rumor and speculation or where there is a price movement of 20% or more above the lowest share price since the time of the approach or a price movement of 10% or more in a single day."

Also, the announcement of intention to acquire should also be backed by endorsement by competent financial advisors about the ability of the offering company to follow through and complete the acquisition. Fixing the responsibility for assessing the ability can be on the financial advisor as he is in a good position to state so.

Article 258:

The offer document should include among other things, total amount of the offer, methods of financing, any restrictions, time schedule, equity stakes of the offering person, and other documents

While Article 258 specifies time schedule as one of the items to be mentioned in the offer document, it does not provide detailed "component-wise" time schedule. Such a mention will enhance the speed with which acquisitions should be undertaken in order to lend stability to market price for both offering company and the subject company.

Article 266:

The board of directors of the subject company should, within seven working days from the receipt of the offer, raise a response to the Authority showing his opinion and recommendation to the shareholders, and publish its recommendation to the shareholders regarding the offer after the Authority's approval of the offer.

The Article 266 only states that a response should be given to the Authority showing the recommendation but does not state the basis of the recommendation. The ideal thing would be to base such a recommendation on the study by independent competent financial advisors.

Article 269:

When a person owns, alone or with his subsidiaries or affiliates, 5% or more of the shares of any listed company, and intends to increase his ownership not more than 30% of the shares of the company, he must disclose his intention upon the disclosure of the interest and provide the company with the information required in this regard

It is quite possible that the 30% threshold is reached due to a reduction in company securities due to actions like redemption, repurchase or cancellation of shares. The best practice is to provide for such a contingency where the Authority could waive any resulting obligation (subject to approval by independent shareholders).

What we suggest;

19. Issue regulations concerning minority squeeze-outs and drag-along rights especially as they relate to the "30% takeover trigger".

Disclosures & Liabilities

Article (395)

The Shareholding companies listed in the stock exchange must disclose the names of any of its shareholders who own 5% or more of the capital at any time, and all changes to this percentage.

An interested person[6] must disclose to the authority any changes in holdings in increments of 0.5%. Directors of a shareholding company have to disclose their holdings in the company for each transaction (Buy, Sell or exercise options on the stock) and the CMA must share the information with the public.

Additional disclosures will be required of the organization and its employees, the most notable of which are:

- In addition to the Board of Directors, all members of Executive Management will be required to have various compensation and salary information available for the General Assembly with all stakeholders having a right to review the same.
- Must disclose name of any and all shareholder's in the company whose ownership exceeds 5% and all changes to this percentage (in 0.5% increment).
- Company must issue monthly reports to clients on their positions.
- The Board of Directors of an institution is liable for any incorrect information contained within a subscription prospectus (Article 372).

What we suggest;

20. Shareholders having portfolio accounts across firms may need to aggregate their holdings and disclose it to the regulator or Investors need to have unique investment numbers/identifiers identifying them as the beneficial owner.

[6] anyone who owns more than 5% of a listed company

Listing rules

Pre-CMA, applications to list companies on the Kuwait Stock Exchange was reviewed and approved by the Ministry of Commerce and Industry (MOCI) in addition to the Kuwait Stock Exchange. The current CMA law discusses listing rules in Chapter 9 Articles 92-99 and is further explained by regulation 3/2011 (Appendix 1)
Relative to the total size of Kuwait Stock Exchange the number of listed companies exceed that of regional peers due to which average company size (measured in market cap terms) is relatively small (Table 3). Also, the top 20 stocks constitute nearly 50% of the total market capitalization leading to market concentration.

Table 2: GCC Markets

Country	No of Listed Companies	Mcap	Average Mcap
		USD Bn	
Saudi Arabia	146	358	2.45
Qatar	42	122	2.90
Kuwait	217	117	0.54
Abu Dhabi	63	74	1.17
Dubai	63	51	0.80
Bahrain	47	23	0.48
Muscat	121	18	0.15
GCC	**699**	**762**	**1.09**

Note: Data as of end of May 2011
Source: Gulfbase

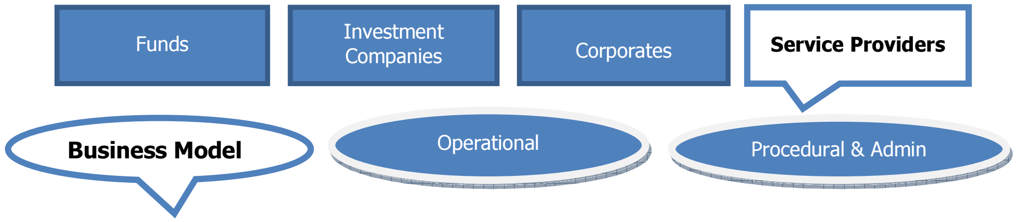
Capital Raising

Under the previous law, Capital raising was under the jurisdiction of the Ministry of Commerce and Industry (MOCI) whereas currently the responsibility of implementing that law is transferred to the Capital Markets Authority. We should note that all registration files and documents are currently under the custody of MOCI. Hence, coordination between CMA and MOCI becomes crucial till all necessary documentation is transferred to CMA.

Approvals

All listed companies will have to gain approval from the CMA on a myriad of issues; some of which are routine while others are unique requests which are normally handled internally such as Internal Auditing procedures and Investment Policies.

Routinely require regulatory scrutiny	Unusual: Part of internal processes
Organization Chart	Policies & procedures for Internal Audit
Policies and Procedures	Investment Policies
Delegation of powers for approval of expenses	Policy for handling investor complaints
Policy for related party transactions	Business Continuity policy (BCP)
Policy for protection of confidential information	
Policies & procedures for Risk Management	
Procedure for combating money laundering and terrorism financing	
Compliance manual and program	
Code of conduct	



Brokers

Currently, we have 14 registered brokers in Kuwait and the new CMA law is entitled to offer licenses to any person who fits the rules and regulation. To become authorized, a Broker would have to pay a license fee of KWD1mn and an annual service fee of KWD 100,000. It is premature to argue that the new provisions will induce a proliferation of brokers as happened in Saudi Arabia. Pursuant to the launch of Saudi CMA, the number of authorized brokers swelled from a modest 8 in 2005 to more than 100 by 2010. At the same time, value traded (which actually provides business to brokers) slumped from USD 1.1 trillion to USD 338 billion leading to diffusion of business activity.

By reducing red tapes around setting up a brokerage firm the CMA would benefit from Licensing fee and annual service fees payable to it. It is expected that the number of brokerage firms will see an increase while commission fees are capped. However, brokerage firms may resort to churning and other unethical activities to boost the bottom line. From a customer perspective competition is healthy and so we may see a differentiation in services provided whereby brokerage firms could offer training, company research and investment strategies to clients based on risk tolerance thereby increasing the sophistication of the investor base.

All in all being liberal in handing out licenses should go hand in hand with being liberal in revoking licenses when brokerage firms stray.

Currently the commission fees are 0.0125% with a cap of $180,832 (KWD 50K) after which thresh-hold commission falls to 0.001%. In a simple scenario analysis, our estimates suggest that if Saudi experience were to repeat in Kuwait, the brokerage income per broker will fall by 85%.

Table 3: Scenario analysis

Number Of Brokers	Average Value Traded (05-10) USD Bn	Commission USD Mn	Per Broker USD Mn
14.00	90.17	112.71	8.05
28.00	90.17	112.71	4.03
70.00	90.17	112.71	1.61
100.00	90.17	112.71	1.13

Source: Gulfbase, Markaz Research

What we suggest;

21. CMA should clarify Broker business practices and spell out fines and penalties for unethical activity

Appendix 1: Kuwait Capital Market Authority Executive Regulation Summary

Chapter	Name	Articles	Summary
Chapter 1	**Definitions**	**1**	Defines key words, that are used continuously in the law
Chapter 2	**Capital Market Authority**	**2-30**	Defines the structure of the Capital Markets Authority, its scope of work and sphere of influence
Chapter 3	**Stock Exchange Markets**	**30-47**	Defines the regulation of Stock Exchanges in the country, there structure and outlines the rights and obligations of an exchange market
Chapter 4	**Clearing Agency**	**48-62**	Defines Clearing Agency's roles and obligation, chapter 4 also defines the role of the CMA in organizing and regulating the entity.
Chapter 5	**Organized Securities Activities and the Licensees**	**63-67**	Defines Company structure, licensing, customer /investors rights and obligation, organizes "Islamic" companies, margin trading, company auditing and liquidation/bankruptcy process.
Chapter 6	**Review of the Licensees' Account**	**68-70**	maintain accurate accounts and disseminating them on a timely manner
Chapter 7	**"Acquisition and Preservation of minority Interests**	**71-75**	Regulate Acquisitions while safeguarding shareholder's rights and acquirer's right
Chapter 8	**Investment funds**	**76-91**	Regulation of the Investment fund industry. Defining the rights and obligations of fund managers and investors.
Chapter 9	**Prospectus of the securities issued by the company**	**92-99**	Chapter 9 defines and regulates the issuance of securities
Chapter 10	**Disclosure of interest**	**100-107**	Disclosure requirements and its legal ramifications
Chapter 11	**Penalties and Disciplinary Actions**	**108-148**	Defines the scope, role of the Capital Market Court and the judicial process
Chapter 12	**General rules**	**149-150**	Confidentiality of CMA proceeding and cooperation with foreign entities
Chapter 13	**Transitional Rule**	**151-165**	Organize the custodial transfer of supervision from the stock exchange to the Capital Market Authority.

Appendix 2: Kuwait and Saudi Equity Fund Summary

Kuwait Equity Fund Statistics					
	Mutual Funds	**Index Funds**	**Sector Funds**	**Special/Skill-baed Funds**	**Total**
No	31	4	2	3	40
AUM (Kd m)	954	101	42	48	1,145
% share	83%	9%	4%	4%	100%
Saudi Equity Fund Statistics					
	Mutual Funds	**Index Funds**	**Sector Funds**	**Special/Skill-baed Funds**	**Total**
No	47	7	7	8	69
AUM (SAR m)	16,963	82	790	268	18,103
% Share	94%	0%	4%	1%	100%
Source: Markaz Research					

Appendix 3: CMA Administrative Order No. 3 of 2012 regarding investment restrictions on Funds investing in Financial Securities

Article (1)

The fund investing in financial securities shall comply with the following rules:

(1) Not own more than 10% of the financial securities of one issuer.

(2) The investments made by the fund in financial securities issued by one issuer shall not exceed 10% of the net asset value (NAV) of the fund.

(3) Not to borrow, or enter into transactions resulting in liabilities of, more than 10% of the net asset value (NAV) of the fund.

(4) The fund may invest a maximum of 15% of its net asset value (NAV) in any Sukuk or bonds issued or guaranteed by GCC governments, and without prejudice to the fund's articles of association.

(5) Without prejudice to item (1) above, the fund may invest a maximum of 15% of its net asset value (NAV) in another fund, and without prejudice to the fund's articles of association.

(6) A fund whose objective is, as per its articles of association, to invest in the shares of companies listed on the KSE, may invest more than 10% of its net asset value (NA) in the shares of any one listed company, provided that the investment does not exceed the ratio of this listed company's market value to the total KSE market value.

(7) The fund whose objective is, as per its articles of association, to invest in shares of companies listed on the KSE that operate within a certain industry or sector, may invest more than 10% of its net asset value (NAV) in the shares of any one listed company in such sector or industry, provided that the investment does not exceed the ratio of the listed company's market value to the total market value of that industry or sector, and without prejudice to the fund's articles of association.

(8) The open-ended fund may not invest more than 10% of its net asset value (NAV) in financial securities that cannot be liquidated within 5 working days.

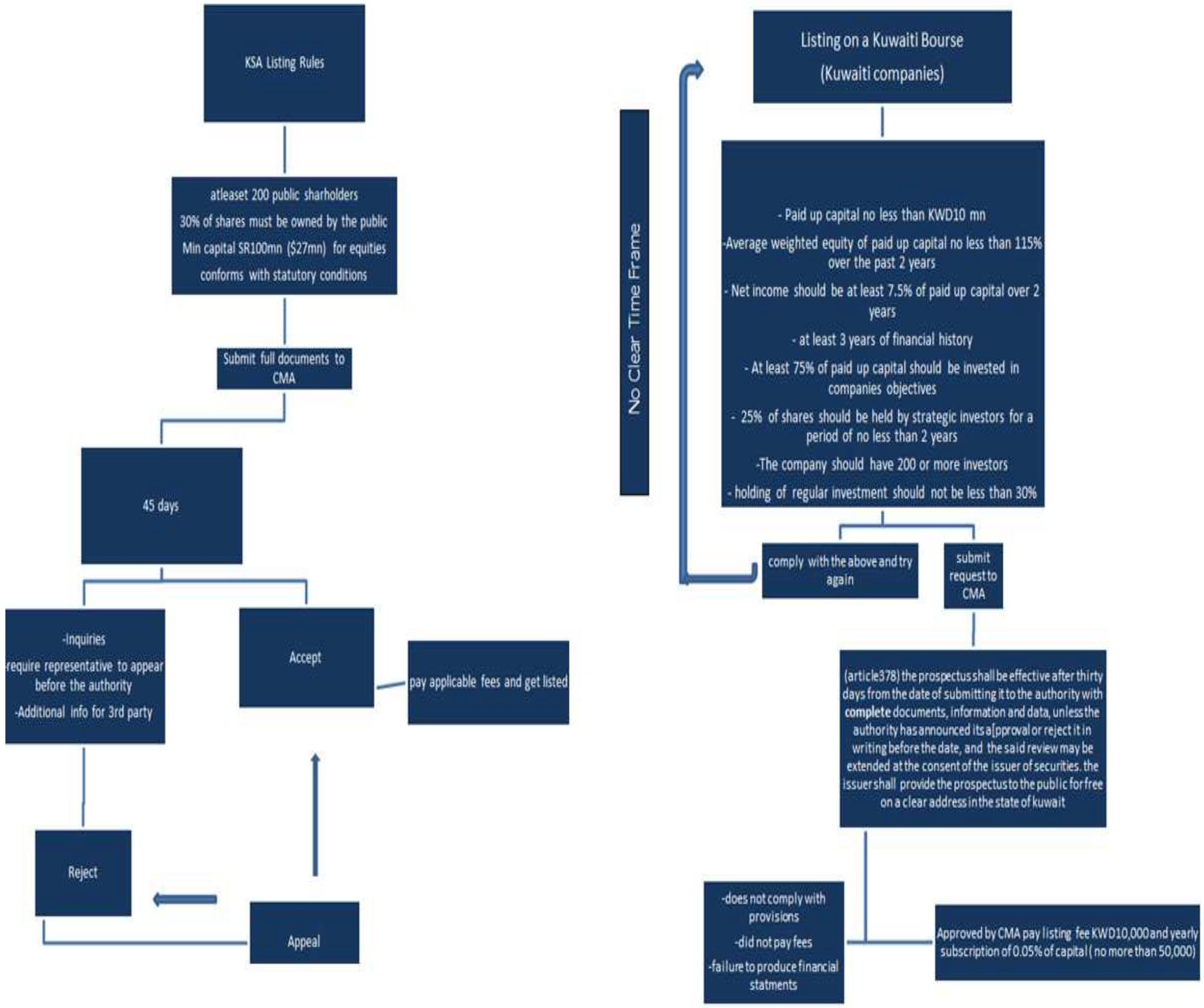
(9) The fund that follows a published index should invest its net asset value (NAV) in all companies composing such index and should follow the weights of all these companies represented therein.

(10) The fund manager, who follows a proprietary index, should have this index approved and documented by the investment advisor, provided that such approval shall be renewed quarterly; and should inform CMA of the same.

Article (2)

The concerned authorities should implement this order, each within its competence, effective from the date of issuance. All resolutions in contradiction with this order shall be cancelled.

Appendix 4: Listing Rules (Saudi versus Kuwait)



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